

by
Ivan de Souza
ivan.de.souza@booz.com
Paolo Pigorini
paolo.pigorini@booz.com
Arthur Ramos
arthur.amos@booz.com

booz&co.

Tailored To Fit

*How Brazilian Companies
Can Improve Their
Governance Structure*

Booz & Company is a leading global management consulting firm, helping the world's top businesses, governments, and organizations.

Our founder, Edwin Booz, defined the profession when he established the first management consulting firm in 1914.

Today, with more than 3,300 people in 57 offices around the world, we bring foresight and knowledge, deep functional expertise, and a practical approach to building capabilities and delivering real impact. We work closely with our clients to create and deliver essential advantage.

For our management magazine *strategy+business*, visit www.strategy-business.com.

Visit www.booz.com to learn more about Booz & Company.

CONTACT INFORMATION

Rio de Janeiro

Paolo Pigorini

Partner

+55-21-2237-8409

paolo.pigorini@booz.com

São Paulo

Ivan de Souza

Senior Partner

+55-11-5501-6368

ivan.de.souza@booz.com

Arthur Ramos

Partner

+55-11-5501-6229

arthur.ramos@booz.com

Ricardo Pierozzi, Jose de Luca, and Eduardo Fusaro also contributed to this article.

TAILORED TO FIT

How Brazilian Companies Can Improve Their Governance Structure

Corporate governance may not seem like a particularly trendy concept. However, as new ideas emerge and gain recognition, some companies integrate them without giving serious and strategic thought to the effects those policies will have on the organization. Sometimes, companies seem like fashionistas, adopting the latest best practices like the newest trends on the runway, without determining if they are a good fit for the organization in the long term.

An effective system of corporate governance should begin with the discussion of ideas and policies, a debate launched to craft a customized structure that suits the individual needs of each company. There is no single, universal approach to governance, but there are tools and steps to support companies responding to the question, “*What is the best governance structure for my firm?*”

Changing Circumstances in Brazil

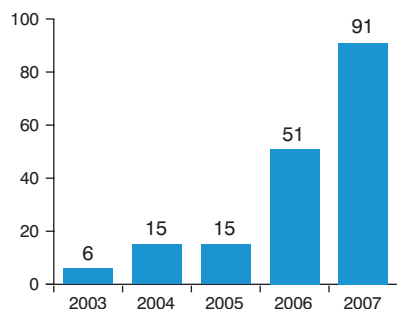
The question of the ideal governance structure is being raised more and more frequently in

Brazil. The macroeconomic stability achieved nearly 15 years after the introduction of Plano Real, along with important microeconomic reforms, such as deregulation, are unlocking the most significant capital market transformation the country has ever seen. With an end to high inflation, reduced external debt vulnerability, a consistent monetary policy, and a healthy financial system, investment and consumer demand are growing rapidly and steadily.

The usual caveats about Latin American country cycles aside, these new circumstances represent a true market-led revolution, resulting in a renaissance of equity financing by local firms. This is unleashing the full potential of capital markets, as evidenced by several factors:

- **Initial Public Offerings (IPOs):** Local companies willing to invest and increase capacity in a balanced debt-to-equity ratio are raising a record amount of capital. In 2007 alone, more than 90 new companies started trading on the Brazilian stock exchange, Bovespa, raising approximately US\$30 billion in initial offerings (see Exhibit 1).

Exhibit 1
Number of New Companies Trading
on Bovespa



Source: Bovespa

- **Foreign Direct Investment (FDI):** Investment from abroad has risen from approximately US\$15 billion in 2002–2004 to almost US\$35 billion in 2007, positively affecting all sectors.
- **Mergers and Acquisitions (M&A):** Nearly US\$60 billion worth of mergers and acquisitions have taken place in 2007, according to ANBID¹, marking a record level of such activity in the country.
- **Institutional Investors:** Local and international pension funds and private equity funds are pouring massive amounts of capital into businesses to benefit from the market's growth.
- **Internationalization:** Local companies are joining other emerging country newcomers on the international “leading players” list. Examples include Vale (mining), Embraer (regional jets), Natura (cosmetics), Gerdau (steel), and Petrobras (oil and gas).

A More Sophisticated Economy Requires Greater Governance

As such complex and widespread capital structures emerge at a rapid clip, the mechanisms that represent shareholders and debt holders must become more sophisticated to protect those interests and continue to attract more investment and growth. That is where corporate governance plays an important role.

Governance acts upon the principal-agent relationship that exists between those who invest capital and those who represent their holdings. Investors, or principals, seek adequate returns for their investments. At the same time, agents, or managers, must evolve accordingly to inspire investor confidence and navigate increasingly challenging regional, national, and global business environments to deliver on shareholders' expectations.

Corporate governance is the system that creates and regulates the relationships between management, boards of directors, shareholders, and other stakeholders with the goals of increasing firm value, improving access to capital, and assuring the enterprise's longevity. There have recently been three important improvements to the institutional aspects of governance: the December 2007 corporate law governing companies, *Lei das S.A.s* No 11.638, which improves the rights of minority shareholders; the more rigorous supervisory rules by the capital market regulator *Comissão de Valores Mobiliários*

(CVM); and the creation of differentiated governance levels on Bovespa. However, beyond these external factors, corporate governance decisions and opportunities are left to the companies themselves.

The pace of this continued evolution in Brazil's economy is still dependent on further strengthening the institutional environment and favorable worldwide market conditions. But the forces pushing Brazilian corporations to enhance governance—including increased attention from investors worldwide—will not fade away. In response to this pressure, a number of companies have come to believe that blind adoption of best practices from textbooks, governance associations, and academia will bring immediate benefits and instantly increase a company's value. While best practices are a good starting point, this approach can actually leave companies with diminished governance capabilities. Companies that decide to adopt new practices without generating a workable plan for doing so may find that the benefits of any changes are short-lived, largely because those changes are not internalized by the company.

There are a number of ways that corporate governance can be improved in the Brazilian market, largely through a tailored, individualized approach for each company. Such customized solutions lead to lasting change and the long-term sustainability of the enterprise.

¹ ANBID “Fusões e Aquisições” 25th March, 2008

What Improved Corporate Governance Can Accomplish

Corporate governance addresses the principal-agent dilemma of value expropriation by reducing agency costs, aligning incentives for performance, providing proper checks and balances to ensure compliance with laws and regulations, and monitoring risks. The goal of proper governance is to guarantee that management decisions are aligned with long-term value generation. Companies that are improving their corporate governance practices are generally pursuing one or more of three specific benefits:

- Increased access to capital markets;
- Superior long-term stock price performance; and
- Assurance of corporate resilience and succession planning.

Of course, rigorous governance is only one factor among many in determining a company's success in achieving these goals; others include strategy, leadership, vision, effective execution, and investors' perceptions. But a number of theoretical and practical studies² indicate that governance is important as well.

Increased Access to Capital Markets: In Brazil and abroad, the market rewards companies that have strong governance structures, because they average better results and have greater transparency in their relationship to capital. That may be cause or consequence; however, it translates into more capital being available to companies that are perceived as having good governance. To exemplify, just in 2007, approximately 60 percent of all IPOs were launched by companies holding differentiated governance levels by Bovespa standards (see Exhibit 2). Good governance standards assure equity

² Some examples of studies that show such evidences are:

La Porta, R.; Lopez-De-Silanes, F.; Shleifer, A.; and Vishy, R. "Investor protection and corporate valuation." *Journal of Finance*, Oxford, v.57, Nº 3, 2002.
 Gompers, P.; Ishii, J.; and Metrick, A. "Corporate governance and equity prices." *Quarterly Journal of Economics*, Boston: Harvard University Press, v. 118, p. 107-155, 2003.
 Black, B.; Jang, H.; and Kim, W. "Does Corporate Governance Affect Firm Value?" Working Paper, 327, Stanford Law School, 2003.
 Bebchuk, L. A.; Cohen, A.; and Ferrell, A. "What Matters in Corporate Governance?" Harvard Law & Economics Discussion Paper No. 491, 2004.
 Leal, R. P. C.; and Carvalho Da Silva, A. "Corporate Governance and Value in Brazil (and in Chile)." Inter-American Development Bank Working Paper, May 2005.
 Quental, G. A. J. "Investigação dos Impactos da Adesão de Empresas Brasileiras aos Segmentos Diferenciados de Governança Corporativa da Bolsa de Valores de São Paulo Dissertação (Mestrado em Administração)." Universidade Federal do Rio de Janeiro, Instituto COPPEAD de Administração, 2007.

Exhibit 2

Bovespa Corporate Governance Standards

Corporate Governance Program	Level I	Level II	Novo Mercado
Minimum tag-along	80% for ON shares; 0% for PN shares	100% for ON shares; 80% for PN shares	100% for all classes
Minimum of 25% of capital as free float	✓	✓	✓
Mechanisms for capital dispersion in public offerings	✓	✓	✓
More detailed quarterly financial reports	✓	✓	✓
Announcement of trading in company securities by controlling stockholders and main executives	✓	✓	✓
Release of shareholders' agreement, stock option plans and contracts with related parties	✓	✓	✓
Release of corporate event agenda	✓	✓	✓
Public meeting with analysts at least once a year		✓	✓
Unified term of office of two years for the entire Board of Directors (which should be formed by at least 5 members – of which 20% must be independent members)		✓	✓
Annual financial information in US GAAP or IFRS		✓	✓
Voting rights for PN shareholders in some circumstances		✓	✓
Public Offer for delisting at economic value		✓	✓
Joining Arbitration Chamber, as a vehicle to resolve conflicts		✓	✓
Existence of only voting shares (ON) in circulation			✓

Source: Bovespa

among shareholders—for example, through tag-along rules. At the same time, they ensure compliance in disclosing information and risks—for example, through international financial reporting standards (IFRS).

Superior Long-Term Stock Price Performance: There is significant evidence linking stock performance with good corporate governance practices. Looking at the differentiated governance standards defined by Bovespa, companies listed in any of the three governance levels (I, II, and Novo Mercado) experienced higher long-term price appreciation than the overall market. Shares listed under the differentiated levels, measured by the Corporate Governance Stock Index (IGC), had a 40 percent premium over the market index since June 2001 (see Exhibit 3). That represents a 6 percent annual premium in price

appreciation for the IGC. While this supports the argument that good governance is generally admired and rewarded by the market, not all firms can claim these benefits. A few recent cases of companies that collapsed shortly after going public emphasize that governance practices need to do more than polish the appearance of the company for an IPO if they are to truly increase the prospects of long-term value generation to shareholders.

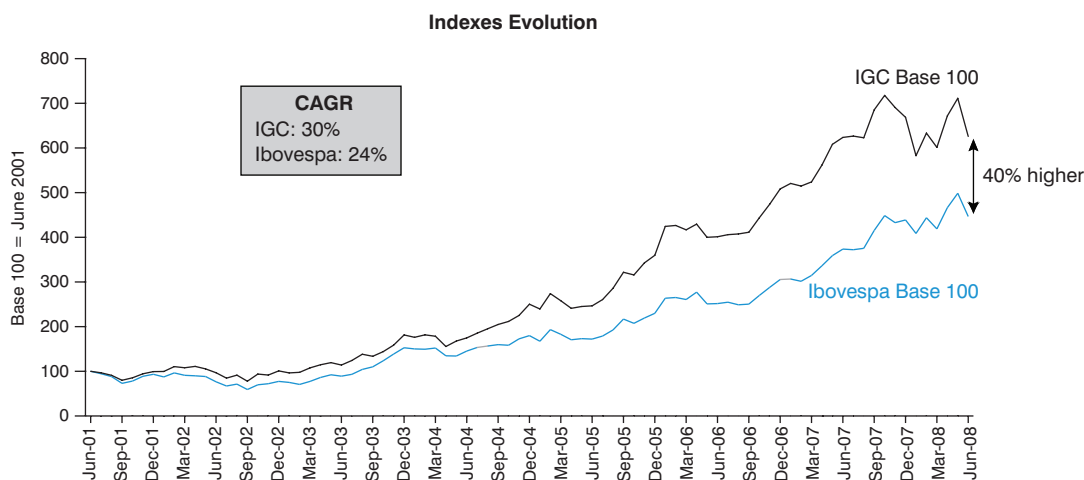
Some studies have compared the performance of stocks before and after the adoption of differentiated levels of governance. When a company migrates to Level II or Novo Mercado, there are statistically significant increases in stock prices, which is not the case with companies that adopt only Level I governance practices. That phenomenon indicates that the equity enhancement brought by

Levels II and Novo Mercado via tag-along for preferential shares is apparently yielding most of the price premium for improved governance in Brazil.

Assurance of Corporate Resilience and Succession: Possibly the most important benefits to companies that enhance their governance practices are resilience and sustainability. Adequate checks and balances, proper risk management, continuity during succession processes, and consistent focus on long-term value creation provide a more solid foundation on which a company can grow and maintain its market position over time.

However, even companies with solid foundations are subject to some volatility. In times of dramatic change, corporate governance ensures that the company is in compliance with laws and

Exhibit 3
Companies in the Corporate Governance Index Outperformed the Market from 2001–2008



Note: IGC = Corporate Governance Index - Formed by Level I, Level II and Novo Mercado shares.
Source: Bovespa, Data from July 2008; Booz & Company Analysis

government regulations while maintaining strict oversight of its responsibilities to shareholders and other stakeholders.

While such benefits may be universally sought within the business world, the path to achieving them is different for each company. Ideally, companies should prioritize these benefits for themselves, and then set goals to achieve them. For example, a company that is pursuing an IPO within the next few years will have different needs than a company that is structuring a family succession. The first will have to meet the governance demands of capital markets, such as equity treatment and compliance, while the second needs mechanisms to ensure that succession runs smoothly and that the family is properly represented and prepared to engender business continuity. The key for each situation is to examine the options from a general toolkit of governance best

practices, choosing and tailoring an actionable set of solutions.

The Building Blocks of Corporate Governance

A solid governance structure can be supported by four building blocks:

- Equity among owners;
- Compliance with regional, national, and international laws and regulations;
- Governance infrastructure; and
- Interaction dynamics.

Each of these blocks, when placed appropriately, has a different impact on the benefits the company will engender (see Exhibit 4).

Equity Among Owners: Investment bank analysts closely examine the relationship between controlling shareholders and other shareholders to ensure that the controlling group will act in accordance with

value creation principles for all shareholders. A company that does not follow this principle may find itself labeled with a corporate governance discount, decreasing the value of the company's shares. Essentially, this governance building block protects minority shareholders by establishing policies and provisions such as: clear and fair dividend distribution and investment to ensure that results apply to all shareholders; tag-along mechanisms in case of a transaction; a management team committed to maximizing the company's value; independent board members whose values align with the company's; and inclusion of special requirements in the shareholder agreement (e.g., veto rights).

In Brazil, where the existence of one or more strong controlling groups is common and sometimes represented by family control, change is usually limited depending on the

Exhibit 4
Applying Customized Corporate Governance Approach to Leverage Benefits

		Benefits Pursued		
		Increased Access to Capital Markets	Maximized Market Perception of Company Valuation	Assurance of Corporate Resilience and Succession
Corporate Governance Dimensions	"Equity" Among Owners	✓ ✓ ✓	✓ ✓ ✓	✓
	Compliance	✓ ✓ ✓	✓ ✓	✓ ✓
	Infrastructure (structure, composition, roles & responsibilities, processes & policies)	✓	✓ ✓	✓ ✓ ✓
	Interaction Dynamics	✓	✓	✓ ✓ ✓

Source: Booz & Company

group's willingness to modify controlling power. Therefore, understanding and modifying governance mechanisms requires a company-specific balance between establishing protection rules for the minority shareholders—one of the keys to generating benefits—and yielding control by majority shareholders.

Compliance: This is the most basic of the building blocks in governance structure since it is a prerequisite to accessing capital markets. Compliance includes the standards, procedures, and rules to adequately disclose essential and valuable information to the public, while controlling financial, management, regulatory, and other risks through the proper institution of checks and balances at every level of the company.

Regulations such as the Sarbanes-Oxley Act, which was largely the result of several high-profile corporate scandals and episodes of mismanagement of companies at the beginning of the decade, define control requirements for U.S.-listed companies. An analysis conducted by Booz & Company of 1,200 large global companies at that time showed that around 13 percent of all losses of shareholder value could be attributed to compliance issues, including deficiencies in both financial and non-financial risk management.

One of the tools that can help with such oversight is the audit committee. Comprised of board members and control experts, the committee's responsibilities include evaluating financial statements before disclosure to the market, conducting ombudsman activities, choosing and enacting appropriate

controls, and overseeing internal audits as well as proper financial function and adherence to the company's ethics code. Because most compliance requirements are set externally through regulation or market practices, this is one area where companies have a somewhat limited ability to customize their adoption when accessing capital markets or adopting given standards.

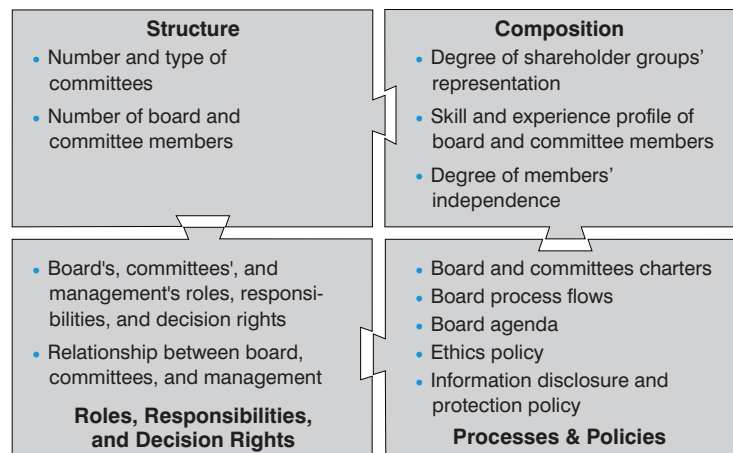
Governance Infrastructure: A smoothly functioning board of directors that has strong relationships with the company and its management is essential in a well-managed company. To most effectively ensure that the company's leadership is working together for the greater good of the institution, four main pillars of governance infrastructure must be in place (see Exhibit 5).

This is the area where companies can best create customized approaches to support the other building blocks, which may have

fewer opportunities for custom solutions. Equity involves change in controlling power and compliance is mostly based on accepted or pre-set standards. Conversely, a company's own infrastructure can be significantly tailored through the implementation of new practices such as creating committees comprised of people with a variety of experiences and viewpoints, defining roles and responsibilities of board and management, and formulating the board's agenda.

As a result, infrastructure, as defined by four key pillars, is the cornerstone to generating governance value. Beyond best practices, each company has to realize its own needs and business characteristics to define its best structure, including the number and scope of committees. Booz & Company recently worked with a large national service company that had done little in the past with using committees as part of its structure. Although the recognized best practice in the client's

Exhibit 5
Governance Infrastructure Pillars



Source: Booz & Company

industry was the formation of six committees, Booz & Company recommended that the client start out with three to give the company a focused start on its areas of most critical need: finance, human resources, and risk management. This tailored approach allowed the company to focus resources on its “burning platforms,” while becoming more versed in the proper steps in creating and managing committees.

Composition allows companies to individually address board member independence. Emerging markets in general, and Brazil specifically, are often short of skillful, experienced, and willing board members. This makes it difficult to find board

members who, in addition to having the necessary technical profile, are also fully independent as dictated by the best practices of most institutions, such as the highly regarded Brazilian Institute of Corporate Governance (IBGC)³ (see Exhibit 6).

While the pursuit of board members who have high levels of independence should be a priority, companies may, in the short term, face a scarcity of skilled candidates for their boards of directors. In such cases, a trade-off between quality and management experience, as opposed to independence, may provide the best short-term answer. This is another example of tailoring

the application of best practices, at least for a limited period of time, in order to reach the best intermediate solution.

Processes and policies involve several pieces of governance infrastructure, including board agenda and decision-making processes, board activities flow, ethics policies, and the like. Booz & Company research indicates that the board of director’s recurrent agenda, which typically includes multi-year strategic plan, financial targets, budgets, and policy decisions, is one of the most critical processes in need of tailoring. It is common to have board sessions focused on themes

³ The Brazilian Institute of Corporate Governance (IBGC) was instrumental in the introduction and dissemination of the corporate governance concepts in Brazil. Today, it is the main reference and only agency in the country that focuses on development of best practices in the field.

Exhibit 6

Good Governance Calls for Board Members to be Independent

Board Members Classification

Internal	External	Independent
<ul style="list-style-type: none"> Board members that are executives or employees of the company at the same time 	<ul style="list-style-type: none"> Board members that are neither executives or employees of the company nor independents, e.g.: <ul style="list-style-type: none"> Former executives or employees Professionals that serve the company (e.g., lawyers, consultants, etc.) Owners or employees of the company’s controlling groups 	<ul style="list-style-type: none"> Does not have any other link with the company, except eventual capital participation Is not the controlling shareholder, a member of the controlling group, or spouse or second-degree relative to any of those Hasn’t been an executive or employee of the company or any of its subsidiaries Does not currently supply or buy, directly or indirectly, services or products from the company Is not a spouse or second-degree relative of any executive or employee of the company Does not receive any other compensation from the company beyond the stipend as a board member

Lower

Independence Level

Higher

Potential conflicts of interests and lower market trust

Greater transparency and higher market trust

Source: IBGC; Booz & Company Analysis

such as performance review and reporting compliance, devoting little time to other fundamental discussions like succession and talent management, risk management, and strategy. This is not an optimal use of board members' time and contributions and represents lost opportunities to define discussion schedules that address the company's most critical challenges. The more complex, dynamic, and demanding the industry or the company's situation, the greater the need for board member dedication and efficient allocation of each board member's time, which is often the main constraint faced by boards.

When large companies are family-controlled, as so many are in Brazil, tailoring becomes more important. While ownership has a significant stake in the hands of minority shareholders, family groups of multiple generations may have controlling power. It is important for both the family and the minority shareholders that transparent mechanisms exist to properly represent family decisions in the company.

Interaction Dynamics: The structure, composition, and processes and policies building blocks each relate to hard, or material, elements of the governance structure: They ensure that the organization is compliant with applicable laws and regulations and management infrastructure is efficiently designed. Interaction dynamics, by contrast, include the soft skills and interpersonal elements that bond the pieces together into a coherent system. From how meetings are

conducted to how directors' skills and personalities complement one another to how various board and management team members communicate, interaction dynamics ensure that communication and interpersonal relationships do not impede the overall health and effectiveness of the board.

Interaction dynamics are another area where companies can customize their approach. In examining how meetings are conducted, the company needs to determine its own essential topics, find balance between analysis and decision-making, and calculate how much information-sharing versus counseling needs to occur. This building block also relates to the actual assembly of the board and what skill sets the company should seek in its board members, even as they develop them to engage in an appropriate level of questioning and contribution. The company should address the frequency and content of interactions, the level of access to and disclosure among various parties, and the board's evaluation tools, which ensure effectiveness and continuous improvement. These tools, together with the actual personalities and styles that form the board of directors, should combine to create a productive and collaborative environment.

Each building block plays such an essential role in the overall governance package that the sum is greater than the pieces. Balancing the equity structure through well-documented and executed processes and a highly independent board of directors can provide a stronger overall governance. Tailoring the building blocks to the company's

specific context is critical to ensure that the governance structure planned for implementation will succeed in both shareholder approval and in actual practice. In the Brazilian environment, this is particularly important because the legacy of previous governance structures, such as special voting powers and internal agreements, can impose immediate limits on the adoption of governance best practices. These boundaries can usually be overcome by meeting specific needs and implementing changes gradually. Every firm should work toward adopting the best practices that apply to its individual situation. However, the path and the timeframe to achieve an ideal and individualized system of governance usually involve a gradual evolution from the current infrastructure to one that meets long-term goals.

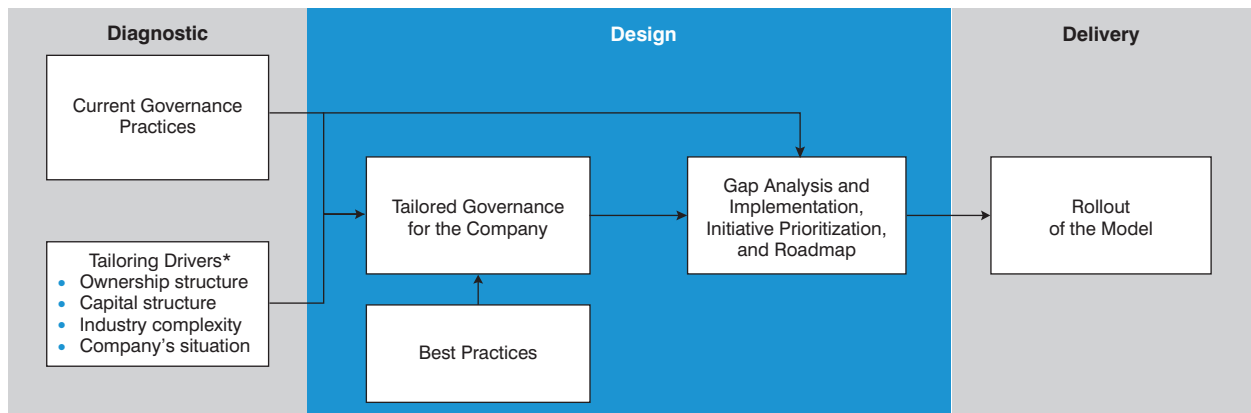
An Effective Approach to Tailoring Governance Structure

Building a tailored governance structure starts with a diagnostic phase in which companies perform an in-depth analysis of current governance practices, which enhances understanding and identifies the tailoring requirements (see Exhibit 7).

Tailoring guidelines involves understanding several specific aspects of the company's legacy and culture and their relationship to governance, including:

- Ownership and control structure;
- Capital structure;
- Complexity of the industry in

Exhibit 7
The Booz & Company Approach to Governance Structure



*Not exhaustive

Source: Booz & Company

which the company operates; and

- Values and culture.

The governance model is designed as a tailored solution that uses best practices as a starting point, but moves beyond them by incorporating decisions and mechanisms that address specific aspects of the company’s environment and situation that were identified on the diagnostic phase. The elements of the new governance model should be debated in one or more workshop sessions with the board before proceeding to detailing and implementation planning. As the new governance model rolls out in the implementation phase, increased benefits are attained.

This method is more effective in improving governance than following standard recipes. The tailored approach provides important benefits, including:

- A feasible solution: The best solution is the one that can actually

be implemented given the culture, history, and resources of the firm.

- No disruption: A gradual evolution to long-term governance guarantees a smooth transition, which is crucial to maintaining business operations.
- Faster implementation: The evaluation of alternatives and trade-offs allows companies to prioritize resources and achieve the most important benefits first.
- Alignment of concepts: The guided debate involving the board of directors provides not only the best solution, but frequently is key in creating a common vision among directors.
- Positive perception: The market recognizes that a structured and realistic approach evolving in the mid- to long-term is better than standard solutions that are not feasible in the short-term.

In summary, the market-led revolution that is taking place

in Brazil provides the right environment for companies to improve their governance and enjoy the benefits of doing so. As markets become even more sophisticated, demands for improved governance will also become more refined. New IPOs will build upon previous successes, while taking lessons from past failures, to distill the solutions that provide tangible results. With this changing landscape, the question “What is the best governance structure for my firm?” becomes even more relevant and challenging to answer. The tailoring method has effectively supported a number of companies in achieving the right governance structure by positioning them to achieve improved access to capital markets, increase company valuation, and build corporate resilience by giving them the latitude they need to adapt the best governance practices for their particular situations.

BOOZ & COMPANY WORLDWIDE OFFICES

Asia

Beijing
Hong Kong
Mumbai
Seoul
Shanghai
Taipei
Tokyo

Australia, New Zealand, and Southeast Asia

Adelaide
Auckland
Bangkok
Brisbane
Canberra
Jakarta
Kuala Lumpur
Melbourne
Sydney

Europe

Amsterdam
Berlin
Copenhagen
Dublin
Düsseldorf
Frankfurt
Helsinki
London
Madrid
Milan
Moscow
Munich
Oslo
Paris
Rome
Stockholm
Stuttgart
Vienna
Warsaw
Zurich

Middle East

Abu Dhabi
Beirut
Cairo
Dubai
Riyadh

North America

Atlanta
Chicago
Cleveland
Dallas
Detroit
Florham Park
Houston
Los Angeles
McLean
Mexico City
New York City
Parsippany
San Francisco

South America

Buenos Aires
Rio de Janeiro
Santiago
São Paulo