



Corporate Governance in Russia: Who Will Pay For It and How Much?

by Igor Belikov
Russian Institute of Directors

April 19, 2004

Speculative investors pose a threat to the implementation of corporate governance reforms because they often disregard good corporate governance in their investment decision process. Therefore, companies in markets dominated by speculative investors have little incentive to spend valuable resources on implementing good governance. An analysis of the investment market in Russia shows that its main players are speculative foreign and Russian portfolio investors who seek to invest in seriously undervalued assets with a high potential for short-term growth. This category of investors seeks high returns through significant growth in stock price and is willing to assume big risks, including bad corporate governance. In this situation, companies have very little hope of getting any significant additional premium for any improvements in corporate governance from speculative portfolio investors. Such investors will continue to recommend improvements in corporate governance, but they will not be inclined to pay a significant premium for such improvements. The challenge is to attract conservative portfolio investors who are willing to commit to long-term investments and who view good corporate governance as a vital part of an investment decision.

Introduction

International investors and financial institutions praise good corporate governance principles. Yet, creating strong functioning systems of corporate governance is time consuming and costly. Are those efforts economically justified?

The need for good corporate governance from an investment viewpoint is easily explained: it is something investors want and, therefore, makes a company more attractive to investors. That attractiveness is expressed in the premiums that investors are willing to pay above the normal market price of a company's securities. Also, companies that have strong systems of corporate governance in place are able to use invested funds more efficiently, thereby increasing their overall efficiency. However, it is the willingness of investors to pay premiums for securities of companies with good corporate governance that is seen as a key factor, especially in recent years. The basic logic often used by consultants, rating agencies, and investment companies is that the more investor recommendations and best practices guidelines a company implements, the higher the premium on its securities it can expect from investors.

Although most agree that investors are willing to pay premiums for good corporate governance, how high those premiums can be remains unclear. Simply, the question is – how much are investors willing to pay for good corporate governance? The issue usually involves company stock, which is a much riskier instrument for investors because if the company collapses, they stand in line behind all other creditors. The premium for good corporate governance paid on a company's debt instruments,

The Center for International Private Enterprise is a non-profit affiliate of the U.S. Chamber of Commerce and one of the four core institutes of the National Endowment for Democracy. CIPE has supported more than 800 local initiatives in over 90 developing countries, involving the private sector in policy advocacy, institutional reform, improving governance, and building understanding of market-based democratic systems. CIPE programs are also supported through the United States Agency for International Development.

Center for International Private Enterprise
1155 15th Street NW • Suite 700 • Washington, DC 20005 • USA
tel: (202) 721-9200 • fax: (202) 721-9250
web: www.cipe.org • email: forum@cipe.org

in particular corporate bonds, has been given scant attention by analysts until very recently. They generally believe that if such a premium exists, it is very difficult to identify and calculate.

In 2003, to evaluate investor interest in good corporate governance practices in Russian companies, the Russian Institute of Directors (RID) surveyed managers, analysts, and traders from 50 different Russian companies. The companies surveyed are professional participants of the securities market and provide brokerage, asset management, and private banking services. RID wanted to see what attention they pay to the corporate governance practices in the companies whose shares they buy. Officers of some companies said in private discussions that they do not heed the corporate governance situation in bond issuing companies. Some traders and managers said off the record that they pay attention to two factors when they buy bonds. One is the company's size (annual sales and earnings), and the other is "goodwill," an unclear factor.

How Much Are Investors Willing to Pay?

Determining the amount of the premium for good corporate governance is not easy. Articles occasionally appear in which the value of the premium is estimated at 10-15% for developed Western countries and 20-30% or even 50% for the countries with developing markets.¹ Some authors believe that Russian companies could even command a three-digit premium. However, studies of investor behavior in Russia present an ambiguous picture.

In 2003, RID conducted a study that compared changes in stock prices of companies with the lowest and highest corporate governance disclosure rates. In general, the study showed an overall positive correlation between good corporate governance and changes in stock price on the leading Russian stock exchanges. However, this conclusion is mostly applicable to a small group of 10-12 blue chip companies. With respect to others, it was not so clear that investors voted with their money in favor of better corporate governance. The study revealed that in most cases it was actually the size of the company and its market share that are the main or, perhaps, even the exclusive factors that investors rely on when deciding whether to buy the stock of a Russian company.

Attempts to establish a definite, stable, and clearly quantifiable correlation between corporate governance and the price of a company's stock on a worldwide economic scale have not yet been successful. There are too many factors that affect the price of shares, and it is very difficult to determine the relationship between them.

Short-Term Investors and Corporate Governance in Russia

What is the real value of the cost-benefit indicator when improving the quality of corporate governance in Russian companies? Is there really a direct continuous relationship between the number of recommended best practices of corporate governance implemented and the size of the premium on a company's stock? Are all investors operating on the Russian stock market willing to pay such a premium?

The quality of corporate governance in Russian companies is assessed by numerous consultants, investment companies' analysts, and the Standard & Poor's rating agency by comparing it to a detailed set of best practice recommendations developed and promoted largely by conservative portfolio investors in leading Western countries. Those types of investors typically include investment funds, pension funds, and insurance companies. Pension and insurance systems in developed countries increasingly depend on the security and growth of the funds invested in them. Significant loss in such funds could cause serious social disruptions. The demographic situation in developed countries, which is increasing the burden on pension systems, and the transition from government to private pension systems make protection and effective investment of the funds transferred into this system even more critical. Therefore, reducing the risks associated with the entities in which these funds are invested has enormous socio-economic as well as financial importance. Improving corporate governance, especially in countries with developing markets, is seen as one of the most important ways to enhance these guarantees. However, experience shows that even companies in developed countries with a good reputation for corporate governance do not follow many of these

¹ The extent to which the low premium for companies in developed countries and the high premium for companies in countries with developing markets correspond to the real investment risks in such countries is an issue that deserves particular attention. Even a rough estimate of the losses incurred by investors from the failure of several large companies due to abuses by their top management and from the failure of such European companies as Achold, Vivendi, Parmalat, and others produces numbers comparable to the losses incurred by investors as a result of the crisis in Asian markets in 1997 and in Russia in 1998. However, the root causes of the corporate governance risks are different in developed countries and the new economies.

requirements. Still, this group of investors manages huge amounts of funds, so their opinion carries a great weight. Discrepancies between the companies' actual practices and postulated recommendations are publicly viewed as weaknesses to be eliminated.

An analysis of the investment market in Russia shows that its main players are speculative foreign and Russian portfolio investors seeking to invest in seriously undervalued assets with a high potential for a short-term growth. In years past, some investment companies have achieved three-figure annual returns. Their investment horizon is usually very short – from several days to several weeks or sometimes months. This category of investor seeks high returns through significant growth in stock price and is willing to take big risks, including bad corporate governance. However, the willingness of short-term portfolio investors to take such risks is not unlimited. Therefore, they advocate improving the system of corporate governance in the companies they invest in. To varying degrees, they monitor and assess the risks of corporate governance in these companies. The most well-known are the assessments of corporate governance and the associated risks made by investment companies like Troika-Dialog and Brunswick UBS. The criteria used by experts in these investment companies is rather limited and is focused primarily on boards of directors and the degree of transparency in those companies. This set of criteria is noticeably less extensive than the extremely detailed best practice recommendations aggressively promoted by conservative foreign portfolio investors.

The experience in Russia shows that the speculative portfolio investors have focused their attention on the stock of a very small group of 10-15 mostly very large companies. The quality of corporate governance in these companies that is acceptable to these investors is much lower than best practice standards and is inextricably linked to the specific characteristics of these companies – their very large size, their dominating position in their industries (and often their leading positions on the world markets for copper, nickel, rare metals, oil, aluminium, etc.), and the high degree of government regulation of their businesses. In other words, investors in this category accept a rather low quality of corporate governance in these companies not only in exchange for a very high return on the investment, but because they also view the company characteristics described above as additional guarantees. This category of investors has demonstrated its ability to create significant price growth in the stock of several of Russia's largest companies.

Rating	Company	Score
1	Marathon	77.2
2	YUKOS	75.7
3	EnCana	74.3
4	ConocoPhillips	74.3
5	Norsk Hydro	69.7
6	Petro Canada	68.8
7	Exxon Mobile	67.8
8	Sibneft	62.0
9	ENI	61.7
10	Chevron Texaco	60.7
11	LUKoil	58.2
12	BP	58.7
13	Devon Energy	50.8
14	Total	50.5
15	Royal Dutch/Shell	46.8
16	Anadarko	45.5
17	Amerada Hess	43.3
18	Repsol YPF	41.7
19	Gazprom	34.8
20	Surgutneftegas	33.3

Source: Energy Intelligence

RID observed that a large premium was paid for the transition from a primitive level to a higher level of corporate governance, which is still below the foreign best practice recommendations. This transition was made by a group of the largest Russian companies, particularly in the resource sector (e.g., YUKOS, Sibneft, and later LUKoil). A review shows that this new level of corporate governance includes such policies as the consolidation of ownership in the parent company, disclosure of the main beneficiary owners, discontinued practices of asset stripping, a move to International Accounting Standards-consistent reporting, the passing of a code/declaration of corporate conduct, election of a few well-reputed foreign businessmen as independent directors (by the controlling shareholder(s)), establishment (or announcement) of two or three board committees (such as the audit, remuneration, and nominations committees), payment of sizable dividends, payment of interim dividends (albeit its timelines are not necessarily the same for all shareholders), and issue (or announcement) of alternative dispute resolutions.

In January 2004, a U.S. analytical firm Energy Intelligence (EI) published a corporate governance ranking of the largest public oil companies worldwide (the ranking is based on evaluation of the boards).² It confirms the powerful effect of the first steps that the largest Russian companies have

² The ranking evaluates the boards of directors by several criteria, scoring each by a 100-score scale: number of board members; separation of positions of the board chairman and CEO; volume of stock owned by directors; independence of the board and its committees, such as the audit committee, the nomination committee, and the remuneration committee; and regularity of the board rotation. To order the complete report, please visit Energy Intelligence's website at <http://www.energyintel.com>.

taken to improve their corporate governance. YUKOS rated second in this ranking, Sibneft was eighth, and LUKoil eleventh. The average score for the U.S. companies is 59.7, European companies had 53.9 and Russian ones had 52.8. The three Russian companies named above were ahead of several leading Western companies, and the lower average score was given to Russia because Gazprom and Surgutneftegas are lagging far behind in their corporate governance.

During the period of most rapid growth in stock prices, a significant premium was paid for improvements in corporate governance in these companies.

However, the tendency is that after the stock prices of these companies have reached a certain level that is significantly higher than the original price (often several times higher) and after the initial positive changes in corporate governance, the speculative investors rapidly lose interest in the stock. At these price levels, the amount of investment required to work with the stock of these companies on a significant scale is too large for this category of investor, and the amount of the possible return, in their view, is too low. As a result, speculative investors lose interest in the shares of this group of companies if they maintain this price level. Since the funds of speculative investors currently remain invested primarily in shares of companies in this group, these investors are interested in further improving corporate governance in these companies as a way of reducing their risks, but they are not willing to pay a significant premium for it.

This trend was confirmed by the views that spread in the summer and fall of 2003 among several investment companies that play a leading role in the Russian stock market. Some investors said that most of Russian stock had "reached its fair price," "the market of liquid Russian shares is overbought," and that investors "are beginning to think about moving into markets where there is an opportunity for larger asset growth."³ Although references were made to the high risks associated with investment in Russian blue chips, the proposed alternative was not improving corporate governance in these companies. Rather, the alternative was going into Latin American markets, which are not famous for their high level of corporate governance or their political or macroeconomic stability. There were also explanations that, RID believes, were much closer to the true motives of this category of investor: "The Latin American markets recently went through a financial crisis and [investors] are moving into those markets. . . in hopes of speculating on their recovery."⁴

Some of the investment companies that played a key role in stimulating the growth of shares of the largest companies in Russia concluded that the blue chips exhausted their potential for growth, and they even began offering their clients instruments tied to commodities instead of stock. For example, Brunswick UBS started to advise its clients not to buy shares in YUKOS, LUKoil, and Sibneft, but rather enter into contracts to sell two-year oil futures on one of the international markets and buy one-year options to sell oil.⁵ It may be argued that these investors decided that in the current situation the sovereign risks were too high and could not be compensated by improvements in corporate governance in the companies. But these fears did not seem to deter these same investors from resuming active stock purchases after their prices fell significantly in the fall of 2003 despite such obvious signs of increased sovereign risk as the increased pressure by the authorities on YUKOS and on big business in general and the coming parliamentary elections.

Who Will Pay for Good Corporate Governance in Russia?

In this situation, Russia's blue chip companies have very little hope of getting any significant additional premium for any improvements in corporate governance from speculative portfolio investors, who constitute the vast majority of Russian stock buyers. Investors in this category will continue to recommend improvements in corporate governance in leading Russian companies that are actively promoted by the rating agencies and consulting companies who see a market here for their services, but they will not be inclined to pay a significant premium for such improvements.

It seems that the leading Russian companies, at least a majority of them, can receive a large premium for improvements in corporate governance and adopting best practices and, thus, increase their capitalization only if they attract the attention of conservative, foreign portfolio investors. It is such conservative portfolio investors who are the main promoters of high standards of corporate

³ *Vedomosti*, June 21, 2003

⁴ *Vedomosti*, September 2, 2003

⁵ *Vedomosti*, September 4, 2003

governance and who are able to pay significant premiums for such efforts since they manage financial resources that exceed the resources of speculative portfolio investors in the Russian market. An investment-level credit rating for Russia from one of the world's leading rating agencies gives hope that this category of investors will eventually appear on the Russian market or at least will begin acquiring shares in leading Russian companies at overseas stock exchanges.

The leading Russian companies, whose shares have become blue chips due to speculative portfolio investors, should base their future policy on these conclusions. It is true, however, that this scenario may take some time, possibly 2 to 3 years, to develop on any significant scale, assuming there are no serious political or economic disruptions in Russia.

The fact that the blue chip companies have mainly exhausted the interest of speculative portfolio investors creates a good opportunity for other companies. Such companies would include primarily large companies that have maintained a closed strategy until now, like Russian Aluminium, Sistema Joint Stock Financial Corporation, ALROSA, several metals and mining companies, and some of the larger companies that are medium-sized by world standards but have leading positions in such industries as forest products (Ilim Pulp), food (Cherkizovskiy APC), and machine-building (the Siloviy Mashiny Association of Machine-Building Plants). RID estimates that at least 40 to 50 companies in this category have already acquired the necessary characteristics to allow them to begin attracting regular investments from speculative investors within the next 2 to 3 years. In the mid-term, about 150-160 companies could fit into this category.

The largest companies in this group might follow the path of the current blue chips. The efforts required of these companies in improving corporate governance will be comparable to those made by the current blue chips, with adjustments for the importance given to corporate governance at the time when the companies' owners decide to open up to outside investors.

RID predicts that Russian and foreign banks might strongly contribute to the advancement of corporate governance in the industrial companies. They can assess corporate governance in issuer companies as the risk factors and link the cost of credits to this factor. Yet, currently, Russian banks do not pay attention to it while assessing the borrower's risks. This trend was confirmed by a 2003 IFC survey of corporate governance practices in the Russian banks. Moreover, foreign banks that operate in Russia do not pay any systemic attention to the borrower companies' corporate governance and they do not correlate the cost of credit with the level of corporate governance in the borrower company. Another role of banks in promoting good corporate governance is that banks can encourage better corporate governance in the companies whose stock they own. They have been very passive on this issue so far.

For the leading medium-sized companies, the decisive factors will be expanding business and increasing efficiency. The quality of corporate governance these companies need to attract serious attention from speculative investors should be higher than that of the blue chip group. As noted above, in the eyes of speculative investors, the large size and stability of the blue chip companies well compensates for the risk associated with the lack of many important components of good corporate governance. However, even though the quality of corporate governance that will bring medium-sized companies a premium from speculative investors is higher than for the blue chips, it will still be significantly lower than the best practice standards advocated by conservative Western portfolio investors.

The Future of Corporate Governance in Russia

The efforts of regulatory agencies, stock exchanges, national rating agencies, and business associations and investors in the area of corporate governance should be focused primarily on helping 150-200 leading Russian companies implement principles of good corporate governance that will produce the largest economic return in the form of a large premium on the stock price for speculative investors. After this quality of corporate governance is achieved, the companies will have to determine whether they can get an additional premium for more improvements in corporate governance from conservative Western portfolio investors by moving closer to the best practice standards.

For the vast majority of medium-sized Russian companies, to say nothing of small companies, the highest-priority task in the area of corporate governance is improving compliance with the law. For most of these companies to develop, they will have to transform themselves into closed, or even open, joint stock companies so that their type of ownership is appropriate for their business. Creating

the same system of corporate governance as in large companies, with the many attributes of Western best practices, is not economically feasible for these companies and entails significant costs and risks.

The experience of other countries shows that the main sources of capital for medium-sized companies are bank loans and direct investors rather than securities put out on a stock market and intended for portfolio investors. Today, the Russian banking system clearly does not meet the requirements for economic growth. The need for banking reform is obvious, and the task of creating a functional banking system cannot and should not be supplanted by unfounded hopes that the stock market can replace the banking system, especially for medium-sized companies.

Igor Belikov is the Director of the Russian Institute of Directors (RID). RID, a non-profit partnership, was founded in November 2001 by a group of Russian companies listed on Russian and foreign stock markets. As the business community's response to the need to improve corporate governance in Russia, it promotes sound corporate governance in order to establish a foundation for Russia's new market economy with a view to increasing the efficiency of using financial resources and their investment attractiveness. As an association of professional company directors, RID also promotes high professional standards and ethical norms throughout Russia.

This article was adopted from a longer article originally appearing in Russian in the magazine Rynok Tsennikh Bumag (2004, No. 5). That version is also available on CIPE's website.

The views expressed by the author do not necessarily represent the views of the Center for International Private Enterprise. The Center for International Private Enterprise grants permission to reprint, translate, and/or publish original articles from its Economic Reform Feature Service provided that (1) proper attribution is given to the original author and to CIPE and (2) CIPE is notified where the article is placed and a copy is provided to CIPE's Washington office via mail, e-mail, or fax.