

[--- Unable To Translate Box ---]

T3573CENTER FOR INTERNATIONAL PRIVATE ENTERPRISE

CONFERENCE ON
"WHY DO CORPORATIONS FAIL? LESSONS FROM
INTERNATIONAL EXPERIENCE"

PRESENTATION OF DR. JOHN SULLIVAN
"CAUSES AND CONSEQUENCES OF CORPORATE FAILURE:
CENTRAL AND EASTERN EUROPE"

March 30, 2003

Egyptian Center for Economic Studies

[TRANSCRIPT PREPARED FROM A TAPE RECORDING.]

MILLER REPORTING CO., INC.
735 8th STREET, S.E.
WASHINGTON, D.C. 20003-2802
(202) 546-6666

pab

MILLER REPORTING CO., INC.
735 8th STREET, S.E.
WASHINGTON, D.C. 20003-2802
(202) 546-6666

P R O C E E D I N G S

DR. SULLIVAN: Thank you very much, Ahmed.

I would like to thank a whole lot of people, but as you can see, Dr. Galal is a very strict German, so I will resist the temptation to do that.

DR. GALAL: I'm going to take that from your time.

[Laughter.]

DR. SULLIVAN: But I do want to thank ECES and our partner organizations who we've heard from this morning. Great presentations from everybody on the opening panel.

There are many reasons why companies fail, as we've heard. The point I would make, to supplement what Dr. Galal has said, is that, as you look at the reasons for corporate failure, when you find a structural reason within the company, as the most important cause or institutional failure in the structure of the markets, then we have to be much more concerned than if it's for business reasons, a change in market conditions or perhaps just a general failure of their particular business model; in other words, not for competitive reasons.

I would also supplement what Steven has said about the role of institutional investors. Just yesterday,

CalPERS issued a warning, in fact, I read about it in Steven's newsletter, if I remember correctly, to Xerox that if they didn't improve their corporate governance, they were headed for trouble. So, clearly, there are market pressures coming now from investors that were not there before.

Shifting to the Central and Eastern European region, what I'd like to try to convince you is that, in fact, corporate governance failures in that region were much more important on a systemic level than they were in the Western countries.

And we all are familiar now I think with the McKinsey ratings. What they've done is asked investors what kind of a market premium they're prepared to take. And the point of this slide is that for countries which have a good overall system put into place, institutional investors are willing to pay a much lower premium.

In other words, if the country is in good shape, as the U.K. is here, which showed up as number one on Steven's rankings, the premium is much lower than it would be, for example, and I picked Russia and Egypt as two cases, but also Poland, and you can see where Eastern Europe, as a whole, ranks here.

Steven has talked about a set of drivers of corporate governance failures in the West, and I'd like to shift attention to a different set of corporate governance failures. As you can see, it ranges from asset stripping, to insider and self-dealing, although that was, of course, part of the problem with Enron, but also the problems with exchanges. And underpinning all of this is the weak legal institutions that existed throughout the region as they transformed from a socialist system to a market system.

Nick is doing his best to keep up--here we go. We're coming back on now.

What I'd like to do is just very quickly, in the interest of time, provide just a very few examples of failures. The first one is from Poland, and the example here, the point here illustrates what Steven has said. In Poland, we have a case of blockholders. These are either large, individual groups or, in some cases, families that own companies and have been engaging, on a systemic basis, in minority shareholder abuse. And that's become the biggest problem.

Recently, the Gdansk Institute for Market Economics got into quite a public policy debate over this

with a competing institute that we're trying to push forward the idea of using corporate governance codes. And the code that was produced by those that are the actual blockholders very much favored the insiders. Whereas, the Gdansk Institute was trying to produce a code which, as I'll show later, was based on transparency.

In Romania, we have the case of Dacia, which engaged in some pretty significant corporate governance problems.

Turning to Russia, of course, it's the big kid on the block in Central and Eastern Europe, although its market, interestingly, is not as liquid as others. Here, the most egregious case of all is Gazprom. And PricewaterhouseCoopers, when they finally did their audit of Gazprom, uncovered a very interesting case where one piece of the assets of Gazprom was sold for just \$1,200. Whereas, its underlying market value is estimated at \$400 million. That's probably the most significant example that we've been able to find. But it's that kind of activity, which is endemic in Russia, which has largely caused the kind of capital flight we've seen from Russia throughout the 1990s.

Moving on to the next slide, hopefully. What I was trying to get to was Poland. Perhaps we'll abandon the slide show.

In Poland, what we've seen is, in recent years, the securities market regulator has put into place over 61 different motions to try to investigate--I think maybe we'll need some technical assistance here.

In recent years in Poland, they've put in over 61 different applications for investigation of insider trading, self-dealing. Not a single one has been prosecuted or brought to trial, and that's an example of a regulator failure.

In the case of securities trading, which is another one of the drivers that I was showing, in Russia now, twice, the Federal Securities Commission has had to investigate trading volumes on the MICEX, which is their over-the-counter.

And it appears that at least one company, Alor-Invest, was engaged in some very heavy self-dealing, which was intended to inflate the volume of trades on the MICEX floor--very similar, as you might be aware, to the Enron case in the California energy markets where simply speeding

up insider transactions causes the overall volume in the market to increase so much.

In Russia, returning back to that country, we have seen a whole series of weak legal institutions which have undermined what, on paper, appear to be some very good standards. And here, a recent study that I would recommend to you that are interested in the Russian market, by the Codar [ph] Brothers, it was just released yesterday--anybody that would like to have a copy, give me your card, and I'll be happy to send it to you. But the Codar Brothers study has shown that, and actually documented the mechanisms by which blockholders and others are able to influence the court system in order to get favorable readings on their mergers and acquisitions processes.

One of the most famous cases of a similar kind of situation comes from the Czech market. You've probably all heard of the famous investor, Ron Lauder, from the United States, the inheritor of the Estee Lauder fortune.

He and a few other people got involved in the Czech market purchasing one of the major media companies. And through a manipulation of the company shares, the Czech minority partner was able to gain control. And despite

getting a series of legal rulings that this was, in fact, not proper and against Czech law, Lauder and company have been unable, to date, to get that enforced.

Underlying all of this, in many cases, has been the privatization process--the way in which a lot of the state-owned enterprises were brought to the market. And if we did have a slide up here, what it would show you, and I think it may be in your kits there, but what it would show you is that the Polish case, which was perhaps the slowest of the privatization processes, had the best result in terms of shareholder protection and preventing corporate governance failures.

Whereas, the Czech model, which is the voucher system, which then later became popular in Russia, Ukraine, and hopefully will not be continued in its current form, produced a huge series of abuses of insider trading, of abuse of minority shareholders.

And here we have privatization magically appearing.

One solution to this that I would recommend for folks that are interested, we could perhaps talk about it later in our closing session, is that the private sector

corporate governance trust in Kenya, and a few other places, are developing corporate governance for the public sector companies, both those that are being traded with minority participation, as they do in China and a few other countries, but also and especially for those that are intended to be brought to the market. It benefits the state. It also benefits the investor.

The next slide here, hopefully--no, you're going backwards. You need to go forward--you're going backwards. All right.

Well, the next several slides we're going to bring up here were going to be on the respect for the OECD corporate governance principles. And we had taken the ratings that had come from these ROSC Reports on Standards and Practices that Steven mentioned from the World Bank, and here is one here.

To show you across the pattern of Central and Eastern Europe, a plus is a good compliance, an asterisk is moderate, and a dash or a negative sign is weak. And as you can see, the pattern is very scattered, and Central and Eastern Europe has not gotten into compliance.

Down the left-hand side of the column are pretty much both the indicators, but also the solutions for the problems in Central and Eastern Europe. And if we can hopefully go to the next slide, what we'll see here is the key case of the equitable treatment of shareholders. And you'll see insider trading is prohibited, but enforcement varies across the region.

The next slide.

And here is the most important, and that is the disclosure that was brought out earlier today. And, in fact, disclosure, which it seems I'm being disclosed very clearly now, disclosure is at the heart of the whole solution for corporate governance in Central and Eastern Europe and in Russia. There are many ways to get to disclosure. There are a lot of different procedures to do that, but from the government side, but also some of the things that we've talked about from the private-sector side. But getting to disclosure, getting to transparency is the key. And you'll notice here that only Hungary really shows consistently high marks in that respect.

And then if we could move to the next question. Board responsibilities, the role of the board of directors,

which was one of the questions from the floor, are listed here along the left-hand side, the dimensions of that. And you'll see the pattern also are weaker here in the formal legal situation.

Basically, there's three or four dimensions to this--the duty of care, the duty of loyalty, and then the evaluation of risk, which Dr. Toromon [ph] was speaking of earlier, are absolutely key to judging the performance of boards.

If we could go to the next slide.

And here we've got a summary of where Central and Eastern Europe, and by comparison, Turkey shows up here on the overall quantitative rankings. As you can see, there is a lot of work that remains to be done, although I would say that in a short 10-year period, the countries of Central and Eastern Europe have moved very far in bringing in Codes of Corporate Governance, improving the legal environment, and becoming much more active as market participants. The EU discipline that the accession countries will get will help a lot.

If we could go to the next slide.

We didn't have an ROSC ranking, a World Bank ranking, yet for Russia, but there is one that this, in fact, this institute, the Russian Institute of Directors, is working on. And you'll see here as a substitute the risk rankings that they have assigned. And this is, again, another example of what Steven was talking about, where a rating system on corporate governance is beginning to drive the stock market.

Director training and a lot of other things can improve these scores, as we'll perhaps get to later.

Let me leave you with just a success story. There is a company called UCOS. UCOS is owned by one of the famous Russian oligarchs, Mr. Khodorkovski. About four years ago, Mr. Khodorkovski discovered that the value of his control of UCOS was at a fraction of the value of the underlying asset. And so he set about instituting internal corporate governance improvements.

He was able to convince the Investor Protection Association, an independent group that we have been supporting over the years in Russia, that ranks companies from the point of view of the independent investor, that, in

fact, he was serious. And as a result--if we can see the next slide--you can see the value of his stock price.

Now, I'm not going to indicate that every company that has a weak environment can get these kind of results. This is an outlier. It helps if you own oil. But even for companies that don't own oil, if you have undervalued assets, and your performance is not being seen and judged the way you feel it should be seen and judged by the markets relative to the price of your stock, you, too, can get results, perhaps not as dramatic as this, but very high.

And then the last slide is missing. The last slide would have shown you net private capital flows to Central and Eastern Europe. And the problem here has been that Russia, which in terms of GDP should be getting the highest if it were to get its "share," is actually the lowest. And part of that is a result of the fact that the instruments of corporate failure are not there for clearing corporate failure, rather, including bankruptcy procedures, legal investments, legal protection for investments and the like.

pab

Whereas, Poland, which does have very good protections and also mechanisms for liquidating companies, has in fact the highest amount of foreign direct investment.

Perhaps we can bring out more in the Q&A, but that's the overview, Mr. Chairman.

[End of Recorded Segment.]

- - -