Governance is a Universal Issue

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- Investing based on environmental or social considerations has faced increasing controversy.
- However, incorporating governance factors appears to be a more universally accepted practice.
- Poor governance has played a role in several prominent business failures over the past six months, and if financial conditions continue to deteriorate, this trend may worsen.

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INTRODUCTION

There is a broad array of opinions on whether investment decisions (especially for retirement funds) should: a) just pursue the best returns b) use negative screens to achieve certain non-financial goals, or c) use some negative screens because they will ultimately lead to better performance. This lack of consensus is one of the reasons why there has been a meaningful amount of news regarding ESG "backlash" over the past year. For example, while some public pensions have banned investments in industries such as tobacco or fossil fuels, there have been efforts in the US to disallow state pensions from investing with firms that use negative screens on items such as fossil fuels.

We believe it is unlikely that these divergent views will align into a single approach to ESG investing, particularly when one is considering environmental and social issues. However, we do believe that achieving universal views supporting good corporate governance is more likely. Since Shenkman's founding, we have believed that having a good understanding of management and the style in which a company is managed is critical to investing, particularly in leveraged debt markets.

RECENT GOVERANCE ISSUES

Governance issues often become an increased problem when there is more financial stress in the economy, characterized by factors such as higher interest rates, lower growth, and tighter funding conditions. In the last six months, there have been some notable business failures, in which poor governance has played a significant role. While the high-profile examples we highlight below have not been issuers in the leveraged debt markets, they are important alerts to remind investors to the importance of good governance in investment selection.
FTX may be the most glaring case of poor governance recently, with management actions triggering criminal charges. While the charges are numerous, it has been reported that the indictments include senior executives taking funds from customer deposit accounts and diverting them to trading operations, giving personal loans to management, and making illegal political contributions.

Despite FTX being a private company, were there warning signs? In our view, yes. As had been widely reported, the company gave investors little to no financial information about the firm, and its founder frequently refused to answer questions about operations or profitability. Additionally, the CEO of its affiliated trading operation was quoted publicly as touting the use of amphetamines as an advantage in operating the company. Disclosure and sound judgment by management are critical features one should identify when making an investment and neither factor appeared to be present in the FTX.

In the banking sector, there have been at least two notable problems recently, the most publicized being Silicon Valley Bank and Credit Suisse. It is important to note that to our knowledge there is no criminal investigation into either company, but in our view, poor governance played a significant part in these failures.

Silicon Valley Bank's business model varied from others in its industry. The bank's clientele was highly concentrated in a single industry and the bank differed materially from its peers in some key ratios - such as a very low loan-to-deposit ratio. Significant deviations from peers should raise concerns and prompt greater scrutiny of a company's governance practices, particularly with regard to asset and liability management.

Credit Suisse required a rescue, engineered by the Swiss government. We believe the factors that drove this event were different than at Silicon Valley Bank but were partially driven by poor governance. There were a number of incidents at Credit Suisse over the years that highlighted poor risk management including the Archegos and Greensill cases. Additionally, there appeared to be continued issues with operating costs and a contentious quickly formulated global restructuring plan which included acquiring the company owned by the individual selected as the CEO of the US investment bank, with the intention of spinning it off. Wherever a firm has repeated risk management issues analysts should take a cynical view and consider if these governance gaps are endemic to the organization rather than an isolated incident.

GOVERNANCE ANALYSIS AS AN INVESTMENT TOOL

While many issues usually need to combine to create a corporate failure, poor corporate governance frequently plays a vital role. Analyzing corporate governance is critical when analyzing a credit. This analysis can be subjective but can still be undertaken with a disciplined approach. This may encompass a check list of items to regularly review such as financial and operational disclosures, managements' history of dealing with various constituent parties (e.g. equity, debt, customers, employees), a rational approach to dealing with balance sheet issues such as maturities, management truthfulness in their statements, and having truly independent directors on the board. Having a strong governance structure and culture may not be as noticeable until there is financial stress but must be analyzed and monitored in all market conditions.

Our Shenkman investment process includes a management checklist in our credit approval report, as well as several elements in our proprietary C.Scope score relating to management practices that are regularly updated. As part of our investment process, we also require that our Analysts speak to management before any investment and continue this communication as long as the company remains on our Approved List. We try to positively influence corporate governance to improve, one of the tools we have used for many years is the Shenkman "Hall of Shame" which hangs on a plaque in our offices, The plaque lists many management teams that do not follow through with their commitments or act in a way detrimental to lenders. We try to use this tool to foster engagement and influence governance to improve. When informing a company about their placement in our Hall of Shame we typically advise managements on what steps could be taken to get off the "Hall of Shame" in an effort to help improve behavior.

CONCLUSION

If economic conditions continue to be under pressure, security prices could increasingly differ between companies with strong governance versus those companies with poor governance or an inadequate governance structure.

While debates on how to approach environmental and social issues are likely to continue to swirl, good governance should become more universally accepted aspect of investing.

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