PASSAGES: GOVERNANCE IN CORPORATE TRANSITIONS

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Cartica Management, LLC is a concentrated, "active owner" in small and mid-cap companies in the emerging markets, actively engaging with management teams, boards, and shareholders to drive long-term, value enhancing improvements in corporate governance, environmental and social factors.

In 1976 Gail Sheehy wrote a best-selling book entitled Passages: Predictable Crises of Adult Life. No crisis ever seems predictable, but that corporations, like people, will have to transit, transform, or tweak is inevitable. And the process is now faster than ever. The average age of an S&P 500 company is now less than 20 years, down from about 60 years in the 1950s. For many companies the mantra is "change or die."

Whether a company is widely held or a family company, it will likely have to shape shift due to fast growth, a change in leadership, a change in its business model (forced or voluntary), or a crisis/turnaround. No matter the scenario, the various components that we collectively call "corporate governance" will likely raise their hands to be counted – or slouch away from their responsibilities. And simply because all companies face their own "passages", it is best that all the elements of the governing mechanism have a degree of flexibility and adaptability.

On fast growth, I think of an Asian industrial company (some details changed for anonymity) whose second-generation patriarch took it from good to great. He built out the best locations, set up the most cost-efficient plants, and created a corporate culture that solicited and valued ideas (good and bad) from every employee. Its period of great expansion was 2013-2016. The stock price tripled over those years. But there was virtually no change in governance. The average age of the Board remained high - 76 years excluding the heir and the compulsory woman. The Board members were all from the same ethnic group. The obsession with cash so common among family companies continued, with cash at close to 20% of assets. ROIC started to slip and dividends started becoming erratic. As investors, we became alarmed when the company was forced by regulation to change auditors. We thought, "Terrific. Now we can get a Big Four auditor!" But nope. The fellow who ran the one-man auditing shop they used before simply closed his shop and formed a two-man auditing shop and that was their new auditor. We had to ask: "Where is the Board? Where are the controls?". Will some dirty news come out once the third generation takes over or the regulators smell a rat? We do not know. It is possible that all the accounts are pristine, but how can we as investors without access to non-public information know?

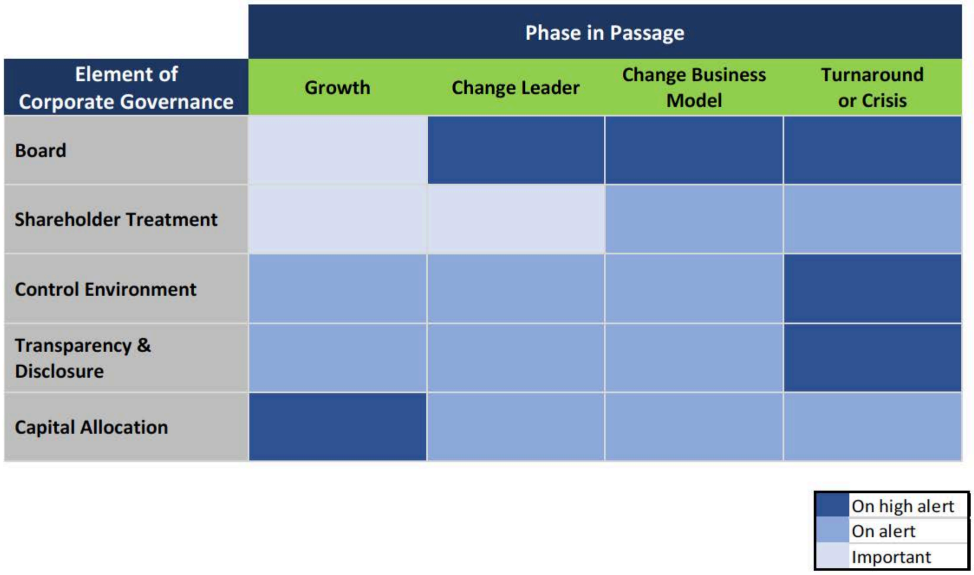
A change in leadership usually requires some shifting of boxes and maybe of mindset. We are in one family company where the executive committee consists of six members – five are family and one is a professional. The announcement that the lone professional is going to leave has been a catalyst for change. Since the professional was the only member of management who talked to the markets, who would now be the face of the company? This has caused the family to rethink all the tenets of a family business. Why do they own the company? What will happen in the next generation (that is not represented in the company)? Is the end game to have a company that endures 100 years or will they sell to a multinational once the youngest sibling reaches age 65? How do they give scope for promotion to younger professionals when all the VP spots are filled by family? And, as often in family business … what is the role of the mother? Should she remain Chair of the Board or would having a sibling take that role free up a VP slot for another professional?

Companies famously have lived or died on whether they changed business models as the world changed. Nokia started out as a shoe company before it was a telecom company. IBM was a hardware company before it was a services company. And sometimes the changes are less dramatic. Natura was a Brazilian company making natural body care products before it was a global company making natural body care products (Aesop's and The Body Shop).

One truly remarkable shift came when Siddhartha Lal was given control of his family's company, Eicher, at age thirty. His first act was to sell 11 of the 13 lines of business and focus solely on trucks and motorcycles. To get a Board of Directors to take such bold steps can be exceedingly hard. Gradual evolution is always easier than dramatic deletion or accretion. There's more visibility on an escalator than in an elevator. From a governance point of view, selling assets and focusing makes many governance elements easier: the control environment is less rangy, transparency and disclosure is less cumbersome, and capital allocation should be easier. But the Board will have to determine if this is the right step for the shareholders.

In the case of Gruma in Mexico, the change of leadership from the father to his two sons resulted in a new focus greatly welcomed by minority shareholders. The sons shifted the major metric from market share to ROIC. They ceased selling Mexican tortillas in Singapore and concentrated on Mexico and the US. The strategy was highly successful.

A crisis is famously the thing you do not want to waste. We have seen companies flounder in crisis: a packaged food company in Asia which was accused (rightly or wrongly) of contaminated



products; a big box retailer in Russia which never recovered from the blow Russia took following the 2014 Crimea invasion, sanctions, and the oil price drop; a Latin American health care company that could not survive regulatory change to insurance rules. Some did not have the financial space to change strategies, some may have taken the wrong decisions, and some may have been blindsided by policy.

We have recently had a ringside seat at a corporate turnaround of a railroad in Brazil. The prior owner had let the assets deteriorate through capex starvation and the new owner was bent on a turnaround. There was no crisis per se, but the owning group created a crisis-like atmosphere. There was a strict five-year capex and turnaround plan as the company adopted Precision Railroading and the highest global standards (which happen to be North American in freight railroading.) The success of the turnaround was reflected in the company's stock rising 1200% from its early 2016 low. This feat required a visionary Board which hired the right leader and set the goals; a steady focus on shareholder return over the long run; a tight control environment; and strict capital allocation. The other element of corporate governance, transparency and disclosure, was also at play – the public knowledge of the five-year plan and the team's performance against plan created a culture of transparency. In addition to meeting plan, the firm, led by the Board, also adopted sustainability metrics as part of both internal KPIs and external disclosure by publishing a Sustainability Report.

When we look at the five elements of corporate governance against these four "passages", we have to say they all matter, but there are times when certain elements may take on accentuated importance.

Using this simple, stylized analysis, one could say that the Board is important in all phases but tends to be more relaxed when earnings are climbing and on alert when the challenges are not just growing pains. In my experience, in the growth phase it is capital allocation that trips companies up most often.

In turnaround or crisis where fundamental change is called for, most of the five elements of corporate governance are being challenged. And, given the constant change and disruption in a world roiled by technology and global flows of information, money, and competition, I am afraid companies are going to need to sharpen all five tools in the corporate governance arsenal. Passages will be constant and tough and probably not as predictable as Gail Sheehy thought.

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