

# Governance Premium: The reward for Good Governance



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**Good governance delivers good businesses and good businesses lead to good reputation.  
Good corporate reputation converts good companies into great companies.**

Corporate governance, a phrase that a decade or two ago meant little to all but a handful of scholars and shareholders, has become a mainstream concern—a staple of discussion in corporate boardrooms, academic meetings, and policy circles around the globe. Separation of ownership and control in corporate organizations creates information asymmetry problems between shareholders and managers that expose shareholders to agency costs. Agency costs arise when managers have incentives to pursue their own interests at shareholder expense, i.e., information asymmetry creates a moral hazard problem. Agency costs also arise when investors cannot discern the true economic value of the firm that is partially a function of the indistinguishable quality of management, i.e., information asymmetry creates an adverse selection problem. The lack of transparent financial information results in greater information risk being imposed on the shareholder. Without adequate controls, effective monitoring, and transparent

financial information, rational investors will price-protect against expected agency costs, effectively raising the firm's cost of equity capital. Corporate governance encompasses a broad spectrum of mechanisms intended to mitigate agency problems by increasing the monitoring of managements' actions, limiting managers' opportunistic behavior, and reducing the information risk borne by shareholders.

## What is Corporate Governance ?

Definitions of corporate governance vary widely. They tend to fall into two categories. The first set of definitions concerns itself with a set of behavioral patterns: that is, the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second set concerns itself with the normative framework: that is, the rules under which firms are operating—with the rules coming from such sources as the legal system,

the judicial system, financial markets, and factor (labor) markets. Corporate governance has evolved and grown significantly in the last decade. Numerous countries have issued corporate governance codes, and the recommendations of these codes, that typify "good" corporate governance, undoubtedly contribute towards increased transparency and disclosure. There are actually many different definitions of corporate governance but they all address the following elements: systems of controls within the company, relationships between the company's board/shareholders/stakeholders, the company being managed in the interests of the stakeholders, greater transparency and accountability to enable users of corporate information to determine whether the business is being managed in a way that they consider appropriate. Put simply, corporate governance is a framework by which a company is controlled and directed in the most effective way. It involves a set of relationships between a company's management, its board, its shareholders

and other stakeholders.

Embedding an efficacious corporate governance framework is really a function of how well its need is understood by the three key stakeholders - Management, the Board and the Shareholders. Needless to say, tone-at-the-top is the most important ingredient. The importance of good corporate governance is that bit more, also because of the fiduciary duty towards customers and other stakeholders, including investors, and for the trust they repose in a company. Because in addition to asking 'what a company does', people today are also asking and are more interested in 'how it does it'.

One important skill set that every governance manager must possess, is the ability to understand the business, because there is no one-size-fits-all solution for governance. While the basic key tenets remain the same and constant, the framework needs to be tailor-made for a best fit.

Some key cornerstones of effective corporate governance:

- **Transparency:** Transparency is a critical pillar of corporate governance which ensures that the processes and transactions of a company are open to scrutiny and verification and that the Company has nothing to hide; it means the Company has made meaningful disclosures, keeps all stakeholders updated and complies with applicable legal requirements.
- **Accountability:** Accountability is a trait that helps take all actions reach the planned goals and objectives. It makes management responsible for its actions – not only for the failings, but also for all accomplishments. Positively

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taken, accountability brings in motivation and drives employees across the pyramid.

- **Diversity at the board level:** A diverse Board is a strong Board. While many countries, including India have mandated participation of women on Boards, the gender diversity continues to be in favor of men. Studies have shown that companies

with women on Boards, perform better, and not just in terms of profitability. Not only gender diversity, but a diverse skill set of directors also brings in better ideas and judgement to the Board table. A healthy mix of independent and executive directors is also essential, so that management and the Board work at their respective levels and there is no overlap of authority.

- **Flow of information:** It's a known fact that more and quality information makes better decisions. It is the responsibility of the management to ensure sufficient and relevant flow of information to the Board, which helps in effective decision making. Regular disclosures to Customers, Regulators, Shareholders etc. also increases confidence and says much about the fairness and transparency levels of the company.
- **Control functions:** It is important to have a clear demarcation between the three lines of defence within an organization - business, risk & compliance and internal audit, which will ensure that conflict of interest situations are handled effectively and there is a proper mitigation of risks. All well governed companies also require to have in place a mechanism for employees and others to raise concerns, around irregularities that they notice and a defined framework to handle these concerns.
- **Board evaluation:** Stakeholders are increasingly interested in Board evaluation results, which is a direct indicator of effectiveness of a Board and its accountability. An effective evaluation

process, helps the Board, its committees and individual directors perform to their optimum capabilities.

- **Effective delegation:** The Board needs to have a well-defined charter/terms of reference, which would enlist its roles and responsibilities and the Board room processes. The Board must also effectively delegate responsibilities to its committees, so as to allow adequate time to discharge its strategic responsibilities and provide the directional advice.

## The Governance Premium

Premium arises when a company shows qualitative improvements in vital aspects of corporate governance such as transparency and disclosures, shareholder rights, board structures, duties and responsibilities and stakeholder engagement. Good corporate governance won't just keep your companies out of trouble. Well-governed companies often draw huge investment premiums, get access to cheaper debt, and outperform their peers. Does good governance pay? In theory, it should increase the market valuation of companies by improving their financial performance, reducing the risk that boards will make self-serving decisions, and generally raising investor confidence. Indeed, surveys suggest that institutional investors will pay as much as 28 percent more for the shares of well governed companies in emerging markets. World is changing more rapidly, so automatic pilot isn't good enough any more. "Good governance" and most of all adaptability have become more important. It took years for the market to comprehend the phenomenon of

a "governance premium". With some of the allegedly "well-governed" companies erring on the governance front, is "governance premium" fact or fiction?

## Why Is Corporate Governance important?

Commitment to good corporate governance—well-defined shareholder rights, a solid control environment, high levels of transparency and disclosure, and an empowered board of directors—make a company both more attractive to investors and lenders, and more profitable. Simply put: it pays to promote good corporate governance. Investors will pay for Good Governance. Investors say they highly value corporate governance. Numerous studies conclude that well-governed companies worldwide perform better in commercial terms. Adopting best corporate governance practices provides:

- Improved access to external financing;
- Lower cost of capital;
- Improved operational performance;
- Higher company valuation and share performance;
- Reduced risk of corporate crises and scandals.

Research by McKinsey, however, shows that investors the world over are looking for high standards of good governance and will pay a premium for shares in companies that meet them. Investors say they would pay more for the shares of well-governed companies. It is hard to measure the market impact of these hypothetical premiums, but there is little doubt that

good governance does make a difference.

## Research findings

- Well-governed firms in Korea traded at a premium of 160 percent to poorly governed firms, a study by Korean and US researchers found.
- An ABN/AMRO study showed that Brazil-based firms with the best corporate governance ratings garnered P/E ratios that were 20% higher than firms with the worst governance ratings. The study also showed that Brazilian firms with above-average corporate governance had ROEs that were 45% higher and net margins that were 76% higher than those with below-average governance practices.
- A study of Russian firms showed that a worst-to-best improvement in corporate governance predicted an astronomical 700-fold (70,000%) increase in firm value. The study's sample size was small (21 firms), so it's unlikely that such a huge increase would occur in a larger, more representative sample. However, the study still demonstrated a correlation between improved corporate governance and firm value.
- A study of S&P 500 firms by Deutsche Bank showed that companies with strong or improving corporate governance outperformed those with poor or deteriorating governance practices by about 19% over a two-year period.
- A Harvard/Wharton study showed that if an investor purchased shares in US firms with the strongest shareholder

rights, and sold shares in the ones with the weakest shareholder rights, that investor would have earned abnormal returns of 8.5 percent per year. The study also found that U.S.-based firms with better governance have faster sales growth and were more profitable than their peers.

- A study of the 100 largest emerging market companies by Credit Lyonnais Securities Asia (CLSA) showed that companies with the best corporate governance in each of a large number of emerging market countries had eight percentage points higher measures of EVA (economic value added) than firms in their country average.
- An ABN/AMRO study (previously mentioned) showed that Brazilian firms with above-average corporate governance had ROEs that were 45% higher and net margins that were 76% higher than those with below-average governance practices.
- The size of that premium varies from country to country: It is as high as 27.1% in Indonesia, 25.7% in Thailand, 24.2% in South Korea and 20.2% in both Japan and Taiwan. Outside Asia, well-governed companies in countries such as Venezuela and Colombia would attract premiums of 27.6% and 27.2% respectively, while the premium is as low as 18.3% in the U.S. and 17.9% in the U.K.
- A new survey by international management consultancy McKinsey & Co. shows that institutional investors are prepared to pay a premium for good corporate governance. International investors, the survey found, are prepared to pay



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a markup of more than 20% for shares of companies that demonstrate good corporate governance.

### Measuring corporate governance practices

One of the major challenges of corporate governance research since its inception has been the definition of measures of 'good corporate governance', i.e. of corporate governance mechanisms that lead to financial efficiency, social legitimacy or more generally goal attainment. It has become increasingly common in financial economics research to use commercially provided corporate governance ratings to measure the 'quality' of the given companies. There is a lack of theory that could guide us in our choices regarding what to include in an index and what not, is even more important regarding the weighting of different variables once they are included. Another concept is the bundles approach which postulates that firm-level corporate governance mechanisms may not matter individually, but develop their effects in combination with other mechanisms. Thus interactions between



CG mechanisms are crucial. Theoretically, most of the existing literature expects good CG will increase performance related to a firm's 'valuation', i.e. stock returns, shareholder value, Tobin's Q or share price, because investors are ready to pay a premium for stocks of companies that credibly commit to respecting shareholders' rights.

Standard & Poor's recently launched a new service, Corporate Governance Scores, to evaluate the corporate governance practices of companies. The analysis evaluates corporate governance practices at individual companies. Using a synthesis of the OECD's and other international codes and guidelines relating to corporate governance practices as cornerstones of the scoring methodology, Standard & Poor's assigns scores to a company's overall practices and four individual components (ownership structure, financial stakeholder rights and relations, financial transparency and information disclosure, and board structure and process). In all, approximately 130 factors of a company's corporate governance practices are evaluated using both public and

non-public information. The extent to which, in the opinion of Standard & Poor's, a company adopts and conforms to international codes and guidelines of good corporate governance practices, is reflected in the award of a Corporate Governance Score ('CGS') on a scale from CGS-1 (lowest) to CGS-10 (highest). In addition, the four components described above all contribute to the CGS and receive individual scores from 1 (lowest) to 10 (highest).

Institutional Investor Advisory Services (IiAS), a proxy advisory firm, has developed an Indian Corporate Governance Scorecard that helps identify right companies for long-term investment, based on their corporate governance standards. The scorecard methodology was first published in December 2016 to evaluate Sensex firms. The Indian Corporate Governance Scorecard Methodology is a set of 70 questions based on the G20/OECD Principles of Corporate Governance. These principles are globally accepted benchmark for corporate governance. Later on, IiAS, International Finance Corporation (IFC) and BSE have

come together and extended the scope of scoring to BSE 100 firms, in 2017.

The top 10 companies in terms of corporate governance standards, according to the methodology in 2017, in alphabetical order, were Bharti Airtel, Bosch, Crompton Greaves Consumer Electricals, HDFC Bank, Hindustan Unilever, Infosys, Mahindra & Mahindra, M&M Financial Services, Marico and Wipro. By the study, Infosys and HDFC Bank, which were in the leadership category even in 2016, retained their status. The sharpest increase in scores, among the ten, was observed for Wipro, for its better disclosures on the website, in the annual report, on aspects of board evaluation, leadership experience and succession planning. The corporate governance scorecard looks beyond compliance by focusing on the substantive issues relating to governance practices, disclosures and control, thereby helping the market move beyond a check the box approach.

It would be wrong to conclude from these surveys that good corporate governance is simple. An effective board of directors involves a combination of the right people, the right structure, and the right processes. Determining the appropriate combination for each individual company is the real challenge. And policy changes are likely to affect different countries differently, depending on existing cultural and economic practices. Each company and country should consider its own circumstances before choosing the best way to improve corporate governance. Shareholders are growing increasingly active in the United States and elsewhere because they believe that

better corporate governance will bring them higher rewards. Yet so complex is the relationship between shareholder activism and higher returns that repeated attempts by academics to show an irrefutable link between the two have failed. The size of the premium that institutional investors say they are willing to pay for good governance seems to reflect the extent to which they believe there is room for improvement ... . In Asia and Latin America, still higher premiums reflect the need for more fundamental disclosure of information, and stronger shareholder rights.

## Conclusion

Research has indicated inconclusive results on the existence of corporate governance premium. While some mechanisms of corporate governance correlated well

with stock market valuations, others had poor correlations. Cynics of corporate governance have always wondered why there is such a gush of financial flows into China, where the pillars of corporate governance and institutional mechanisms are relatively weak. The answer is that corporate governance is not the only criteria for investment; and the quality of investors and their behaviors may differ between China and, say, India. Research is increasingly showing that good corporate governance can lead to improved share price performance. What's more, the evidence is that the potential for out performance is greatest in developing economies. Studies also show that investors are keener to invest in well-governed companies.

Companies and policy makers should take heed. If companies

could capture but a small proportion of the governance premium that is apparently available, they would create significant shareholder value. Moreover, McKinsey warns that those companies that fail to reform will find themselves at a competitive disadvantage when it comes to attracting capital to finance growth; High governance standards will prove essential to attracting and retaining investors in globalized capital markets, while failure to reform is likely to hinder those companies with global ambitions. The engagement of the board has to be qualitative with much deeper data availability, analytics and reflections, and a sharper focus on the Board's strategic role with appropriate allocation of time may help in optimal value creation and sustainability over a period of time. ■

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