AUSTRALIAN INSTITUTE of COMPANY DIRECTORS

Challenges of IPO Boards

As Australia’s float pipeline expands in 2017, directors must understand the opportunities and risks of governance of newly listed companies.

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Broo founder Kent Grogan had a crash course in running a public company. A 2011 promotion offered Broo shares to people who bought a carton of its beer – an inspired form of “beer crowdfunding” that was ahead of its time.

About 6,500 people each received 10 shares, giving the boutique brewer a ready-made customer base. But it meant Broo, then a private company with barely any revenue, had a large shareholder base for its size and had transitioned to an unlisted public company.

“The promotion was incredibly naïve at the time,” says Grogan, executive chairman of Broo. “I just wanted people to try our beer and come on Broo’s journey. In hindsight, having to run Broo as a public company earlier than we planned was the best thing that happened to us.”

Crossing the threshold of 50 non-employee shareholders meant Broo had to change from a Proprietary Listed to Unlisted Public Company by Shares. That meant higher regulation, lodging financial reports with the Australian Securities and Investments Commission, and having a minimum of three directors and a company secretary.

“Getting all the reporting and administrative requirements in check prepared Broo to become a listed company and made the transition to IPO much easier,” says Grogan. “We ran Broo like a publicly listed company well before it listed.”

Broo raised $11 million and listed in October 2016 through an Initial Public Offering (IPO). The 20-cent issued shares have rallied to 36 cents, making Broo one of the financial year’s best-performed floats.

Few micro-cap IPOs are as prepared for their listing as Broo. Some companies are formed to raise capital through a float. Others move quickly from private ownership to a public listing when capital is available, presenting challenges for newly formed boards.

More directors this year will be invited to join the boards of early-stage companies through an IPO, pending shareholder approval. The float pipeline is filling rapidly as a rally in global equities encourages larger IPOs and as mining floats return after several years’ absence.

Investor-relations adviser and company director Rod North, MAICD, says the Australian IPO market is on track for one of its best years in a decade. “The activity in capital markets reminds me of 2005-06 when there were 270 floats. It’s going to be a very strong year for IPOs.”

North, managing director of Bourse Communications, is one of Australia’s leading investor-relations experts for IPOs, having advised on dozens of transactions over the past three decades. He has served on several boards and is currently a non-executive director of iBosses Corporation, a 2015 IPO.

Stronger IPO activity means more companies forming or expanding boards, and rising demand for directors. It also means considerable due diligence by directors before accepting these roles, such are the higher risks of joining the board of early-stage listed companies.

North says some directors, to their peril, take a “cavalier approach” to board appointments when the IPO market is hot. “They jump at the opportunity to add another directorship to their portfolio, or get their first board seat, and forget about the importance of due diligence. There’s potentially a high price to pay if the company goes insolvent and is shown to have breached its legal and fiduciary obligations.”

No place for unprepared directors

IPOs present unique opportunities and risks for prospective directors. Governing an emerging fast-growth company as it transitions to an ASX listing can be immensely rewarding, professionally and financially (for directors who receive shares or options).

The Chair of an IPO, particularly for emerging companies, has a vital role in establishing governance structures, composing the board and ensuring the organisation has appropriate processes to meet its continuous disclosure obligations.

Boards of early-stage IPOs tend to be more hands-on than those of larger organisations – an attraction for directors who like greater involvement with management. Such roles can be a stepping stone in listed-company governance or round out the portfolio of a director who serves mostly on large organisations and wants the experience of small-venture boards.

But small IPOs come with extra governance risks. The company typically has no or limited history as a listed entity and often a short financial history. Directors doing due diligence on the IPO must rely on the prospectus and the independence of advisers who help prepare information for investors.

Founders of small-cap IPOs often remain the controlling shareholder after listing, causing problems for directors if the original owners cannot adapt to the higher governance requirements of listed companies, or if they see the board as “window dressing”.

Often, the board of an IPO is governing an organisation in rapid transition. Directors must know that the management and board composition is right for the current stage of the company’s lifecycle, and that controlling shareholders will allow it to change as needed.

Understanding the CEO’s traits and reputation – a key part of due diligence for any prospective director in early-stage IPOs – is another challenge. Successful small IPOs tend to have CEOs who are risk takers and excel at company promotion. Boards must be satisfied the CEO can “sell” the venture to the market, but not so much that he or she comprises the organisation’s governance, values or reputation.

Capital is another governance consideration. Some micro-cap IPOs, such as junior explorers, live from one capital raising to the next as they develop projects. Insolvency risks for the organisation, and by default its board, are heightened because there is no cash flow or profit in the company’s formative years.

A lack of information compounds these challenges. Many IPOs are too small to be researched by stockbroking firms or the media, or attract capital from institutional investors. There can be fewer people to talk to about the company as part of the director’s due diligence.

North says prospective directors should talk to the firm’s auditor and law firm before accepting a position. “They don’t have to be top-tier firms for small-cap floats, but directors must feel confident the advisers have sufficient skill and independence.”

Separate meetings with the company’s Chief Financial Officer and Company Secretary are valuable too, says North. “The director should assess if the executive team has the right experience and is capable of standing up to the CEO or board if needed.”

Analysing the share register is another part of IPO due diligence. "Consider who the main investors are and their level of control," says North. "Has enough of the stock been made available to the public and is there sufficient share liquidity? I've seen too many IPOs over the years come unstuck because of liquidity and control issues. You don't want to be on a board of a company whose stock trades by appointment, otherwise it may as well not be listed."

Understanding what the CEO wants from the board also helps prospective directors in IPOs, says North. "Directors need to know they can add value to the board, that they are the right fit for the organisation, and that the executive team will benefit from the board's good counsel and work ethic."

The CEO perspective

John Thompson, CEO of Knosys, a 2015 IPO, says the board and management's capacity to evolve is critical. "There aren't many cases where the founder can take the start-up all the way through to becoming a large enterprise. As the business gets more complex, different skills are needed. Management must be able to grow with the company, and directors must be prepared to retire sooner than expected if different board skills are required."

Thompson joined Knosys as CEO in July 2016. Former Victorian Treasurer Alan Stockdale chairs Knosys, a leading provider of knowledge-management platforms for organisations.

Thompson has been CEO of three tech companies over a career spanning more than two decades and has led start-ups and IPOs. "In my experience, founders and early investors tend to transition out of the business within 12-24 months of its listing. Directors must prepare for significant change and focus intently on succession planning in the venture."

He says prospective directors of IPOs should start their due diligence on the financials. "You must be satisfied that proper financial reporting and processes are in place. There must a competent finance manager or Chief Financial Officer (in larger firms) and good visibility on monthly financials. You have to have confidence in the numbers."

Also, directors should assess the risk of "founder issues" before joining the IPO board. "Some founders transition well to majority owning and running a publicly listed company," says Thompson. "Others still operate as if in private-company mode. You need to know the founder is prepared to step back, if needed, for the company's next evolution, and values the benefit of board independence and director advice."

Thompson says effective directors of emerging tech companies usually have industry experience, are slightly younger and willing to be more hands-on. "You want a mix of directors who have skills that are industry relevant, technology relevant or financial-markets relevant, for example. Career directors who have more generalist skills tend to join tech boards later."

Directors, he says, must be prepared to spend more time on IPO boards than they might for the board of an established company. "Smaller ventures often have limited resources. They need directors who can roll up their sleeves and be available at short notice. The director's role can be a lot more than attending the board meeting, reading board packs or being on a sub-committee."

Thompson says directors of start-ups, particularly those that have recently listed, also need to focus on the organisation's risk-management systems. "Boards, particularly in the first year or two after listing, should ensure management is implementing strong foundations to scale the business. That ranges from contracts and policies to reporting. The challenge is to have robust systems and structures without them being too cumbersome for a start-up."

Due diligence on speculative ventures

Professor Allan Trench, of the University of Western Australia, has served on more than a dozen mining company boards since 2003, and authored 'Strictly Mining

Boardroom' – a popular governance book for mining directors. He researches the mining IPO market.

Junior exploration companies are an important source of IPOs by volume, and of board formation and director appointments. Mining floats on ASX are returning this year after a long absence as commodity prices rise and resource-sector sentiment improves.

Mining IPOs, by their nature, have different challenges for prospective directors. Those with non-mining backgrounds have to comprehend highly complex geological reports and rely on the independent geologist's report in the prospectus, to assess the quality of the company's projects.

Trench recommends prospective directors meet the independent geologist to gain more perspective on his or her view of the company's resource assets. "The standard of technical reports can vary widely in junior explorers. Directors must be satisfied the independent technical report is truly independent, and has not been fed to the geological advisers by the company and recycled back to investors through the prospectus."

Trench says understanding the IPO's arrangements with its advisers is crucial for prospective mining directors. "Often, there might be a single broking house behind the IPO that gets exclusivity in the company's capital raisings for a certain period, and monthly fees. These contracts can become a nightmare for junior explorers when they are listed."

Assessing the company secretary, a role often outsourced in junior explorers, is vital, says Trench. "The company secretary role in junior explorers can be a revolving door. You need to know there is a competent company secretary who can ensure the mining IPO meets its continuous disclosure obligations after listing, and is not too cosy with management."

Ultimately, prospective directors of mining IPOs must form a view on the CEO's personality and reputation, says Trench. "There's no hard and fast rule. You don't want the CEO to be the geological equivalent of an internal auditor. He or she needs to have a risk inclination, see the opportunity and excel in company promotion. It's all about balance."

Broo's Kent Grogan ticks those boxes. He believes Broo will one day be a leading brewer in the Asia Pacific, having secured a nationwide distribution deal in China in November 2016. "We want Broo to be a globally recognised beer brand within five years," he says.

Grogan is willing to step aside if Broo needs a CEO with large-company experience and an independent non-executive Chair. "We have to plan for that change as Broo grows, and be prepared to hand over the reins if it's in the best interests of shareholders. I see our board continuing to evolve over the next few years."

Broo wants to expand its board and is interviewing for directors. The company may add another two directors, for a six-member board. "Broo has had a board since day one, and gets great value from its directors," say Grogan. "We tweaked the board a little upon becoming a public company and are evolving it again now that we are listed."

Broo has come a long way from the company that gave shares to beer aficionados. Grogan knows that good governance is crucial for an Australian brewer that has a shot at cracking the giant Chinese market – and a shareholder base that loves a drink.

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