Contactus@
ausbil.com.au

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The pitfalls and opportunities in small company governance

Research & Insights

Ausbil Investment
Management Limited
ABN 26 076 316 473
AFSL 229722
Level 27
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200

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There is a common misconception that smaller companies have higher ESG risks relative to their larger counterparts. Ausbil's active engagement shows that smaller companies have thorough ESG processes. Smaller companies do, however, face significantly different ESG issues to those of larger companies, particularly the governance of founder-led businesses. In this report we unpack the unique features of small company governance, including pitfalls and opportunities, and we explore a more nuanced approach to ESG analysis and engagement for smaller companies.

Måns Carlsson, OAM
Head of ESG

Meri Vukasin
ESG Analyst

Beyhan Irmako
Equity Analyst, Small & MicroCap

10-minute read

Key points

- Small companies look different to large companies from a governance perspective which can create risk but also opportunity.
- A 'big size' approach – such as the typical proxy adviser approach to analysing companies – doesn't necessarily fit 'small size' problems.
- A 'best fit' governance approach to smaller company ESG is more appropriate than 'best practice'.
- Taking time to actively engage small companies and understand their path to sustainability, including clarity around their actions and reporting, can yield significant rewards.

Why ESG in small companies is different

Smaller companies face significantly different ESG challenges compared with their larger peers. When discussing ESG, emphasis is often heavily placed on the environmental ('E') and social ('S') aspects of ESG. But our active engagement with smaller companies frequently centres around governance issues ('G').

Smaller companies are typically more 'capital light' and tend to have higher intangible assets. They often create competitive advantage through strategic initiatives, entrepreneurship, innovation, culture and speed to market. Small companies can also rapidly grow their 'challenger' status. Environmental and social issues are common for larger companies, but typically less common (though no less important) for small-cap investors.

Governance is the most important factor when assessing the sustainability of smaller companies. Small companies typically need to spend on expansion and growth to generate future profit. Governance must focus on how companies identify, manage, mitigate and optimise risk across the organisation. Strong governance frameworks are essential, particularly when assessing capital investments, both organic and inorganic, because these decisions generally determine the success or failure of smaller companies.

Founder-led small caps tend to have more alignment with investors

Some of the founder-led businesses we have seen recently. Because we recognise that it is the unique culture embedded in founder-led firms which drives their success, we believe a more pragmatic approach to long-term ESG engagement is more fruitful than adopting a 'big-size-fits-small' approach.

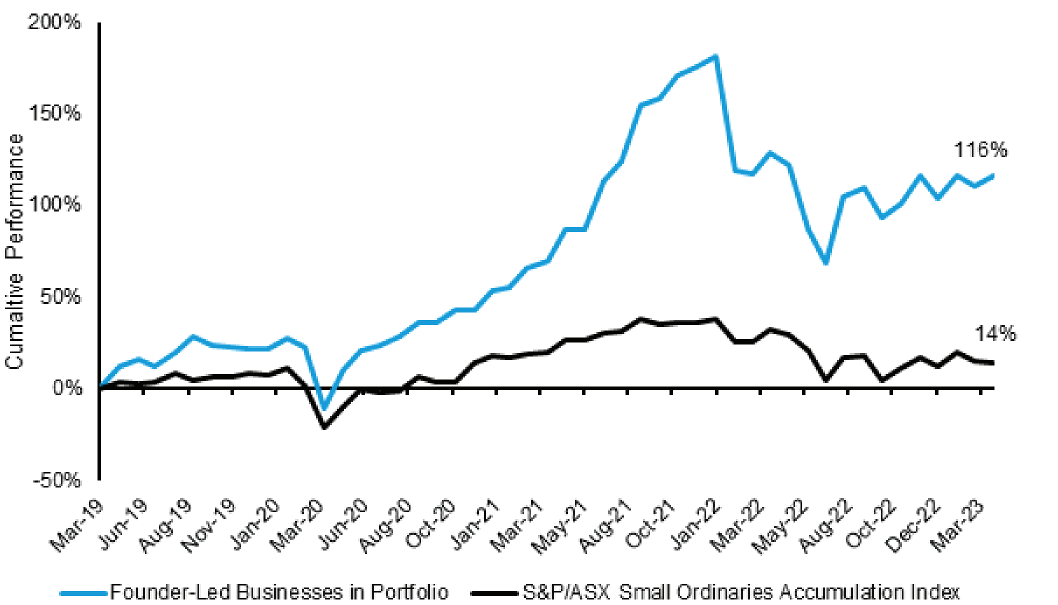
Source: Ausbil. Ausbil has been invested in each of these businesses over time, however we may or may not currently hold these names in our portfolios, depending on where they are on their journey. Any references to particular securities or sectors are for illustrative purposes only. It is not a recommendation in relation to any named securities or sectors.

The outperformance of founder-led businesses

A unique feature of the smaller end of the market is the prevalence of 'founder-led' businesses or those with a family influence. Having executives with 'skin in the game' usually means the interests of owners and managers are strongly aligned.

Academic research has shown that founder-led businesses tend to be more successful, on average, than professionally managed firms run by executives with little equity (Adams, Heitor & Daniel 2003; Fahlenbrach 2009; Lee, Kim & Bae 2016). The Ausbil Australian SmallCap Fund has a bias towards investing in founder-led firms. Founder-led firms in our portfolio have significantly outperformed the market (S&P/ASX Small Ordinaries), as illustrated in Figure 1. This outperformance is attributed to the founders' longer-term mindset and their ability to build an entrepreneurial, high-performance culture. Having 'skin in the game' creates a huge incentive to succeed.

Figure 1: The relative performance of founder-led small caps



Source: Ausbil, Bloomberg. Total returns calculated from 31/03/2019 to 31/05/2024. Ausbil Founder Led businesses calculated as equally weighted average of portfolio holdings as at 31/05/2024.

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly-owned subsidiary of New York Life Insurance Company. As at 30 June 2024, Ausbil manage over $18.6 billion in funds under management.

The unique challenge of governance in founder-led businesses

The 'principal-agent' problem is created when the interests of a company's owners are not aligned with managers (who make decisions on behalf of owners). Robust governance frameworks aim to align the interests of executives (agents) with those of shareholders (principals) to maximise the long-term sustainable value of the firm (and not maximise personal gain for management). Corporate governance principles and ASX governance practices emphasise board independence and long-term incentive structures for management as part of a robust framework.

In founder-led companies, however, the agency problem is more nuanced. Founders often act as both principal and agent. Their majority ownership aligns their decisions closely with the firm's long-term value creation and, as a result, its minority shareholders.

Nevertheless, proxy advisers are often concerned about board independence in founder-led businesses. As discussed, founders, co-founders and executives are likely to comprise the majority of the board in small companies. This can reduce board independence and critical oversight in remuneration, strategy and performance reviews, which can impact shareholders.

Why, then, are founder-led businesses more likely to outperform firms run by career managers? Founder-led businesses have inherently strong drivers of success, particularly the founder's large personal stake and emotional investment in the firm. These characteristics motivate founders, incentivises them to protect their equity capital, and reduces the need for high-risk investment decisions. By contrast, in professionally run firms, any structures designed to incentivise a long-term mindset in managers are simply attempts to recreate the drivers of success and culture of founder-led businesses.

Moving from 'best practice' to 'best fit' governance

Because we recognise that it is the unique culture embedded in founder-led firms which drives their success, we believe a more pragmatic approach to long-term engagement is more fruitful than adopting a 'big-size-fits-small' approach. This provides smaller companies with an avenue to implement rational changes throughout their lifecycle as they progress from micro cap, to small cap and, eventually, through to large cap in size and status.

Proxy advisors, however, are less likely to recognise the unique cultural factors of a smaller firm. They typically prefer rigid adherence and compliance when making voting recommendations. Yet it is more beneficial to understand the company, the people and the strategy and to engage pragmatically. Sometimes a vote against is warranted. But at other times we can work more flexibly with small companies to ensure that their goals are appropriately aligned with shareholders' interests, and that governance remains strong.

In his book What's Wrong With Boards, Former Fairfax CEO and academic, Fred Hilmer, recommends a 'best fit' rather than a one-size-fits-all 'best practice' approach to governance. Best practice, Hilmer argues, can lead to a short-sighted and rigid pursuit of compliance that lacks flexibility. We believe the 'best fit' approach helps preserve the unique, entrepreneurial culture of small-cap boards, while committing to a continual process of corporate governance improvement. We find that engagement is the best tool to achieve this balance. Engagement allows us to not only understand the company's reasoning behind certain decisions, but to provide practical recommendations for future improvements, and to set a rational and pragmatic path forward for sustainable growth.

Of course, this is not a claim against the place of proxy advisers. They play an important role in providing shareholders with critical analysis to help make decisions that could potentially impact shareholders. Rather, there are unique factors and practical constraints within the smaller market that need to be considered. As active investment managers, knowing and understanding a management team and their governance is hugely beneficial.

How we engage with smaller companies

How, then, do we engage with smaller companies given their unique governance challenges? We prefer majority independent boards. However, we recognise the practical and financial limitations that smaller companies might face in attracting and financing larger boards. We encourage companies to add a lead independent director if they are still early in their listing life and if they are hesitant to remove other founders or executives given their strategic merit. This ensures some clear separation, especially for decisions regarding remuneration, related-party transactions or executive share sales.

Related-party transactions can cloud management credibility and erode trust with minority shareholders. We do not view all such transactions as inherently harmful. Founder or family ownership of property leased by the firm, for example, can be done on a commercial, arms-length basis. Oversight by a separate independent sub-committee from the board can provide greater transparency. We engaged with one founder-led company on multiple occasions. Our main concerns were the lack of board independence and related-party transactions. After providing practical examples and feedback on how to improve, the company adopted a related party transaction policy to manage and reduce these types of transactions.

Engagement often centres around remuneration. Smaller companies have unique factors they want to reflect in their remuneration, such as sales targets. We prefer long-term incentives (LTIs) that align with minority shareholders, typically over three years, and usually composed of deferred equity. However, we understand that smaller companies may lack the resources to consult and update their remuneration quickly. It can be beneficial here to engage, understand their pathway, and offer practical changes.

The disconnect between smaller companies' ESG reporting and actions

Ausbil produces proprietary ESG research on ASX-listed companies. Our ESG research team covers all S&P/ASX 200 companies plus any ASX-listed company outside the S&P/ASX 200 held in any of our Australian equity strategies.

From an ESG perspective, small-cap companies are often overlooked due to their lack of reporting, which leads to potential large-cap bias. Many small-cap companies cannot produce sustainability reports beyond what is required. This can create a disconnect between their actual ESG efforts and what they report to the market, leading to lower ratings from rating agencies and investors.

In some instances, companies received lower ESG scores because of insufficient reporting capacity, which has prevented us from accurately assessing their efforts based simply on their reporting. However, when we engage directly with these companies they can detail more ESG initiatives and actions than they have been able to report, allowing us to score them accurately and improve our evaluation.

A good example is a small-cap retailer we recently engaged. Our preliminary score for the company was based on their public disclosure. But after meeting them, it became clear their ESG risk framework was more comprehensive than their disclosure suggested. They had a dedicated sustainability manager and were able to demonstrate that sustainability was operationally embedded in relevant teams. Most important to us was their sound approach to ethical sourcing. Rather than relying on third-party audits, they had strong relationships with their private-label suppliers and visited factories. This approach provided better oversight and more leverage. They have only had to take minor corrective actions so far in relations to their suppliers, which indicates they understand both the legal and reputational risks around ethical sourcing, and that they have a long-term view of managing these risks across the entire supply chain. If we had simply relied on their reporting, we would have missed out altogether.

Ironically, we have found that smaller companies can be better at ethical sourcing than their larger peers. In some instances, smaller companies exhibit superior ESG risk management.

Larger companies tend to have a more transactional relationship with their suppliers, whereas smaller companies often adopt a more hands-on, partner-driven approach. They frequently maintain more strategic supplier relationships, which compels them to comply with ethical sourcing standards.

This is the benefit of Ausbil's proprietary ESG research. It allows us to move beyond the large-cap bias and discover small-cap firms with robust governance structures that drive their environmental and social initiatives. The diversity within the small-cap universe offers numerous opportunities for investors to find companies with compelling ESG credentials, and companies whose ESG credentials are misunderstood or maturing. This provides a broader and potentially more impactful investment landscape than the more limited options available in the large-cap segment.

Active management is vital for ESG engagement

In our experience, founder-led businesses often receive an unfair assessment from proxy advisors on ESG and governance. Their quirks do not easily fit into the rigid models of proxy advisors. This means both the risk and opportunity for investors can be misrepresented. Yes, small companies have governance quirks, but that doesn't necessarily mean they are problematic or detract from long-term value creation.

In our view, it is more important to adopt a 'best fit' rather than 'best practice' approach to governance in the early stages of growth. There are many opportunities to invest in smaller companies that are driving change on sustainability issues, but these stocks can be overlooked due to large-cap bias.

As a final note, we believe ESG engagement is only possible through active management. ESG assessment has always been integral to Ausbil's investment philosophy and is central to evaluating sustainable businesses within the small-cap investment process. While time consuming, integrating investment fundamentals with ESG analysis can help identify and incorporate a wider range of risks to company performance, and improve the sustainability of long-term returns.

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Contact Us

Institutional

Adrian Amores
Head of Global Institutional Distribution
Phone 0435 962 052
Email adrian.amores@ausbil.com.au

Fawaz Rashid
Senior Manager, Global Institutional Distribution
Phone 0401 830 483
Email fawaz.rashid@ausbil.com.au

Wholesale

Hik Chadirchi
Head of Wholesale Distribution
Phone 0424 160 728
Email hik.chadirchi@ausbil.com.au

Andrea McGarry
Business Development Manager, QLD & NT,
Wholesale Clients
Phone 0411 465 426
Email andrea.mcgarry@ausbil.com.au

Dimitri Giannaras
Business Development Manager, NSW & ACT,
Wholesale Clients
Phone 0431 576 815
Email dimitri.giannaras@ausbil.com.au

William Orr
Business Development Manager, NSW,
Wholesale Clients
Phone 0402 620 188
Email william.orr@ausbil.com.au

Marko Matosevic
Business Development Manager, VIC, TAS & WA,
Wholesale Clients
Phone 0431 340 553
Email marko.matosevic@ausbil.com.au

Michael Peros
Business Development Manager, VIC,
Wholesale Clients
Phone 0401 430 426
Email michael.peros@ausbil.com.au

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ausbil.com.au

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