NORTHCAPE
CAPITAL

Australian Equities - Governance in Founder Led Businesses

At Northcape, acceptable corporate governance oversight is a non-negotiable minimum standard for companies to be considered of sufficient quality to be investible. Over the long run, this minimum standard approach has directly led to consistent returns above those of the market for decades.

Recent press articles have called into question the behaviour of prominent founders at ASX listed Mineral Resources (MIN) and WiseTech (WTC). We have no specific insights into the merits or circumstances of either set of claims. However, neither of these businesses are on our Approved List of companies from which we invest on behalf of our clients due to structural governance concerns.

We are not opposed in principle to founder led investment opportunities. "Skin in the game" can be a powerful motivator and driver of alignment, and we are typically encouraged by board members and senior executives with a meaningful financial interest in the same outcomes that our clients as shareholders do.

However, it is important to appreciate that the risk profile and culture of a business needs to evolve as it matures. Creating a business from nothing is inherently a high risk, high reward undertaking. A founder's self-confidence (and the ability to project it, even when things are behind plan), desire to disrupt, single minded focus and not taking no for an answer are all ingredients for getting off the ground. Early-stage co-investors are also often willing to accept high risk, high reward payoff structures, as the potential rate of return on winners at this phase of business development can compensate for losing bets elsewhere in the portfolio.

As a business matures beyond IPO stage, the larger base effect in the value of the business reduces the rate of return that can be expected from further growth, compared to that which existed at the start-up phase. To remain an attractive investment opportunity relative to alternatives, the risk profile inherent in the business also needs to reduce. If the founder retains the high risk, high reward mindset they held at inception, their instinctive actions, behaviours and investment plans may come into conflict with the interests of minority shareholders, who expect a more balanced consideration of downside risks as well as upside opportunity. Betting the company's future on a radical strategic pivot on the whim of a founder may make perfect sense when survival is the exception rather than the rule at start-up stage. However, independent shareholders in listed companies are entitled to expect that the Board of Directors has the capacity and authority to scrutinise these decisions independently, based on their acumen, experience and authority.

Day 1 founders forgo the steady salary most of us take for granted, in the hope that their time and effort will be rewarded in the long run by an increase in the value of the company they are creating. This can lead to a blurring of the lines between personal exertion and the financial resources of the company the founder has created. The introduction of independent minority shareholders changes this dynamic profoundly. It is the role of the Board to carefully scrutinise and transparently report any related party transactions to prevent real and perceived conflicts of interest. This needs to be a non-negotiable standard that applies to all. Allowing exceptions for founders is a slippery slope. This is not simply a question of ethics and legality – it goes directly to corporate culture, staff morale and ultimately shareholder value creation.

Corporate governance standards are routinely reported by all listed companies, mostly in generic legalese. The standards described are a necessary precondition but not in and of themselves sufficient to protect the interests of shareholders. The Board must act in a way that provides true oversight of all executives in a way that is transparent and equitable, on behalf of all shareholders. Actions and behaviours that are tolerated, especially by those at the top of the company hierarchy outside of these standards, can quickly become poisonous.

At Northcape, acceptable corporate governance oversight is a non-negotiable minimum standard for companies to be considered of sufficient quality to be investible. At times, this will result in us missing out on the rapid share price appreciation of the hot stock of the moment. However, over the long run, this minimum standard approach has directly led to consistent returns above those of the market for decades. We unapologetically expect the same standards to be applied by Boards to the companies they oversee, even when remaining founders are highly valued. Infallibility is a myth, and blind faith by Boards can't will it into existence.

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