If only: Independent Directors on the Boards of Family Businesses

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Independent directors have a strong role to play on board, especially on the board of family run businesses, but they need to assert their power to protect the rights of minority shareholders, and balance the agendas of all stakeholders. Companies that have embraced the expertise and experience of outside i.e. non-promoters, directors have grown, and generated good returns.

Family-run businesses in India are the norm

The genesis of industry in India has been in families. Several of the large industrial groups in India began as family ventures. But as time progressed, the ones that professionalized their management and their board were the ones that survived.

The first generation of Mafatlal started in the late 1800s. The second generation worked through the Indian Independence and built the business. It was, at one time, one of India's leading business houses, but has been obliterated from Corporate India's landscape. This is a family that was unable to maneuver through the changes in environment and did not embrace outside influences. Shirtsleeves to shirtsleeves in three generations.

Modi, Thapars, Singhania's, Mafatlal - all household names in the 1950's and 60's have been overtaken by professionally run rivals.

Take Asian Paints as an example. This is a company started by a couple of enterprising gentlemen out of a garage. In 2013-14, Asian Paints reported revenues of Rs.128.5 bn and profit after tax of Rs. 12.2 bn. It has outperformed the major indices and its stock price as generated over 360% return to shareholders in the past 5 years. In a company this large, the promoter family does not hold an executive position – they hold board positions, but in a non-executive capacity.

Dabur, Marico, …… are all similar stories.

Smaller, unlisted companies make an effort to professionalize too. One of India's largest hospital furniture providers began its operations with four brothers. The next generation of the four brothers entered the business in the mid-2000's. The generation gap and different working styles began causing friction. Instead of breaking up the business into parts, the two generations of promoter families professionalized the management. Today, the company continues to thrive.

While this may be anecdotal, let's look at the larger picture. Around 65% of listed companies in India are family run[1] – yet, roughly 72 of these (36%) form part of the BSE 200 index today. IiAS believes that many of these family owned firms may not remain part of the major indices over the next decade or two, unless they relent the family control and run the business professionally.

Board composition – there is more than meets the eye

For listed companies, if the Chairman is a promoter or an executive director, then 50% of the board must comprise of independent directors; else the board must have at least a third of its board comprising of independent directors. In unlisted companies with a certain size[2], the board must have at least 2 independent directors. Smaller companies have been left out of the ambit of the regulation to provide them the flexibility to operate as they need to, in order to grow.

Given this requirement, investors would think that their interests are protected by the independent directors on the board. Assuming decisions are made by majority, the number of independent directors balance the board to ensure minority interests are protected. But the truth lies below the surface. Independent directors have been on the same board for several years – in some cases, for over 30 years. Clearly, if they've spent as much time on the same board, their ownership of previous decisions comprises their ability to be objective about ruthless choices that need to be made. Moreover, given the length of association, their familiarity with the promoter and the promoter family may impede their ability to speak freely during board deliberations.

The concern over a director's independence becomes far more critical in boards that resemble the family dinner table. There are eight companies[3] that have 5 or more family members on the board.

The next generation is joining the board. At one level this is important, to give them exposure to the business, but including recently graduated daughters and undergraduate housewives to the board, will not help.

Independent directors have not performed their role well

Boards are dysfunctional in several companies. There are companies where independent directors do not attend board meetings regularly - there are independent directors that have not attended a single board meeting in three years. But, it appears that a few promoters favor appointing absentee and agreeable independent directors.

Shareholders are not the only stakeholders that bear the brunt of dysfunctional boards – lenders do so too. Companies under Corporate Debt Restructuring (CDR) programs, like Gammon India and Gujarat NRE Coke, continue to ask for increases in borrowing limits despite the fact that they are defaulting on servicing the existing debt. One company is paying shareholders dividends even as they remain continually in default of debt repayment. The most public recently has been the reappointment of Dr. Vijay Mallya on several boards despite having been declared a willful defaulter by lenders.

Independent directors have been far less effective than shareholders might have wanted them to be – irrespective of the nature of ownership structure. In cases of family run businesses, the role of independent directors becomes more crucial in case the goals of the promoter don't align with those of the minority shareholder.

Shareholder empowerment to mitigate ineffective boards

In an ideal world, where the board is effective, the agendas of all stakeholders get aligned. The need for shareholder activism would be minimal. But, that is not always so. Therefore, the new regulation has significantly empowered the minority shareholder.

SEBI guidelines, Listing regulations and in a limited manner the Companies Act 2013, do not allow promoters or controlling shareholders to vote on transactions in which they have an interest: these transactions include all related party transactions (save where the transactions are with wholly-owned subsidiaries or between two government entities), mergers and acquisitions with promoter-owned or promoter-controlled entities, and delisting resolutions. The revision in regulation has been brought in to give public shareholders a stronger voice; it enhances the power of public/ minority investor. Concurrently, promoters have become vulnerable in areas where their votes had a dominant influence.

The regulations imply that power of public shareholders' vote in such transactions is now significantly higher than the actual shareholding. For example, if the 'promoters' own 75% of the shares in a listed company and the public 25%, this 25% will account for 100% of the voting power for related party transactions. This gives one share a voting power of 4x: this exponential power of a single share can be described as a 'Voting Multiplier.' This multiplier means public shareholders can now impact the outcome by vetoing transactions that they believe are unfair.

Regulators must also consider enabling cumulative voting, where investors are allowed to realign their voting rights and weigh in on a decision they consider important. If independent directors' reappointment were decisively determined by the minority shareholder vote, perhaps their focus and commitment would change.

All-in-all, family ownership structures work in India

Institutional investors in India own close to 30% of the BSE 200 scrips. Interestingly, domestic financial institutions (DIIs; including mutual funds), hold a higher share in non-family run businesses, while foreign financial institutions (FIIs) hold a higher share in family-run businesses. So while Indian investors seem more skeptical about family run businesses, FIIs seem to have had their fill of professionally managed firms elsewhere.

We both firmly believe that family run models are good, largely because there is a controlling shareholder with skin in the game. Therefore, in most instances, what is good for promoters is good for minority shareholders too. But independent directors on the board of family-run businesses need to be far more assertive and provide better quality direction to management. That is possible the only way in which the family-run businesses become institutions and survive the test of time.

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[1] We define family-run companies as those where a member of the promoter family is in the executive position. This is different from institutionally owned companies (MNCs or PSUs), where an institution controls the decision making.

[2] Paid-up share capital of greater than Rs.0.10 bn, or revenues of greater than Rs.1.0 bn, or external debt of greater than Rs.0.50 bn

[3] Of the 72 family-run business that form part of BSE200