OUR THOUGHTS ON

SHAREHOLDER VALUE CREATION AND CORPORATE GOVERNANCE

THE DUNROSS WAY
This is Dunross

Dunross is an independent, global investment company focused on Breakout Nations. At present, Dunross has offices in Sweden, Cyprus, Singapore and Luxembourg. Dunross is a dedicated long-term value investor.
Dunross is a long-term value investor in the global equity markets. For us it is extremely important that the companies we invest in are committed to transparency and proper information disclosures, that we get reasonable access to the company’s management, and that the company treats all shareholders - big and small - equally. It is of equal importance that the company maintains high standards of corporate governance, because good corporate governance ultimately leads to shareholder value creation by lowering the cost of equity and the cost of debt.

There are many ways to unlock the true value of a company, and one often overlooked factor is good corporate governance. By applying some very simple measures, it’s possible to significantly improve the market’s confidence in the company and reduce the perceived risks. This in turn will reduce the company’s cost of equity and debt, and thereby increase its value. This is our guide to corporate governance and shareholder value creation – the Dunross way.
**Capital structure**

One of the most fundamental corporate governance measures a company should implement, is to decide upon an appropriate capital structure to set the framework for the company’s total cost of capital, and seek to minimize both cost of equity and cost of debt.

We don’t encourage companies to over-leverage, but rather to take on an optimal amount of debt depending on the business, thereby optimizing the cost of capital. For example, capital-intensive businesses with high earnings visibility such as infrastructure or real estate should have a higher amount of debt, whereas highly cyclical companies or those with very lumpy revenue streams should carry less debt. Examples of other factors that affect the suitable debt level are the interest rate level, the quality of the company’s franchise, potentially hidden or overstated values in the balance sheet, as well as political and regulatory risks. The figure below visualizes how a company can minimize the cost of capital (WACC – Weighted average cost of capital) by increasing leverage, where the optimal gearing level in the below example is 40%. Note also the acceleration effect of the cost of capital at gearing levels higher than the optimum:

From experience, we also know that it’s very important that companies set targets for their capital structure (e.g. debt to equity, net debt to EBITDA, and/or interest coverage ratio) because this framework will affect all the decisions by the company and in the end how the shareholders’ invested capital is allocated, for example either retaining capital or distributing it through dividends and share buy-backs.

**Dividend policy**

A well-defined dividend policy is one of the most important ways in which a company can communicate financial strength and its commitment to shareholder value creation. A transparent dividend policy sends a strong signal to the market that minority shareholders will be treated equal to its main shareholders.
The dividend policy should ideally be based on a percentage range of annual earnings rather than a fixed amount or fixed percentage, making shareholders feel that they are part of the company’s successes or failures and not like a bond holder. Allowing shareholders to feel a stronger connection with the company and its profits also rewards the company with more engaged shareholders that will work as marketers for the company. This will further enhance the liquidity of the stock, which also lowers the perceived risks.

Moreover, it is also important to declare the dividend payments together with the record and ex-dividend dates in a timely manner, to allow all investors to settle any transactions in connection with such payments and eliminate any ambiguity that otherwise may arise. Share buy-backs should also be a part of a company’s dividend policy, and deserves its own headline, please see below.

\textit{Share buy-backs}

Share buy-backs should be part of the dividend policy and are normally a more cost-effective way to return capital to shareholders compared to cash dividends, since dividend payments almost always are subject to taxes for shareholders. Share buy-backs are of course an especially suitable and profitable alternative to dividends if the company’s share price is undervalued by the market.

If and when a company decides to buy back shares it is of utmost importance that the acquired shares are cancelled. If the company
chooses to keep the shares as treasury shares, investors will include these treasury shares in the denominator when calculating per share earnings, resulting in an unchanged EPS and no increase in long-term value. Furthermore, a buy-back program without cancellation of treasury shares will be interpreted as if the company will sell the treasury shares back into the market eventually, thereby creating an overhang that will negatively impact the valuation of the company. Or even worse, the treasury shares could be interpreted as a power tool by the management or the controlling shareholder, creating mistrust between the stock market and management/main owner.

**Major transactions**

It is paramount that all major transactions by the company – be it asset disposals, share issues, acquisitions etc. – are to be resolved at a general meeting, where all shareholders can vote (except of course when it comes to related party transactions where only unconnected shareholders should be allowed to vote). As such, the board of directors should not be given any wide-ranging mandates, such as the rights to issue shares or options or to conduct major transactions, because this can create a feeling of mistrust from investors.

**Pre-emptive rights**

When conducting a share issue it is very important that all shareholders are entitled to pre-emptive rights, i.e. the right of existing shareholders to have the first right of refusal to subscribe to any new shares issued by the company. To allow existing shareholders the possibility to take part of a share issue is not only fair, but more importantly, will lower investors’ perceived risk of being diluted by directed share issues to other parties.
Nomination of Independent directors

Nomination of independent directors of the company should be approved by the minority shareholders of the company. Alternatively, the minority shareholders should be represented in the nomination committee appointing the independent directors.

Remuneration policies

Directors and management of companies should be satisfactorily rewarded if they do a good job, but not if they don’t deliver. In order to avoid excessive pay for sub-par performance, it is important that companies keep policies for bonus payments and share option grants transparent and subject to shareholder ratification at the general meeting. By being transparent on pay and setting remuneration – whether being cash, options or shares – at a long-term performance-based and morally justifiable level, investors will feel increased confidence in the management and the company. Management and directors should also be encouraged to hold and continuously acquire shares in the company, making their long-term interests more aligned with that of the shareholders.

Related Party Transactions

To the largest extent possible, avoid transactions (and by transactions we mean all kinds: disposals, acquisitions, loans, guarantees, etc.) connected to affiliates and/or with companies related to board members or management of the company. If, however, related party transactions are being pursued, there must be a transparent framework which clearly states the process and terms of such transactions. Also, of great importance is that...
the connected shareholder should be restricted to vote on related party transactions, so that the decision on the transaction rests with the minority shareholders, and that there is an independent valuation of the transaction.

**Insider shareholding disclosures**

Even if it’s not required by stock market regulations, we advocate for companies to keep investors informed about all transactions in a company’s share conducted by the major shareholders and members of the board and management.

“Keep investors informed about all transactions in a company’s share conducted by the major shareholders and members of the board and management”

but the important thing is that investors receive transparent and frequent updates on how insiders act.

**Focus on Core Business**

A company should solely focus on its core business, since a strict focus always will be rewarded by the market and the company’s shareholders. If, however, an amendment to the business focus is justified, this should be subject to approval at a shareholders’ general meeting. Naturally, we also discourage all types of non-core investments and crossholdings that could be viewed as part of a “power strategy”.

**Avoid becoming a value trap**

No company ever sets out to become a value trap, i.e. one which over time requires more capital from shareholders than the combination of what value that is created within the company and what is distributed as dividends and buybacks, but some companies do end up as value traps anyway. Why? We believe this has to do with misaligned targets and incentives. For example, if the company has aggressive growth ambitions and management is incentivized based on growth, revenue and assets will increase but shareholders returns will suffer.

In order to avoid becoming a value trap, a company should have a strict adherence to
profitable growth, because “growth just for growth’s sake is the ideology of the cancer cell”. As such, we discourage all growth targets and endeavors to increase market share etc. if it’s not combined with sustained or increased profitability. Exactly how a company balances growth vs. profitability also becomes a valuable tool in discerning whether the company is actually run with the sole intention of creating value for all shareholders, or for some other conflicting interests, e.g. as a power base for management or as an extension of the government. We also urge companies to divest from classical value trap industries, where technological development is so fast that the depreciation of investments tends to be underestimated.

Growth that in the short run only creates needs for new equity must convincingly be demonstrated that it is a more profitable strategy in the long-run than otherwise, or else it will be regarded by the market as a value trap, resulting in a higher cost of equity.

**Disposals and Spin-offs**

As with share issues, we also believe that the company should apply the same pre-emptive rights principles on disposals and spin-offs. If a company decides to divest and IPO a part of its business, it is important that the board always considers the option to either sell the business to the parent company’s shareholders by using purchasing rights allocated on a pro rata basis, or to distribute the shares as a special dividend. In this way, the shareholders can decide for themselves if they want to be owners of the divested business or not, and it also creates the possibility for the company to use the shareholder base to get a wide distribution of the shares, thereby ensuring liquidity in the divested business’s shares. Remember that the shareholder base also is a valuable asset.

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“<span style="background-color: yellow">If a company decides to divest and IPO a part of its business, use the shareholder base</span>”
CONCLUSION
By being proactive and implement good corporate governance policies, the company will not only demonstrate to the market that it is a role model for other publicly listed companies, but also, and more importantly, it will increase shareholder value and lower its cost of equity and cost of debt.

THE DUNROSS GUIDE TO GOOD CORPORATE GOVERNANCE & VALUE CREATION
• Open, informative and constructive dialogue with all shareholders.
• Set appropriate targets for the capital structure.
• Design a well-defined dividend policy and within that.
• Introduce a policy for buy-backs with cancellation.
• Ensure that major transactions are resolved by shareholders and not by the board.
• Safeguard pre-emptive rights in share issues.
• Allow minority shareholders to nominate independent directors.
• Introduce transparent and justifiable remuneration policies.
• Minority shareholders should have deciding power on related party transactions.
• Disclose all insider shareholdings and transactions.
• Focus on the core business.
• Avoid becoming a value trap by focusing on profitability over growth.
• Use existing shareholder base for disposals and spin-offs.

…and last but not least, you’re always most welcome to use Dunross as a discussion partner on how to create shareholder value.