Ownership Structures as a Competitive Advantage

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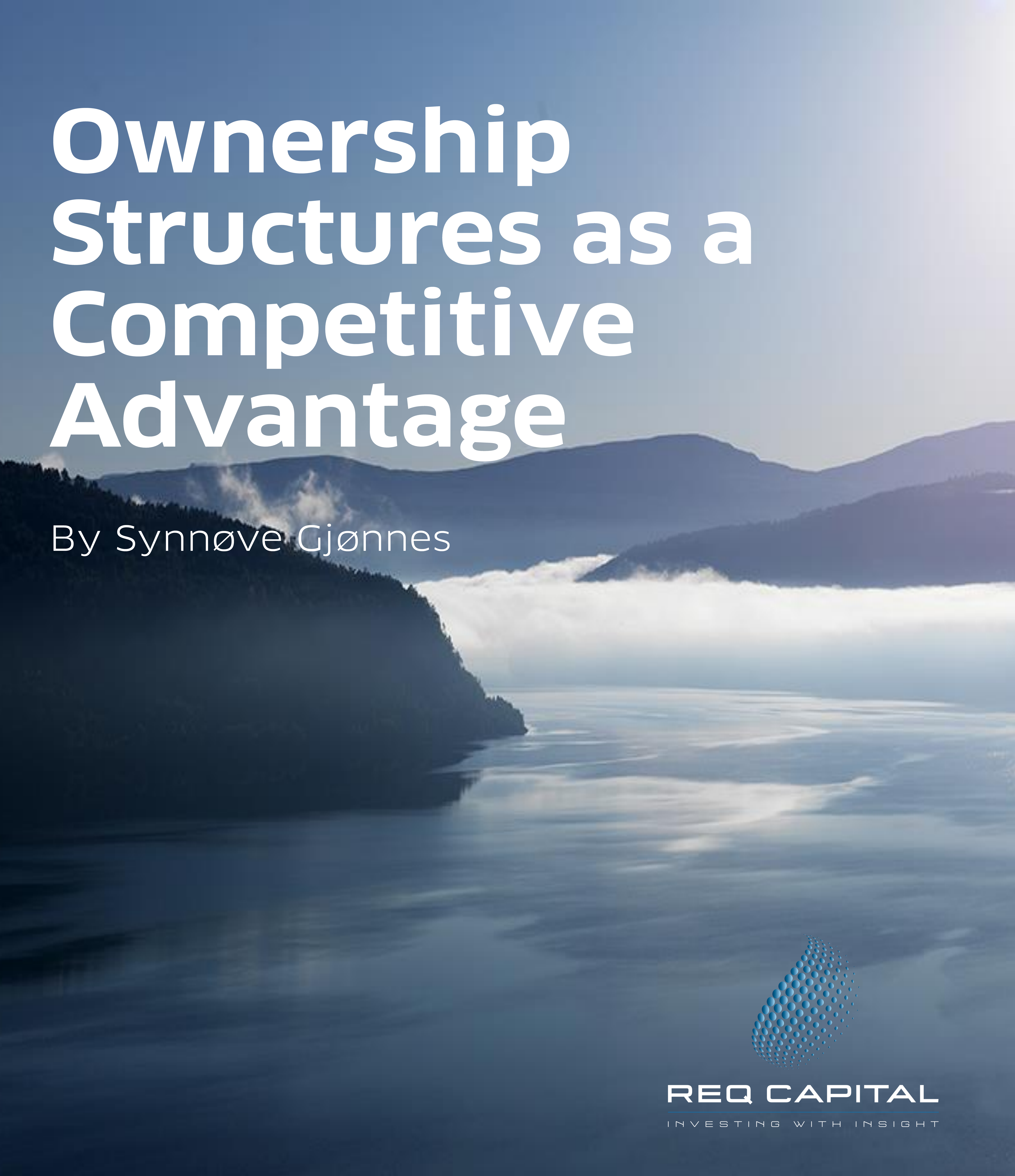

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At REQ Capital, a company's ownership structure is an important investment criterion. We believe that companies with a high level of insider ownership in most cases are better managed than purely institutionally owned companies. Insiders have a longer-term view on a company's performance, and implement that long-term view through board representation, management composition, and the company's strategic direction. We claim that the ownership structures of our companies are a competitive advantage since it allows the companies to act in the best interest of long-term shareholders.

We define insider ownership as shares held by senior management, board members, and large private owners (often families), as these are all stakeholders that can have a significant impact on a company's performance.

Management ownership as a mean to avoid short-term thinking

When senior management own a significant stake in the company, they treat the company as their own. You treat your own car better than a rental car. Management with ownership tend to avoid decisions that increase short-term profitability at the expense of longer-term value creation. This requires ownership stakes not being given away for free in the form of warrants or options, but through investment requirements and long-term-incentive plans, with appropriate lock-up periods.

Private ownership secures long-term strategic thinking

It is a paradox that from a governance perspective, high institutional ownership is perceived by many to be better than one or a few larger private owners. The argument is often that institutional investors are professional and have experience in implementing appropriate governance measures.

However, institutional investors in many cases have a short-term view on investments, often with a blind trust that management will maximize shareholder value. This gives management a great deal of freedom, in many cases without proper alignment of incentives. In addition, institutional investors rarely take board seats, as this limits their ability to trade shares.A private owner, on the other hand, often has a generational perspective on the ownership stake, and wants to take a seat on the board. This ensures a long-term perspective in the board room, which we prefer.

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Ownership in the board room gives incentives to long-term thinking

Some will argue that in a well-governed company, insider ownership does not matter as control mechanisms will ensure that the company is well-managed. We believe incentives through stock ownership works better than formal control mechanisms. If incentive structures are not properly aligned, management and directors seldom implement a long-term perspective. The aggregated value of the ownership stake should well exceed annual compensation.

When is high insider ownership bad?

There are instances when insider ownership can be a significant negative factor for companies. This is especially the case in conjunction with poor governance, where insiders act irrationally to maximize their own personal value at the expense of other stakeholders.

One such an example can be when a business is heavily indebted and enters a downturn. Instead of raising equity to repair the balance sheet, a majority owner that holds most of his or her personal wealth in the company, may choose to postpone a capital increase to avoid dilution. This is suboptimal for the company because management may spend more time worrying about the capital structure, instead of focusing on operations during a difficult downturn.

Therefore, it is important to carefully consider whether a company has the right governance mechanisms in place when investing in companies with high insider ownership. Much of the risk of insider ownership can be mitigated by examining a company's governance mechanisms, in addition to its business model, organizational structure and management profiles.

Conclusion

We believe high insider ownership creates long-term value, because insiders often have a long-term view on the company, and want to maximize long-term shareholder value. This means that management do not focus on empire building, or make suboptimal short-term strategic or financial decisions. We have high insider ownership in our portfolio holdings, and believe this is an important investment criterion to ensure long-term value creation.