Coping With the Challenges of Small Companies

By Jesse Rhodes

The majority of companies in the United States are small, defined as being below $500 million in market capitalization. Though these businesses are rich in ingenuity, they are under constant pressure to grow and evolve. A single decision has the potential to make or break the company—and the time and talents of management and the board are often spread greivously thin.

The National Association of Corporate Directors (NACD), in partnership with Epsen Fuller Group, Fenwick & West, and Latham & Watkins, hosted its second Small-Cap Forum at the Four Seasons Hotel in San Francisco, where a collective of experts dissected the board's role in helping build companies. Following are highlights from select sessions.

Thinking Innovatively About Strategy

It's a simple question that every small-cap board needs to ask: Do we have a strategic plan? What this means, and how a board can and should respond, however, is a complex issue. **Dr. Cheemin Bo-Linn**, director at Violin Memory and CEO and president of Peritus Partners, and **Susan A. Schreter**, director at Jones Soda, advised the more than 100 directors attending the forum to drive the conversation about strategy and risk at their companies—and to engage in the out-of-the-box thinking needed to grow the business.

"The transition from a private equity-backed company to public is quite significant not only in terms of the administrative responsibilities at the board level, but adjustments to reporting quarterly performance throughout an organization," Schreter said. She honed in on two major risk factors for newly public companies: ensuring the right CEO is in place and managing cash purposefully. "After a public offering, a company can break the budget in terms of pent-up spending and not necessarily deliver added financial or operating value," she explained. "Continued discipline toward implementing a solid three-year plan is required."

While company founders may have the vision and drive to get the company off the ground, they may not have the skills to take the company to the next levels of growth and profitability, Schreter said.

The board should be candid about these expectations and provide support for the founder/CEO, which may involve finding a successful founder/CEO from another company who can serve as a mentor. If the founder/CEO is unable to fulfull these new responsibilities, the board will need to ensure that he or she is able to take on a different role within the company. And while a delicate subject, succession planning needs to be acknowledged as the duty of every public company and therefore a continuous part of boardroom discussion.

Shareholders also are a consideration in the company's day-to-day operations. On this subject, Bo-Linn advised that the board should proactively address key potential issues.

"It makes good business sense to think about the same terms and the same topical areas that various stakeholders, such as shareholders and activists, might think about," Bo-Linn said. "Boards need to develop a game plan—perform a self-assessment and consider what qualities about their company would attract attention: strategy, execution, corporate governance, current and three- to five-year stock price performance, compensation, capital structure, M&A, etc."

Andrew Shapiro, founder and president of Lawndale Capital Management, spoke from the floor and offered his perspective on what activists typically look for when they engage with a company. First and foremost, he said, severe undervaluation in the security price is what initially attracts activist investor attention—in particular, low return on assets, which indicates a misallocation of assets; too much or not enough debt; company costs in relation to its peers; and a poor investor relations communication program. "So," Shapiro said, "regarding those factors, good boards will recognize these issues. It's not rocket science. And good boards take actions and steps to address these issues."

While financials absolutely require attention, boards can have a tendency to focus too much on the numbers. A game-changing strategic plan will never evolve from the ledger, nor can it be crammed into an hour within a regular board meeting.

Bo-Linn remarked that when it comes to planning, boards can fall into a creative rut if they lack diversity of thought and experience among directors. "Let's think through 'what if's' on

Adam J. Epstein

activities and events that might have been initially lower on their priorities list and challenge assumptions so that the board realizes they should be more aggressive—or less—with more clean-slate thinking."

Key Committee Issues

Small-cap company board committees may be unprepared for the new challenges they encounter. In a discussion moderated by **D'Anne Hurd**, director at Hiperos, panelists **Stephen M. Graham**, managing partner of Fenwick & West's Seattle office, and **Beatriz Infante**, director at Sonus Networks, Emulex, and Liquidity Services and CEO of BusinessExcelleration, advised how to effectively oversee CEO succession and risk management.

In general, every public company has three key committees: audit, compensation, and nominating and governance. While committees are created to divide this workload among the directors, small-cap boards can be so small that the same independent directors end up serving on all committees.

"Most experts will say you should not be on more than two of the key committees," Graham said. "If everyone is required to serve on every committee, right away you have a situation where every director is stretched so thin that the question is raised as to whether they can properly do their jobs—and that becomes a risk management issue." Adding board members may not be an option for reasons of cost or control. This area needs to be actively managed, either through collateral support or limiting director service on other boards.

The compensation committee or the nominating and governance committee will be saddled with the questions of company leadership. This is a potentially volatile issue because in a founder-driven environment, the founder/CEO is often viewed as the company's one irreplaceable asset. In addition to orchestrating a shift in thinking, Infante noted that succession planning only becomes awkward when it becomes an imminent requirement. It's best to ease into these conversations as early as possible. The board and management need to consider the hypothetical situation—if the CEO is suddenly incapacitated and unable to lead, who within the company would be able to temporarily take the reins? Those conversations can then segue into longer-term planning to coach these potential candidates.

"We find that when you go through that process, you discover where you have giant gaps," Infante said. Graham added that a company should have a profile—a "living document"—detailing the attributes required of the CEO at any given phase of the company's life, so that if the need suddenly arises, you at least know who you're looking for. "If you don't spend enough time on this subject, you're not properly managing risk," he said.

The audit committee traditionally handles risk management, which is no small task. While this needs to be a concern for every director on the board, having an expert in every area of risk isn't realistic, especially in the small-cap environment where a typical board may consist of only eight members. Rather, the board needs to identify risks, understand that those risks require management, and determine whether the appropriate expertise already exists within the company or to bring in consultants to audit specific risk areas as needed.

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—SUSAN A. SCHRETER

Risk Is Relative

"Directors of small-cap companies face resolutely unique challenges," small-cap governance expert and *NACD Directorship* columnist **Adam J. Epstein** said in his keynote address. "A one-size-fits-all approach to corporate governance doesn't work." While the general tenets still apply, risks that would barely faze a mid- or large-cap company could readily shutter a small-cap business. Epstein outlined three areas for directors to focus on with regard to identifying and managing these challenges:

Nominating/governance functionality and corporate finance. Small-cap boards have inherent resource issues, he said. Boards tend to be small and the company likely can't compensate directors as robustly as a mid- to large-cap company does, which creates an issue in sourcing talent. Furthermore, smaller companies operate on very narrow margins, meaning that directors need to be keenly aware of all the risks that could affect the company, because one misjudgment could spell the end of the business.

Some 80 percent of U.S.-listed public companies

"Good boards recognize these [undervaluation] issues. It's not rocket science. And good boards take actions and steps to address these issues."
—ANDREW SHAPIRO

are small-cap. Most of them don't have the cash flow needed to fund growth initiatives and therefore seek outside assistance—typically by way of an investment bank. With most small-cap company boards lacking a director with expertise in corporate finance, the company's financial viability then rests in the hands of a third party. There is a fundamental conflict of interest in these relationships at the expense of shareholders: the company is beholden to the banker and the deal the banker sets up.

Asymmetric information flow. In the small-cap environment, independent directors are usually selected by the CEO. While this may not necessarily impede the board's ability to act in the shareholders' best interests, it may create two sources of risk: a board of homogenous thought and a board that is easily managed

Talent Abounds—Know Where to Look

Building and funding an effective board can provide a small-cap company a much-needed competitive edge. But with traditionally small boards—the average small-cap board comprises just eight directors—and with so little room for error, how does a company compose a high-impact board? Epsen Fuller Group Managing Director and CEO **Thomas J. Fuller** suggested the following framework for determining how a small-cap company board should look.

"As you look to define the optimal mix of talent on the board, you need to have a full understanding of the characteristics of the company and its future goals," Fuller said. "Define the board's mission. Having a formal mission statement is a tool that provides focus, a center of the company universe around which the remaining framework elements orbit."

People. Board talent needs to align with company challenges and objectives. Global perspective and diversity are key qualities in composing a board of well-rounded, innovative thinkers. All directors need to contribute; otherwise, they are not adding value.

Agenda. Ask whether the board is spending enough time and energy discussing the company's success drivers and the creation of long-term value.

Team dynamics. Assess the quality of boardroom discussions, and evaluate whether those conversations are robust and whether directors display mutual respect.

Culture. Trust and openness are key, egos need to be kept in check, and all opinions need to be heard. This creates an environment where directors can challenge themselves outside their areas of expertise and be continuous learners.

Information flow. Too many boards are focused on financials and need to take a more holistic view of the company. A wider range of topics needs to be up for discussion to effectively oversee the long-term growth and viability of the company.

Structure and process. What is the optimal size for your board? Small-cap boards can range from as few as five or six directors to as many as nine. Size is determined by the characteristics of the company and the number of committees that are needed.

Board composition, however, is not a one-time process: it needs to be monitored on a regular basis. Fuller suggested using scorecards to rate the board in each of the framework areas and to rank each individual director with regard to their skills and areas of expertise. Going through this exercise illustrates where the board's strengths are as well as where the knowledge gaps are, allowing for focused recruitment efforts to complement the existing talent.

When it comes to finding new talent, small-cap companies should create a recruitment committee. While this committee can save money by looking within their own professional networks, the drawback is that the candidate pool is immediately limited, and activist investors may argue that cronyism is a factor in how the company is run. Search firms are a preferred method, not only to expand the reach of the search, but also to serve as objective counsel throughout the process.

Fuller also warned against the trend for public companies of all sizes to include only sitting or recent CEOs in their slate of potential board members. "I encourage you to at least peek outside the box when you are building your high-performance board," he said. "Focus on board director candidates bring a specific skill or knowledge base that will enhance the board's overall portfolio. Look for directors that are passionate about your company and will be tireless in helping your company achieve its goals."

by the CEO. Strategy development is hindered when dictated by the CEO because such discussions should be ongoing and dynamic. Circumstances can change in an instant, and having varied perspectives on the strategic breadth and potential of the company will help to ensure its survival. The nominating chair is the most likely candidate to remind a domineering CEO that, statistically speaking, better-governed companies generate stronger shareholder returns. Boards comprised of "friends of the CEO" may attract activist investors.

Working with professional services providers managing material risks. The quality of professional services available to small-cap companies varies wildly. Affordability aside, selecting and managing service providers becomes an area of risk because the CEO and CFO are often running a public company for the first time, and some providers may not be sensitive to the specific needs of small companies. This creates a governance issue, so directors need to ensure that management is asking the right questions to choose the right provider for the company.

Directors also need to be mindful of overstepping bounds. Regardless of company size, there is always a difference between governance and management. Directors need to maintain their "nose in, fingers out" relationship with the company—no exceptions. Although directors should be aggressive in their oversight, balance also needs to be maintained. "One of the big differences between governing in the small-cap ecosystem versus the large-cap ecosystem is that directors need to regularly get right up against that line," Epstein said.

Shareholder Communications

In the age of social media, investor activism has exploded. In this strange, new investor landscape, not having a developed shareholder communications strategy becomes a risk issue.

Keith Gottfried, partner at Morgan, Lewis & Bockius, moderated a discussion between **John W. Heilshorn**, founding partner of LHA Inc., and **Beatriz Infante** on how directors can effectively engage with shareholders.

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—STEPHEN M. GRAHAM

It's a good exercise to have a lead director engage in conversation with the key institutional investors and learn their concerns. "There's really no substitute for having a live conversation with some of your shareholders, because at that time, concerns come out that you can respond to immediately," Infante said. Though you want directors to engage actively with shareholders, a balance needs to be struck between directors initiating their own dialogues and "active listening."

It's also imperative that directors establish protocols for these engagements. Rule number one is to actively absorb information without providing commentary on the company's actions. Second, it helps to have these conversations with a third party present in order to avoid the possibility of "he said, she said" accusations down the line.

Before any engagement, think about the messages you, the director, want to convey to the investor. The director's responsibility is to actively listen and report back to the board. Furthermore, investor engagements should be ongoing, requiring directors to meet outside of regular board meetings.

To this point, Lawndale Capital's Shapiro again spoke from the floor about the activist's perspective, suggesting that overdelegating shareholder interaction to management, rather than to an informed independent representative of the board, signals ineffective board dynamics—and could trigger increased activist engagement. He asked Heilshorn for his observations on how those interactions are handled: do boards tend to engage when the situation is less hostile and disruptive, but otherwise pass the situation on to the CEO to spearhead the fight?

"My recommendation is to take the CEO out of the conversation," Heilshorn said. "I want the CEO to focus on managing the company. I usually like—whether it's a formal committee or two or three independent directors—to interface with the activist. That way the board gets an unrestricted flow of information about the concerns that the activist has." Management's face-to-face interactions with key institutional investors, he explained, can help to create an intimate relationship that may mitigate activist involvement.

Although activist engagements can be disruptive, Heilshorn says they can be a positive influence. "The activist may allow management to take decisive action that it might not otherwise take." Furthermore, those engagements allow the company to look at itself through fresh eyes—and in an environment where the company is rapidly growing and changing, that feedback can be invaluable to bolstering shareholder value.