

# WHO CAN YOU TRUST?

## *Corporate governance risk in emerging markets.*

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The Organisation for Economic Co-operation and Development (OECD) outlines the function of a corporate governance structure as one that "...specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs." Less formally, however, we can define it as the relationship of a company to its shareholders or, more broadly, to society itself. Given such definitions, investors must recognize that there is a potential cost when management fails to treat shareholders, or the environment and world around them, with respect.

An optimal corporate governance system requires a strong and functional legal system in which to operate. Good governance systems also need countries that have introduced legislation with effective legal tools for the protection of shareholders.

Within emerging markets, corporate governance is a very important issue because such markets typically have rudimentary and developing legal systems as well as a poor historical record in accounting transparency. However, substantial progress has been made in recent years in many emerging market countries, such as Mexico and South Korea where minority shareholder protection has been improved. But, even with such improvements, large multinationals still have the ability to take advantage of poor tag-along rights during corporate changes in ownership, enriching themselves at the expense of emerging market minority shareholders. Since externally available research in this area is sparse at best, it is important for emerging market investors to conduct their own research and use corporate governance risk analysis as an integral part of their overall research process.

Within the last several years, there have been numerous examples of poor corporate governance within the emerg-

ing markets. For example, Telesp Cellular Part ("TCP") was taken over by Portugal Telecom between 2000 and 2001 at discounted valuations when Portugal Telecom enacted a number of aggressive rights offerings. In 2003, TCP also attempted to take advantage of limited tag-along rights to acquire Tele Centro Oeste at discounted valuations at the expense of shareholders. Similarly, Compaq Digital Global Software, a 51% subsidiary of Hewlett Packard (HPQ), was merged with HPS ISPO, a 100%-owned subsidiary of HPQ in 2003. The deal was structured so that HPQ's 100%-owned subsidiary received much higher valuations than the 51%-owned subsidiary.

Another example of poor corporate governance occurred when SK Corp., an energy company in South Korea, underwent a massive \$5 billion fraud that included a cost of \$850 million to SK Corp itself. Finally, the well-known case of Gazprom involved asset stripping by the chairman, who sold these assets to family members and political allies at severely discounted prices.

### **Setting good examples**

An example of more favourable corporate governance is Ceska Sporitelna in the Czech Republic, which was taken over by Erste Bank at fair valuation to all shareholders. Wimm-Bill-Dann, the Russian dairy and fruit juice company, provides an example of full disclosure in its prospectus of some of the activities of its controlling shareholders.

Ultimately, the greater volatility inherent in emerging market equities means that owners of companies are often unwilling to relinquish equal rights. As a result, corporate governance practices are sacrificed. One solution could encompass equal shareholder rights in return for a larger and more dedicated investor base, leading to greater liquidity and reduced volatility. This could be done through the tax-incentivization of pension plans, for instance.

Until then, investors ought to ask appropriate questions of governments and regulators and be sure to incorporate corporate governance as an integral part of risk analysis. ■