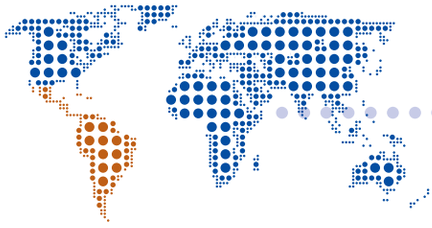

Is blood thicker than money? Family firms and improved corporate governance

By Sandra Guerra[1]

Not a great historical precedent

Family controlled companies have been regarded by international investors – both shareholders and creditors – with a certain level of mistrust. One cannot blame them for that. History is rich in stories that give enough reason for doubt and distrust when considering buying stakes or offering credit to a family-owned firm. In such companies, ownership is concentrated and transparency to outsiders is near zero.

Comprehensive evidence has pointed to extensive expropriation of minority shareholders and creditors by controlling shareholders[2]. Expropriation varies from the simple stealing of profits to the selling of assets at lower than market prices by the controlling company to another firm controlled by the same owners. At times, unqualified family members have been placed in managerial positions. There is often no indication that accountability and fairness principles are rooted in company culture. This is still the case with the majority of family companies across the world.

Blame it on globalization

Family-owned firms often resist reforms that would offer a higher level of confidence to outsiders. Arguments are founded in the belief that the family's own wealth is capable of financing business growth. So, why bother with opening up company governance to strangers in the boardroom who will just go snooping around the balance sheets? This argumentation is too simple in an increasingly complex world.

Family-owned companies face unique governance challenges. Succession planning is one of them and normally a highly sensitive issue. How objective can everyone be when family feelings come into play? It is increasingly difficult to maintain aligned interests within a growing family, especially as it is continually challenged to create wealth for future generations in an increasingly competitive marketplace.

Today, companies have to compete with newcomers or consolidate with others in order to be operationally competitive. Rapid technological development pushes the pace up. One of the major dilemmas facing family-owned firms today is how to maintain the values behind the business' beginning while at the same time opening the doors to continuous innovation? Globalization and domestic competition are constantly growing, placing continual demand on companies to be strategically positioned to speedily react to market changes.

[1] Sandra Guerra is the Coordinator of the Companies Circle of the Latin American Corporate Governance Roundtable and Managing Partner of Better Governance.

[2] La Porta, R., F. Lopez-De-Silanes, A. Shleifer e R. Vishny (2000), «Investor Protection and Corporate Governance», Journal of Financial Economics, Vol. 58, nº1.

Is blood thicker than money?

Family firms and improved corporate governance

What drives the family-owned firm?

The reasons for a family-owned firm to adopt good governance practices are multiple. The need to attract outside capital is the most obvious. But there are others. How about getting the firm the experience needed to meet the challenge of new international competitors? Yet another is the need to ensure the future of the business independent of family uncertainties and potentially divergent interests, or a lack of interest or competency among heirs for that matter. Research done in 2006[3] published by the Brazilian Institute of Corporate Governance (IBGC) took a look at 15 family-controlled companies and their good governance motivations. The results point to five main drivers:

1. The desire to institutionalize and perpetuate the business model
2. The means to implement the strategic plan defined
3. A way to add value to the shareholders
4. Enhancing the possibility of capturing creditors' resources and shareholders
5. A way to improve the company's image abroad, facilitating internationalization and reaching foreigner investors.

It is always a combination that gives many family-owned firms the incentive to professionalize management and governance. Such firms as those that make up the membership of the Companies Circle of the Latin American Corporate Governance Roundtable[4] - a benchmark group of companies in implementing good governance practices.

In Latin America, as elsewhere, family fights and uncertainties have lessened company value to the detriment of all. One of the Circle members, Ferreyros, had another experience. Ferreyros is a Peruvian company working in the import and sale/rental of machinery and equipment as well as product support. At Ferreyros, there have been significant changes in the pattern of ownership and control over time and this transformation has its roots in family factors. The first generation of founding partners passed on their ownership to a second generation, where not everyone was interested in participating in the business. The opposite is the norm. It is more common to bear witness to fights for power among members of second and third generations. The Ferreyros' heirs had other intentions for their careers and lives.

Considering this perspective, the owners decided to turn over company management to new professional managers and to create a wide and diverse base of shareholders. As a way to attract and facilitate the transfer of the company's stakes to new owners, Ferreyros registered its shares at the Lima Stock Exchange (BVL). As part of this process, the firm had to implement corporate governance improvements to attract investment and enhance the company's controls and performance.

Acknowledge investor behavior

Family-based capital isn't always enough to meet growth and other goals. Most firms need to attract financing to cover plans. At the same time, international investors are searching for investments that offer more. They are looking for balanced risk and greater assurances of business sustainability.

[3] Governança Corporativa em Empresas de Controle Familiar: Casos de Destaque no Brasil, IBGC, Ed.Saint Paul, 2006.

[4] The Companies Circle was launched by OECD (Organization of Economic Cooperation and Development) and IFC (International Finance Corporation – World Bank Group) and is also supported by GCGF (Global Corporate Governance Forum). The initiative brings together leading companies with practical experience in implementing best practices in corporate governance in the Latin American context.

Growing a family business

In my 30 years of manufacturing citrus processing equipment for export to Mexico and Morocco and many countries in between, I've seen the positive way citrus has improved lives. Some believe that Costa Rican political, social and economic stability is due to coffee. Many people grow coffee for a living and the country is dependent on it. When you have a stake in something, you've got something to lose and you think twice before acting irresponsibly.

I carry this same philosophy through to my citrus processing business TicoFrut. It is a family business that I began with my business partner in 1987. My partner has since passed on, and two of his daughters now have a very limited stake in TicoFrut. Since I hold the remaining shares, we clearly remain a family business which, I hope, my four sons will own in future. Three are engineers and all have MBAs. One worked as TicoFrut General Manager for a period of four years. Another currently works at TicoFrut and all are members of the company's Board of Directors. They have a stake in the company and are very aware of what we are doing.

I want to get more of my sons involved in company management as I feel they are sufficiently qualified. My sons' and my philosophy is simple.

We are in the process of consolidating TicoFrut. This requires the doubling of our orange processing volume from 200,000 metric tons per year to 400,000. Eventually, we want to triple the figure to 600,000. To help us accomplish this, we have taken out subordinated debt financing from FMO along with long-term debt. As a result, we have been asked to improve our corporate governance and to make TicoFrut more transparent and accountable in the eyes of external actors.

> "The job must be done by the most qualified person we can find. I realize that it is difficult for a father - or a sibling for that matter - to be objective about his son's or brother's performance… but we must try."

I am having a lot of difficulty convincing myself that another outsider should be brought onto the Board, alongside our independent lawyer. Ours is a very specialized industry. The decisions we make are mostly associated with expansions, logistics, cost-cutting, process changes, addition of by-products to our product line, etc. In my opinion, these require industry knowledge. We would have to invest in educating an outsider for a long time before we could derive any benefit.

We now better understand the importance of our accountability not only to shareholders, clients and lenders, but also to our employees. And while we are not yet masters of it, our sense of corporate governance is improving.

We have always been very conscious of the environment. It is essential to us that the sum of our impacts on the environment be positive. But FMO has opened our eyes to the social aspects. They are helping us in our efforts to design policies that we then put into practice. We are now one step ahead of our clients' requests. Firmenich and Coca-Cola simply cannot afford to antagonize public opinion by getting involved with a firm that raises eyebrows. Our firm's social and environmental policies speak to all of their points.

Citrus is now doing the same for the Costa Rican lowlands as coffee has done for the higher altitudes. My partner and I shared a vision to develop the country's citrus industry. When we started TicoFrut in 1987, there were no oranges and no processing facilities. We began both as a means to induce people to plant. We gave them a guaranteed market for their fruit. And they began to plant. In Costa Rica, one properly cultivated hectare of citrus, at 80% of today's prices, should generate USD 2,250 in annual profit. It does not take many hectares for a poor family to be able to dream and to see many of these dreams come true.

Carlos E. Odio,
President TicoFrut, Costa Rica

Carlos E. Odio

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For these reasons, investors are keen to sign up to companies that are not only well managed, but well governed. The evidence is clear. Research[5] into 4411 companies from 29 countries demonstrated that American investors invest significantly less in poorly governed companies; that is, firms whose ownership structures are more conducive to outside investor expropriation.

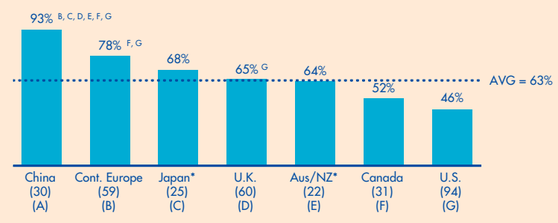
Good governance drives more efficient decision-making and upholds processes that are transparent and fair to all stakeholders. Investors then have the clarity needed to make sure that their piece of the pie isn't diminished by the controlling shareholder. As investors become global actors, so do the standards they adhere to. For example, rating agencies have standardized good governance requirements. As an institutional investor to the 2006 ISS Global Institutional Investor Study put it, "Global capital markets have become more integrated. Corporate governance becomes a common theme in the global investment community. It can serve as a screening tool to nail down the portfolio candidates. Moreover, it can also serve as a benchmark for our investment portfolio."

A majority of investors say that corporate governance is more important today than it was three years ago. The trend is continuing and even growing. The following exhibit shows the anticipated growth in importance of corporate governance in the coming three years.

Investors have got it right

Those family firms keeping good governance reforms at bay may be encouraged by the recent findings in Brazil. The bottom line is that good governance really pays. The same IBGC study reaches unquestionable conclusions on the value of good governance. The firms sampled were listed companies with a certain liquidity position who adhered to a set of corporate governance principles. The research found a relevant and meaningful positive correlation between the quality of corporate governance[6] and operational and market success. The sampled firms are on average bigger and more valuable, with higher market multiples, more operational profitability, greater liquidity, higher dividend payouts, higher short term solvency and were better leveraged than the median of all listed companies at BOVESPA (Brazilian stock exchange).

Anticipate that Corporate Governance Will Become Significantly/ Somewhat More Important in the Next Three Years, *By Country/Region*



** Small Base*
A, B, C, etc = significantly different form (A, B, C, etc.) at the 90% confidence level.
Q. Which of the following best describes how to expect your firm's views of the importance of corporate governance to change in the next three years? Do you expect CG to be significantly more, somewhat more, neither more or less, somewhat less, or significantly less important?

Another recent study[7] in Brazil of 217 medium-sized and big family companies concluded that the higher the level of corporate governance, the faster the revenue and profit growth. In the past five years, these companies showed a 66% growth in revenues while their counterparts with lower standards of governance had just a 27% growth rate. The pattern is similar in the case of profits. The well-governed companies registered highs of 42% against 18% for those less well-governed. The study considered good governance to include having: 1) a board of directors or an advisory board; 2) more than four board meetings per year; 3) a board that evaluates company performance and the CEO; 4) independent directors; and 5) financial reports audited by external auditors.

A study by Professor Panikkos Poutziouris, of the Cyprus Institute of Management, analyzed the performance of 42 companies listed on the London Stock Exchange. The performance of the Family Business[8] Index showed that the family-owned model works only if the interests of shareholders and management are aligned. In 2003, Anderson and Reeb also proved this result when investigating

CORPORATE GOVERNANCE PROGRESSION MATRIX FOR FOUNDER/FAMILY – OWNED (UNLISTED) COMPANIES

ATTRIBUTES	LEVEL 1 *Understanding the need to professionalize the Company*	LEVEL 2 *First concrete steps toward best practices*	LEVEL 3 *Implementation of best practices*	LEVEL 4 *Leadership*
A. COMMITMENT TO CORPORATE GOVERNANCE	- The basic formalities of corporate governance are in place including: - Board of Directors; - Annual Shareholders' meeting; - Shareholders and shareowners identified and recorded. - Board member or high-level company executive explicitly charged with responsibility for improving corporate governance practices.	- Written policies established addressing key elements in family firm governance: - Succession planning; - Human resources and family member employment; - Non-family member share ownership. - Management/Board approves annual calendar of corporate events.	- Corporate Governance policy covers: - Role of Board vis-à-vis management; - Long-term planning for corporate governance of company commensurate with business plan.	- Applicable corporate governance, accounting, auditing and internal controls, and shareholder information practices are equivalent to those in place at best practice public companies (i.e., little would need to be done to qualify to make a public offering). - Company fully complies or explains any deviations from all applicable provisions of voluntary code of best practices of the country (some elements of which may be applicable only to public companies).
B. STRUCTURE AND FUNCTIONING OF THE BOARD OF DIRECTORS	- Board of Directors constituted and meets periodically.	- Board Meetings held according to a regular schedule, agenda prepared in advance, minutes prepared and approved. - Non-family members (probably company executives or ex-executives) appointed to the Board and core competency (skill mix) review of Board conducted, or advisory Board of independent professionals established and consulted on a regular basis.	- Board composition (competencies/skill mix) adequate to oversight duties. - Annual evaluation conducted. - Audit Committee of non-Executive Directors established. - Directors independent of management and owners appointed to the Board (perhaps "graduated" from the advisory Board).	- Audit committee composed entirely of independent directors. - Nominating Committee established. - Compensation Committee established.
C. CONTROL ENVIRONMENT AND PROCESSESS	- Adequate internal control systems are in place and are periodically reviewed by independent external auditors.	- Internal audit and internal control systems are in accordance with highest national standards.	- Internal audit and internal control systems are consistent with highest international standards.	
D. TRANSPARENCY AND DISCLOSURE	- Adequate accounting and auditing systems in place including: - Quarterly financial reports prepared by internal accounting and approved by the Board; - Annual financial statements audited by independent external auditors and approved by Shareholders' Meeting.	- Accounting and reporting are performed in accordance with the highest national standards. - The annual audit is performed by a recognized accounting firm in accordance with the highest national standards.	- Accounting, reporting and auditing systems meet the highest international standards.	
E. SHAREHOLDERS	- All shareholders kept informed of company policy, strategy and results of operations. - Annual shareholders' meetings held.	- Shareholders provided with all material information and detailed agenda in advance of shareholders' meetings.	- Family council established (if number of family members large or substantial portion are not working in the business).	- Company in position to quickly implement all aspects of best practice code with respect to shareholders when company to go public.

[5] Leuz, Lins and Warnock (2006) Do foreigners invest less in poorly governed firms?

[6] Gerdau, Gol, Itaú, Klabin, Localiza, Marcopolo, Natura, Net, Pão de Açúcar, Randon, Sadia, Saraiva, Suzano, Ultrapar , Weg

[7] Performare Consulting, "Crescimento e Longevidade da empresa familiar", 2007

[8] A family business was defined by the study as one where at least 10 per cent of the shares of a company were owned by the founding family and also had a family member on the board.

the link between founding-family ownership and firm performance in large, publicly traded and S&P 500 listed firms in the U.S. They found that family firms perform better and are more valuable than non-family firms. The study concludes that family ownership is an effective organisational structure. Family-owned firms demonstrate the greatest potential, provided that the shareholder base is dealt with even-handedly and transparently. Good corporate governance, good business.

Blood or money?

The path to good governance is unique for each company, requiring a tailor-made approach that addresses the particular vision, purpose and associated challenges. Suzano Group, another Latin American Corporate Governance Roundtable Company Circle member, decided to operate in a model based on family control, a tight relationship with capital markets and management by non-family executives. The founders' descendents only sit on the board. They acknowledge this move as responsible not only from the perspective of better company development and expansion, but also to protect the business from possible intra-family conflicts.

Working towards a new set of standards

"Good governance has never created a great company – great leaders, great CEOs have done so."[1]

So, why all this pressure for good governance? Because evidence shows that the more accountable and transparent a company is, the better its business performance, access to lower-cost capital and overall growth. Development banks often point to the high correlation between business performance and a firm's contribution to economic development. Taken together, good corporate governance means greater impact.

This past March 8-9, 2007 in Amsterdam, the Netherlands, IFC and FMO jointly hosted a Development Finance Institution Conference on Corporate Governance. Acting as co-chairs were Edward Nassim, Regional Vice President of IFC and FMO's CEO Arthur Arnold. On the first day, over 80 representatives from over 25 development finance institutions actively took part in sessions on governing financial institutions, family-owned businesses and state-owned enterprises. On the second day, IFC shared and trained participants in the uses of tools to assess/improve the corporate governance of clients and potential clients.

> "Businesses need to take risks to thrive. Corporate governance helps them to take smarter risks. It also helps ensure that their shareholders benefit fairly from their vigorous pursuit of business opportunities."
>
> Teresa Barger, Director of Corporate Governance for the World Bank and IFC

It all culminated in the launch of an effort to collaborate on our approach to corporate governance through a DFI Approach Statement. The Statement seeks to provide a common yet practical framework for promoting good corporate governance among our investee companies. Very lively and constructive discussion took place on this first draft. There are many advantages to DFI coordination. Think of efficiency gains when co-investing on the practical side. On the policy-side, a unified approach strengthens DFI ability to catalyze commercial partners and host governments. However, it is also important to keep things simple. The conference was concluded by an ambitious undertaking: to have the Approach Statement ratified by as many DFIs possible during the Annual Meetings of the World Bank and IMF in October 2007. Is it doable? Keep an eye on progress by periodically checking www.ifc.org and/or www.fmo.nl.

[1] Dissenting voice on the *US Commission on Public Trust and Private Enterprise.*

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Other companies may address their challenges with a different set of solutions. These can include mechanisms to separate ownership functions from control and management. Additional options are the creation of "family offices" to underline the split between family and company wealth, and programs to strengthen the capacity of heirs to act as responsible owners no matter their official company position. The path to better governance is not a short hike. As a firm becomes more seasoned, it is better able to handle the challenges of the changing roles along the way. The first time a family invites strangers into the company and the boardroom is likely to be an uncomfortable one. Over time, the value will become more evident.

This sort of challenge was felt by Suzano's Max Feffer - David Feffer's father – thirty years ago. The different stages experienced through the years helped to make it possible for Suzano to react quickly and effectively following Mr. Feffer senior's death. The family had created a model to survive its own uncertainties. I advocate that the extent to which a family-owned firm adopts good governance practices is related to its maturity level. The more a company is exposed to growth, markets, stakeholders… the more it opens itself up to deeper changes that permeate the family bonds behind the company. It's not a question of blood being thicker than money. At this stage, the company's owners understand that blood and money can live and prosper in perfect harmony provided there are good governance practices. Good governance is a journey and not a destination.

Rebuilding a family-owned firm

Understanding the enhancement of corporate governance practices in the Suzano Group demands, at first, rebuilding the path since its foundation in 1924 by my grandfather, Leon Feffer. My grandfather's management ended with his death in 1999, at the age of 96 years, leaving behind the entrepreneurship as his legacy, which enabled a substantial growth of our business. Then, my father, Max Feffer, assumed the command and marked his management by preparing the Group for the strategy towards the capital market. Under his leadership, the Suzano Group defined its growth platform, divested from non-core assets and focused the investment in our main businesses that were separated into two different companies, Suzano Papel e Celulose and Suzano Petroquímica.

I took control after my father's unexpected death in 2002, with the unanimous support of the controlling shareholders – my brothers, my aunt and my mother. It became clear to us all, that our organization had to make a fundamental choice how it faced the future: either stay a family business, or become a professional company with a strong and clear capital market strategy.

In the first case, I explained, Suzano could easily meet the needs of the current generation, but beyond this, the future would become uncertain. Accessing the necessary resources to modernize and grow our two highly capital-intensive businesses would become much harder. Investing, reinvesting and competing in the marketplace could become increasingly difficult for us.

> "Professionalizing the companies and reinforcing the partnership with the capital market would allow us to leave the 21st century better than how we started it. And ensure that we had access to funding needed to successfully face future challenges."

Both options were correct. And they were in line with the values and beliefs of the founders. That is, the perspective of solid value generation and business sustainability. Like them, we were not just thinking about the present, but also the future generations. Everybody realized that taking the capital market route would mean living from results rather than simply from the business.

The transition from family-run to professional company was surprisingly smooth. It actually reinforced our way of doing business – we communicate sincerely and realistically. A new chapter in Suzano's history began, with the Feffer family being among the many shareholders. We made the painful request of being dismissed from our positions. We had to create a meritocracy in the Group. We paved the way for stronger development, reformulation of assessment parameters and above all, shareholder equity.

All these changes were very challenging. I had grown up to one day become the Group's President. Suddenly, I was forced to commit a kind of ritual suicide. I left management's front line to become Chairman of the Board of Directors of both companies. The Boards define the business politics, long-term global strategy and supervise and manage the Directors. Later, we hired in executives. With their expertise, and the support of a professional senior management, we defined and aligned strategic actions for the pulp and paper and petrochemical businesses.

In 2003, we implemented the new management model, adopting high standards of corporate governance practices, based on family control, professional management and partnership with the capital market. With independent members on both company's Board of Directors, meetings became important debating forums, on value creation within the businesses. The Boards of Directors have internal rules defining its operating procedures, and performance guidelines qualifying and assessing its members. We created the Audit, Sustainability and Strategy, and Management Committees, to support in strategic decision making. We launched our Code of Conduct based on guiding principles of integrity, equality, transparency, professional recognition, corporate governance and sustainable development.

Today, Suzano Papel e Celulose and Suzano Petroquímica are listed in Bovespa's differentiated levels of corporate governance. These ensure a fair, transparent and reliable relationship with the shareholders and the capital market, whose vital role is to permanently evaluate company and management performance. Unsatisfactory results are criticized by analysts, and investors are deterred. It's all about keeping promises. With good management, promises are delivered; the capital flows. Otherwise, the market penalizes the company.

Companies with high corporate governance standards should bear greater responsibility for results. The balance between right and wrong has a higher importance since the control systems acquire a wider perspective, with respect to detailed and clear rules. For Suzano Group, corporate governance guarantees the sustainability of what the founders created. It is the evolution of a dream. We may face difficulties along the way, which are natural. But good corporate governance practices contribute to the continuity of the Suzano companies. They make its foundations resilient to our volatile and increasingly globalized marketplace. And, thanks to these governance principles and our businesses' performance, the capital markets have learned to value and respect our controlling position.

David Feffer,
President of the Suzano Group

David Feffer