Navigating the start-up governance minefield

Founders must prioritise governance from the outset, rather than deferring it until just before the IPO if they want to create long-term value.

Start-ups attract our attention either when based on their rising valuations they are celebrated or when their valuations come crashing down. Three years ago, the music did not stop, and valuations kept soaring. Then, every other day a new soonicorn (a valuation of between US$ 500.0 million and US$ 1.0 billion/ Rs 40-80 billion) or a unicorn (a startup with a valuation of over US$ 1.0 billion, or Rs 80.0 billion) was anointed. And now just suddenly, it seems, that the chairs have all been removed.

Why has the mood soured? The uncomplicated explanation is that the valuations moved lockstep with the flow of funds. As the fiscal taps opened, money flowed and asset prices escalated, including those of start-ups. Once this tide turned, money became expensive, and valuations dropped. This is at best a partial explanation as it suggests that macro headwinds and tailwinds rather than the start-ups themselves, create their destiny.

Many factors explain the success and failures of start-ups, not all within the start-ups control. But one thing start-ups, as an asset class, should do is to is to increase focus on governance. Its absence, in large part accounts for the business breakdowns or governance missteps as seen in a string of entities - Siply, BharatPe, Trell, GoMechanic, Byju's, Mojocare, Zilingo, ZestMoney. To name just a few.

Even as start-up governance remains in a dark space, the governance in listed companies is somewhat better. This is validated through the G20/OECD Principles of Corporate Governance and the scorecard has been developed by Institutional Investor Advisory Services (IiAS, the firm where I work) jointly with International Finance Corporation and The BSE Limited. IiAS' annual assessment based on the scores of the S&P BSE 100 index constituents, that account for over 70% of total market capitalization is a proxy for the governance practices of corporate India. The scores have been inching up over the past six years.

This, as mentioned above, is in sharp contrast to start-ups "who are completely new to the regulatory world when they list," according to Cyril Shroff, managing partner at Cyril Amarchand Shroff, a law firm. These he adds, "comes at them in terms of tsunami of regulations, related party transactions, semi-scrutiny, proxy advisors and things they had never factored in. So, in the first six months of listing, they get a massive shock in terms of what came through and they thought it was just about getting market cap and they realized this comes with conditions attached. That is something which they don't realize."

Akash Prakash, from Amansa Capital, a fund manager, voiced a similar view, holding their investors equally responsible. He says, "I'm actually astonished at some of the stuff, which is taken as part of the game in private companies would never pass public (market) muster."

This points to the focus start-ups and their investors place on being the first to identify a market, build out a product and grab market share, paying insufficient attention to governance. Most see governance as a something that comes in the way of doing business. They expect to concentrate on the governance aspects, closer to their IPO or when the company reaches a particular size. In doing so they fail to recognize that governance is a fundamental building block that will give investors' confidence to fund, suppliers the comfort to deal with the business and talent the incentive to join and stay with the company.

The best way forward is to build out the business and the accompanying governance systems in parallel. This means appointing a fully functional board, a compliance team and a financial reporting team.

The roles and responsibilities of each of these should be fit for purpose, and steadily expand with the business, getting closer to public market standards even before the company lists. For example, independent directors should be inducted on the board, board committees constituted with a broader remit, including risk, CSR and stakeholder management, the board and various committee agenda and functioning should be benchmarked to listed peers as well as by undertaking board evaluation. Similarly, the compliance and finance teams each can start to incorporate regulations that the larger listed companies adhere to too, along with their disclosure practices. These include related party transactions, conflict of interest and behavioral codes, risk practices with focus on asymmetric information sharing.

Waiting till just before the IPO implies neither does the company have the processes and systems in place, nor have these been internalized, leading to avoidable time being soaked up. And while I have spoken about IPO, this approach is equally helpful as start-ups move from Series B to Series C and to further funding rounds. In other words, governance must be prioritized from the outset, rather than deferring it until just before the IPO.

Today, India has one of the largest and most vibrant start-up ecosystems in the world - a testament to the country's entrepreneurial spirit and its ability to foster innovation and growth. The best way to maintain our leadership position is for start-ups to adopt best governance practices and build investor and stakeholder trust. This no doubt is as hard as building the commercial end of the business, but there is no better way to create long-term value.

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