Corporate governance develops in emerging markets

Shareholders in emerging markets show they're willing to pay a premium for good governance standards.

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Companies in emerging markets often assert that Western standards of corporate governance—particularly the US and UK models of governance that put maximizing shareholder value at the core of a company's mission—don't apply to them. "Things are different here," executives often say, citing extensive family ownership and different corporate cultures as conditions that make developed country standards of corporate governance less a priority.

We think otherwise. Our research indicates that both foreign and domestic investors in emerging markets do reward companies that adopt rigorous corporate governance standards. At one level, the findings suggest that emerging markets are naturally responding to the global trend in recent years of large activist shareholders pushing corporations to improve their governance structures and practices. And in light of the financial crises that have plagued emerging markets over the past five years, our research also provides evidence that a consensus is forming in the developing world that publicly stated strategies mean little to investors if a company lacks disclosure, transparency, management accountability, and ultimately a strong commitment to shareholder value.

In McKinsey's Emerging Markets Investors Opinion Survey 2001,[1] 76 percent of investors in Asian companies say that they worry about board practices as much as or more than financial issues. In every country surveyed, investors state that they would pay a premium for a well-governed company, as high as 30 percent in some emerging markets.[2]

Good governance is rewarded

Is there any hard evidence that improving corporate governance actually pays off? If investors are indeed putting their money where their mouth is, then there should be a clear link between a company's market valuation and its corporate governance practices. We evaluated 188 companies from six emerging markets[3] to see if such a link exists. Each company was rated along 15 elements of good corporate governance (Exhibit 1). To ensure consistency in the ratings, we developed explicit criteria for how ratings should be assigned. To control for researcher bias, we directed local teams to evaluate the companies from each market.[4]

The result: there is clear evidence that good governance is rewarded with a higher market valuation. Companies that have a higher score on our corporate governance index also enjoy higher price-to-book ratios.[5] This is true even after we controlled for a company's financial performance and other firm characteristics,

Exhibit 1. 15 elements of good corporate governance

1. **Dispersed ownership:** Although the presence of a large or majority blockholder is not necessarily a negative governance issue, a more dispersed ownership normally tends to be more attractive to investors. Most important, a company should have no single shareholder or group of shareholders who have privileged access to the business or excessive influence over the decision-making process.

2. **Transparent ownership:** A company's actual ownership structure should be transparent, providing adequate public information on breakdown of shareholdings, identification of substantial/ majority holders, disclosure on director shareholdings, cross and pyramid holdings, and management shareholdings.

3. **One share/one vote:** A company should offer one share/one vote to all of its shareholders, and have only one class of shares. All shareholders should receive equal financial treatment, including the receipt of equitable share of profits.

4. **Antitakeover defenses:** The company should not have any share-, capital-, or board-related antitakeover defenses.

5. **Meeting notification:** Shareholders should be notified at least 28 days prior to each general shareholder meeting to allow overseas investors to participate, and online participation should be available for shareholders.

6. **Board size:** The board should be neither too big nor too small. Empirical analyses suggest that the optimal board size is from five to nine members.

7. **Outside directors:** No more than half of the directors should be executives of the company.

8. **Independent directors:** At least half of the non-executive directors should be independent outsiders.

9. **Written board guidelines:** A company should have its own written corporate governance rules that clearly describe its vision, value system, and board responsibilities. Based on the rules, directors and executives should be fairly remunerated and motivated to ensure the success of the company.

10. **Board committees:** The board of a company should also appoint independent committees to carry out critical functions such as auditing, internal controls, and top management compensation and development.

11. **Disclosure:** Frequent and credible disclosure and transparency. At a minimum, a company should provide disclosure on financial and operating performance; business operations and competitive position; corporate charter, bylaws, and corporate mission; and board member backgrounds and basis of remuneration.

12. **Accounting standards:** A company should use an internationally recognized accounting standard (US GAAP, UK GAAP, or IAS) for both annual and quarterly reporting.

13. **Independent audit:** A company should perform an annual audit using an independent and reputable auditor.

14. **Broad disclosure:** A company should offer multiple channels of access to its information, including both on-line and off-line access. Information should be in both local language and English.

15. **Timely disclosure:** Information should be disclosed in a timely manner based on standards at the listing stock exchange.

Source: Derived from *OECO Principles of Corporate Governance,* Organization for Economic Co-operation and Development, 1999.

such as size. Investors are more confident in—and actually pay a premium for—a company that is committed to protecting shareholder rights, has frequent and transparent financial reports, and has an independent board providing management oversight. These fundamentals apply even though the corporate governance approaches that individual companies emphasize can vary.[6]

The premium investors will pay can be quite large. In all countries and industries, a firm could expect a 10 to 12 percent increase in its market valuation by moving from worst to best on any one of the 15 elements of corporate governance (Exhibit 2). Consider Alsea SA, a company in the Mexican food industry. Its book value and market value were 720 million pesos and 1,440 million pesos, respectively, in 1999. The company's onerous antitakeover provisions earned it the lowest possible score on that component of the evaluation. Even if Alsea didn't completely eliminate its array of takeover protections, it would be reasonable to assume that its market value would increase by more than 10 percent based on our research of companies in similar situations.

We also found important differences between countries in how companies rate on corporate governance. In general, Korean and Malaysian companies had the highest average scores, while Mexican and Turkish companies had the lowest. This is due to the concerted efforts in Korea and Malaysia after the 1997 Asian crisis to improve corporate governance, efforts that were not made in Mexico or Turkey after their respective crises in 1994. The fact that Korean and Malaysian companies have larger, more established capital markets is also a factor, since this means that there are more outside investors who are likely to scrutinize companies and demand change.

Exhibit 2. Effect of moving from worst to best in one component of corporate governance

Country	Industry	Effect
India	Chemicals	10.6
	Textiles	12.4
Korea	Auto Parts and Equipment	10.0
	Textiles	9.8
Malaysia	Building Materials	10.4
	Engineering and Construction	10.0
Mexico	Food	11.8
	Retail	11.8
Taiwan	Electronics	10.7
	Food	10.7
Turkey	Building Materials	12.0
	Food	12.2
	Textiles	11.8

Source: McKinsey analysis

Korea in particular stands out as a pioneer in advancing the cause of board responsibilities and shareholder rights.[7] Korea in many ways led the governance reform efforts after the Asian crisis. The government mandated, among other things, that the major banks and chaebol[8] appoint a majority of outside directors and establish committees and transparent board responsibilities. It removed ceilings on foreign ownership, thus sparking competition, and lowered the threshold for a group of shareholders to sue the board if they failed to protect their interests. So far, the shareholder rights group People's Solidarity for Participatory Democracy has challenged major companies such as SK Telecom and Samsung Electronics to test these new reforms.

Ties to nearby developed countries clearly help shape the approaches that some emerging countries take to higher standards of governance. Mexican companies, for example, generally score poorly on corporate governance measures largely because of their reluctance to give up family control. But they score very highly on transparency. This is because among the six countries surveyed, Mexican companies were most likely to be cross-listed on US exchanges, and even family-controlled boards must comply with tough SEC standards on financial reporting.

Leapfrogging the competition

Adopting sound corporate governance practices can also help companies leapfrog competitors. To follow up our statistical analysis, we took an in-depth look at 11 companies in seven countries that have all substantially improved their corporate governance practices. As expected, their performance also improved: each beat its respective local market indices by at least 20 percent in the 12-month period from May 2000 to May 2001.

Market valuation is driven by many factors, of course. Further research will be needed to draw firm conclusions about the impact of governance on valuation. Still, a closer look at our case studies illustrates why good governance should translate into improved performance. Disclosure and transparency around financial results, for example, allow a company to set clear targets and hold employees accountable for results, all the way from top management to the newest employees. An audit committee is an essential check on the CFO and can bring a much-needed market perspective to risk management strategies and techniques. Similarly, a management compensation committee is critical for creating the right incentives. And independent, outside directors bring a fresh and objective perspective to the company, which is critical for decisions that are counter to the interests of company insiders. **MoF**

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1 We surveyed attendees at the International Finance Corporation's Global Private Equity Conference (May 10–11, 2001). The 46 respondents, all of whom are private equity investors, manage approximately $5 billion in assets, 90 percent of which is invested in emerging markets.

2 McKinsey & Company's Emerging Markets Investor Opinion Survey 2000. We surveyed institutional investors on their views of corporate governance and, in particular, their willingness to pay for well-governed companies. In aggregate, respondents managed approximately $3.25 trillion in assets.

3 India, Korea, Malaysia, Mexico, Taiwan, and Turkey.

4 We tested the relationship between market valuation and corporate governance using a least-squares regression. The independent variable was each company's aggregate corporate governance score, stated as the percent difference from the average score in the given industry and country. The dependent variable was the company's price-to-book ratio at the end of 1999, again stated as percent difference from the country-industry average. A price-to-book ratio above average indicated that investors were willing to pay a premium for the company.

5 This result was statistically significant at the 95 percent confidence level.

6 For example, executives in Korean companies stress shareholder rights and corporate board reform, while those in Mexico focus on account transparency.

7 For more on the Korean effort, *see* "Building Asian Boards," Dominic Barton, Robert F. Felton, and Ryan Song. *The McKinsey Quarterly*, 2000 No. 4 Asia.

8 Korean term for a conglomerate of many companies clustered around one parent company. Chaebol usually hold shares in each other and are often run by one family.

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