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. We focus on finding the best countries to invest in, where we pick companies with a strong franchise, market-leading positions and strong growth prospects. Given that our holdings are leaders in their respective industry, we of course also want them to excel when it comes to shareholder value creation and corporate governance. And this is where this brochure comes in.

There are many ways to unlock the true value of a company, and one factor often overlooked is good corporate governance. By applying some very simple measures it is possible to significantly improve the market’s confidence in the company, reduce perceived risks and make the company best in class. In turn, this will lower 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.
**Guiding principles**

For us it is extremely important that the companies we invest in are committed to proper information disclosures, that we get reasonable access to the company’s management, and that the company treats all shareholders equally. The above is especially important to bear in mind for companies where the controlling shareholder holds 50, 60 or even 70% of the shares. Minority shareholders should be regarded as an important and valuable long-term asset and not as a nuisance.

**Transparency**

Misunderstandings are the cause of many troubles, and to avoid these, we encourage companies to be transparent about everything that can be of interest to investors. Even if something is completely clear to the company internally, it might not be so for investors, so we advocate that companies always explain the background and rationale behind all decisions and suggestions to investors beforehand.

*We encourage companies to be transparent about everything.*

This is especially important regarding significant changes such as a property acquisition, nomination of new directors, or a proposed mandate to issue new shares. A transparent company will command a lower risk premium and thus have a lower cost of equity and debt, creating a competitive advantage in the long-term. There are many ways to accomplish and communicate a company’s strategy and goals, for example through quarterly reports, annual reports, press releases, the website etc., but one very effective way from our experience, is to arrange regular capital markets days, inviting among others all substantial and interested shareholders, institutions, brokerage firms and banks.

**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”.

*Capital markets days are very useful communication tools.*
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 the capital generated internally 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 shareholder returns will suffer.

In order to avoid becoming a value trap, a company should have a strict adherence to profitable growth, because “growth for growth’s sake is the ideology of the cancer cell”. As such, we discourage all growth targets and endeavours 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, “ego-enhancer” or as an extension of the government.

Growth that in the short run only creates a need for new equity must convincingly be demonstrated as 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 and debt.

Capital structure

One of the most fundamental corporate governance measures a company should implement is to decide on 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 generating recurring income, 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 optimizing leverage. 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 well-founded and sound 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 (with necessary cancellation). Naturally, these targets also need to be communicated clearly to the market so everyone knows what to expect from the company.

**Dividend and share buyback policy**

A well-defined policy of returning capital to shareholders is one of the most important ways in which a company can communicate financial strength and its commitment to shareholder value creation.

The shareholder remuneration policy is an important communication tool for the company, and should first of all state that all shareholders should be treated equal to the main shareholder. Second, annual dividends should ideally be based on a percentage range of earnings per share rather than a fixed amount, making shareholders feel that they are part of the company’s successes or failures and not like a bond holder, with a fixed coupon.

If capital is returned through dividends, it is important to declare the dividend payments together with the record and ex-dividend dates in a timely manner, to allow investors to settle any transactions in connection with such payments and eliminate any ambiguity that otherwise may arise.

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, especially for international investors. Share buy-backs are of course an extra suitable and profitable alternative to dividends if the company’s share price is undervalued by the market. In order to increase visibility even further in this regard, the company could for example have a policy saying that should its’ shares trade below a certain discount to its “intrinsic” value (defined in a transparent and credible way), then capital will be returned to shareholders through buybacks rather than dividends.

**Dividends should follow earnings, and consider buy-backs when the stock price is low.**

Cancellation of treasury shares necessary and extremely important

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 not subtract these treasury shares in the denominator when calculating earnings per share (EPS), resulting in an unchanged EPS and no increase in 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 cost of equity. 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. Should local regulations for some reason not allow cancellation of treasury shares, the company should be very transparent about how and when it will resell the shares into the market.
**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 right 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.

**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 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 wider distribution of the shares, thereby ensuring liquidity in the divested business’s shares. Remember that the shareholder base is a valuable asset.

**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.
shareholders, and that there is an independent valuation of the transaction.

**Independent directors**

When nominating independent directors, we urge companies to think long and hard about which candidates to propose, because they will be the voice of the minority shareholders on the board. As such, it is not enough for candidates to be classified as independent on paper. For this reason, the board should consider whether they can be viewed as credible and truly independent, because in our view a de facto independent board member will bring more value to the board’s work than someone who might fit the bill but in the end just thinks and votes like all the other board members. Nomination of independent directors of the company should ideally 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 should be satisfactorily rewarded if they do a good job, but not if they don’t deliver. To understand what is expected of management, their pay should be tied to the company’s financial targets (which of course also need to be clearly communicated), and 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. It is also very important that the goals set must be relatively bold and aggressive, making it clear that bonus should only be paid out if these goals are reached, thereby securing above par performance. 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 acquire shares of the company at market price, making their long-term interests more aligned with that of shareholders.

**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 major shareholders and members of the board and management. Exactly how this should be done is up to the company (if not regulated) but the important thing is that investors receive transparent and frequent updates on how insiders act.
THE DUNROSS GUIDE TO SHAREHOLDER VALUE CREATION AND CORPORATE GOVERNANCE

• Open, informative and constructive dialogue with all shareholders.

• Focus on the core business.

• Avoid becoming a value trap by focusing on profitability over growth.

• Set appropriate targets for the capital structure.

• Design a well-defined dividend policy and within that, introduce a policy for buy-backs with cancellation of treasury shares.

• Ensure that major transactions are resolved by shareholders and not by the board.

• Safeguard pre-emptive rights in share issues.

• Use existing shareholder base for disposals and spin-offs.

• Minority shareholders should have deciding power on related party transactions.

• Allow minority shareholders to nominate independent directors.

• Introduce transparent and justifiable remuneration policies.

• Disclose all insider shareholdings and transactions.

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