

GETTING ON BOARD



Having the right board for an IPO is an art – but it must be right for investors as well as founders. **Ann-Maree Moodie** reports.

WHEN PETER FARRELL resigned as chief executive of ResMed, the company he founded in 1989 to commercialise a device for treating obstructive sleep apnea, the news served to bring focus on the belief that those involved in the creation of an idea should also manage its development, marketing and sale.

The fact that Farrell was also the executive chairman of Resmed strengthened the argument; his subsequent appointment as non-executive director of the board sealed it.

Like many first-timers, the ResMed board is one of a long line of boards of new companies which emerge from an initial public offering (IPO) composed of similar types of members: the inventors of the idea, their friends or colleagues and the investors who are funding its development.

But this typical composition is increasingly being challenged by regulatory expectations and the demands of institutional investors.

“When a company is getting off the ground, setting up a board isn’t usually a high priority,” says Dr John Kapeleris, the deputy chief executive of the Australian Institute for Commercialisation. “There is usually only one director and that person is the chairman and the CEO or ‘executive chairman’.

“But when they are looking for an appropriate path to market as part of a long-term strategy, investors are increasingly asking about the composition of the board of a company planning an IPO. Institutional investors in particular are focused on the skills and experience of the board members.”

In 1986, only 6.9 per cent of individual Australians held shares in companies listed on the Australian Stock Exchange, (ASX). At the time there were 1200 listed firms or only one per cent of all Australian companies.

Over the ensuing 20 years, high profile privatisations including the Commonwealth Bank, Qantas, GIO and Telstra, drew attention to the private equity market. Spin-offs and demutualisations such as Woolworths, National Mutual, AMP and NRMA further increased interest. By November 2000, the proportion of adult Australians with direct shareholdings was 40 per cent.

But it has been this past decade which has seen the biggest growth in private equity investment in

Australia. In 2006, 195 floats were announced of which 133 sought investments up to \$10 million. This figure is expected to double this year with 122 floats announced by the end of June, compared with 73 for the same time last year.

The high-profile failure of RAMS Home Loans, which floated on the ASX on July 27 this year only to succumb to the global credit crisis and be offloaded in a fire sale to Westpac Banking Corporation just 10 weeks later for \$140 million, is considered an anomaly in an otherwise upward trajectory. Investors cite successful 2006 floats of drilling services firm Boart Longyear and Platinum Investment Management Limited as examples of the strength of the private equity market.

The intense activity leading up to an IPO is primarily concerned with business administrative issues of commercialisation, the process which involves converting an idea or piece of research into a marketable product, service or process that will derive successful benefits or economic outcomes. Activities include preparing financial forecasts that the market can use to value the company against its performance over a 12-18 month period. The key issues of consideration for potential investors upon which management concentrates its efforts are the historical accounts, financial forecasts and the post-IPO company structure. There is less attention given to governance.

But with the ASX Corporate Governance Council stipulating in its 2003 non-mandatory Principles of Good Corporate Governance and Best Practice Recommendations that listed-companies perform to a certain set of standards or explain why not, companies planning to go public need to take heed.

The Principles were reviewed this year and the revised version will be effective from January 2008. Among the requirements are that listed companies “structure the board to add value” and to compose a board of predominantly independent directors. Independence is defined materially. For example, an independent director “is a non-executive director, (that is, not a member of management), who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to interfere materially with – the independent exercise of their judgement.”

This is contrary to US practice where the chief executive is traditionally also the chairman (although

the merit of separating the two roles has been hotly debated since the collapse of Enron). According to US management academics Mark Kroll, Bruce Walters and Son Anh Le, newly-listed company boards are advised to challenge the premise of ‘agency theory’, which proposes a separation of the role and duty of the board and of management.

“In contrast to traditional agency theory prescriptions of board composition, we contend that boards of young firms having recently gone public are best comprised of a majority of original top management team, (TMT) members rather than independent outsiders,” say the researchers in a recent article*.

“We anticipate that such board members possess valuable tacit knowledge of the firm and its entrepreneurial vision and are in the best position to provide oversight. We additionally expect that outside board members who serve on such boards should be directors who can provide resources that might prove useful to the original TMT in executing the firm’s strategies, rather than emphasising their roles as mentors. Our results support our contentions regarding original TMT participation as well as our expectations concerning ‘advice and counsel’ business experts.”

With the ASX Principles influencing the composition of all listed company boards, the obvious issue then becomes how to source these directors when the elevation of management to fill all board positions is not regarded as best practice corporate governance. Whether an advisory board is a worthwhile initial first step is also a consideration.

Early this year, a partner of a global search firm requested I attend a meeting with one of his clients. The search firm was advising on a new CEO for the client, a company which had been privately-held by family interests and was now preparing for an IPO. The owner of the company wanted help in establishing its board and the governance structure of the new listed entity. Ask who he would want as the directors of the board, the owner said: “I’ve already asked some of my friends, guys who are financial people and lawyers who have advised me over the years.”

This comment is typical of business owners who misunderstand that the purpose of the board is to be independent of management (and owners) and must act in the best interests of the company as stipulated



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by the directors’ duties listed in the Corporations Act (Commonwealth) 2001.

Alternatively, those business owners who do appreciate the board’s role as one of stewardship are often reluctant to have their long-held authority as chief executive challenged by a group of their peers. In another case, the owner of a private business whom we advised as to the merits of an advisory board versus a formal board leaned towards a board of advisors. “After all this time, I don’t want to be told what to do,” the owner said.

Annual research by Korn/Ferry International shows that the demographic of board members has changed little during the survey period of about 10 years. Board members are still predominantly men, aged 50-60, with backgrounds in law, banking and accounting, says the Board of Directors Study in Australia and New Zealand. Women account for 8.7 per cent of board seats, according to the Federal Government’s Equal Opportunity for Women in the Workplace Agency. There has been only an incremental rise in this figure since the survey was first conducted in 2002.

Although it is wrong to correlate gender with diversity, these results indicate that boards continue to fill vacancies with like-minded people, primarily because of the perceived importance of creating “collegiality” in the boardroom.

As I concluded in my analysis of the group dynamics of Australian boardrooms, *The Twenty-First Century Board: Selection, Performance and Succession*, (AICD:2001), boards tend “to play the game of ‘who do you know?’”. One director told me: “You often hear people talking about boards being a ‘club’. But in practice, when you’re asked your opinion about filling a vacancy, your answer will be influenced by those directors whom you’ve seen performing well on other boards. That’s why you see the same names appearing.”

Any assessment of board performance must begin with an audit of the skills and experience of board members and then to compare this with the company’s position in its business cycle as well as to its strategic plan. The same approach is relevant for a company preparing for an IPO.

The company must assess whether it is appropriate for the founder and the investors to be members of the board, unless each person also brings to the table a particular required skill. For example, founders are often happier working on the new invention rather than being burdened by the daily grind of business management. But if the founder of a new piece of technology is also passionate about accounting, then that person provides two important attributes to the board’s role of oversight.

“We advocate a mix of skills including corporate governance, finance, marketing, strategic leadership, industry knowledge and technical expertise,” says Kapeleris. “But if the company wants to first establish an advisory board, it must determine the purpose of that board – is it an advisory board for technical or

commercialisation advice? In either case, we advocate an independent chairman.”

Finding the members

Sourcing such directors is tricky. While tradition supports using networks, there is a slow shift to expanding and deepening the pool of available candidates.

Hot names are always preferred, but unless the company can demonstrate it is serious about its governance structure, and that it has appropriate board protocols and processes in place (such as board and sub-committee charters and a part-time or full-time company secretary, for example), high profile directors are reluctant to join.

Board members can be found in a variety of forums including registers held by professional organisations such as the Australian Institute of Company Directors and Chartered Secretaries Australia. Executive search companies like Egon Zender, Heidrick & Struggles and Russell Reynolds also have board practices which specialise in finding candidates for board vacancies.

Networking remains the preferred method, but there are indications that the ‘game of who do you know?’ is extending beyond the traditional old-school-tie pools.

A recent survey found that although women account for only a small percentage of board seats, those women are increasingly younger – meaning aged under 50 years. A survey by Sydney-based search firm Boardroom Partners, found some women who left their executive roles to have children looked for board seats as part of a portfolio of part-time work while they devoted the majority of their time to raising a family.

This is in contradiction of former views which considered women who had not received operational experience, particularly as a chief executive, were not ready for a board seat. The survey cited former financial services executive Meredith Brooks who serves on the board of Perpetual Limited.

Finally, any company that wants to create a substantial board to help it attract investors during an IPO will also ensure that the recruitment and induction of its board will be professional. “The company needs to establish a set of rules for engagement to make sure there are formal processes,” says Kapeleris. “Even if it’s only an advisory board, building a relationship with board members makes everyone feel valued for their contribution to helping an idea come to fruition.” ★

**“The Impact of Board Composition and Top Management Team Ownership Structure on Post-IPO Performance in Young, Entrepreneurial Firms”, October 2007, The Academy of Management Journal.*

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