



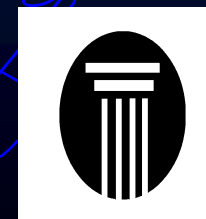
# **3rd Eurasian Corporate Governance Roundtable**

## **Shareholder Rights, Equitable Treatment and the Role of the State**

**April 17-18, 2002**

hosted by  
**Securities and Stock Market State Commission of Ukraine**  
**State Property Fund of Ukraine**  
**PFTS**

with the support of  
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**The Global  
Corporate  
Governance  
Forum**

# Shareholder Treatment, Value Creation and Corporate Governance

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*Kiev, April 2002*

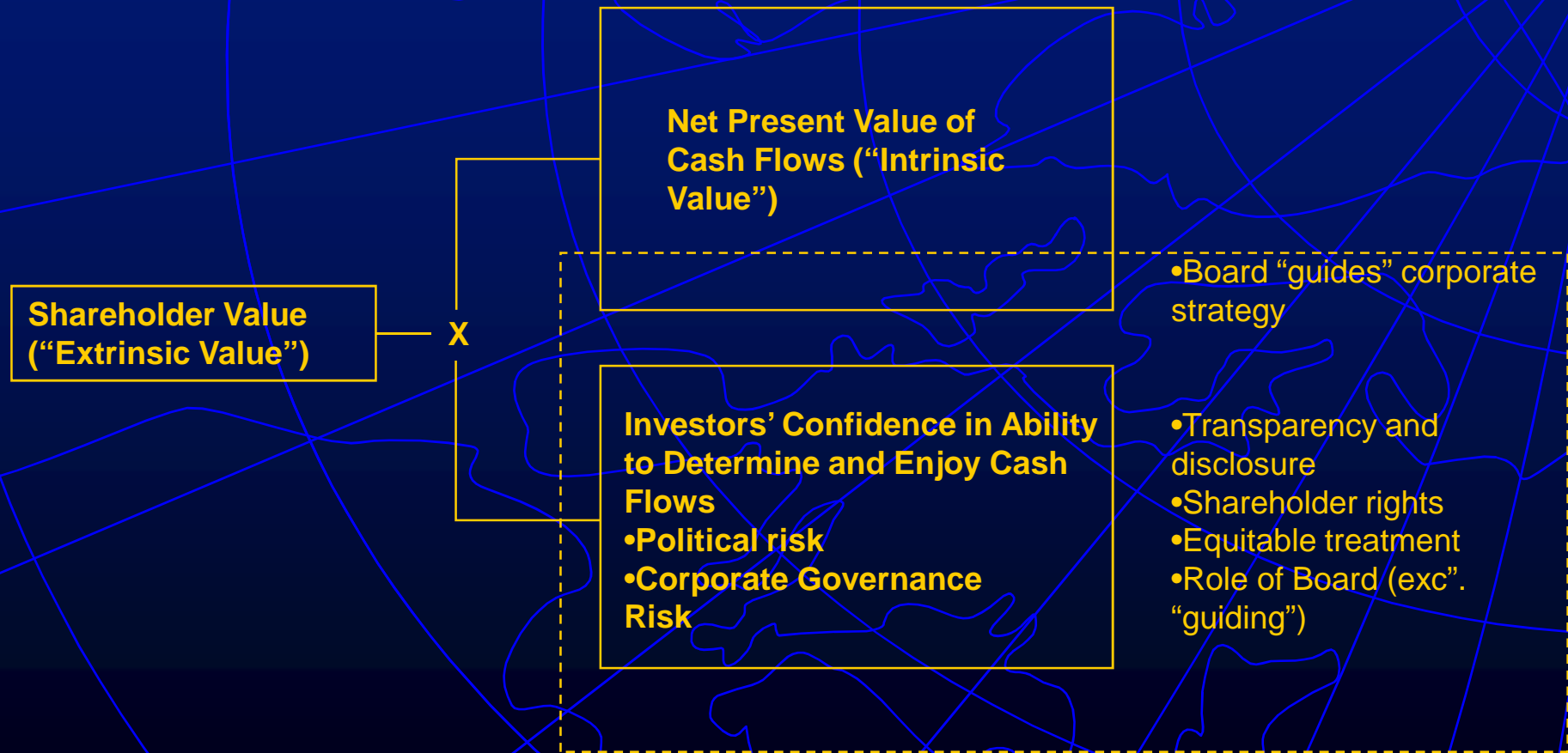
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## Respect for shareholder rights is implemented by rules but is driven by economic incentives. Policy makers must not only establish good rules but promote the right incentives

- Good corporate governance does not so much create shareholder value as guard against its destruction
- This destruction can be substantial and is greatest where the need for equity capital is least
- In the long term, the need for equity capital will drive better corporate governance
- However, certain situations that diminish the need for equity (e.g., state ownership, under-priced credit, market bubbles, looming insolvency) create dis-incentives to good corporate governance
- Policy makers need to identify these situations, to discourage them where possible and to increase oversight/investigation where they cannot be discouraged

# Good corporate governance does not so much create shareholder value as guard against its destruction

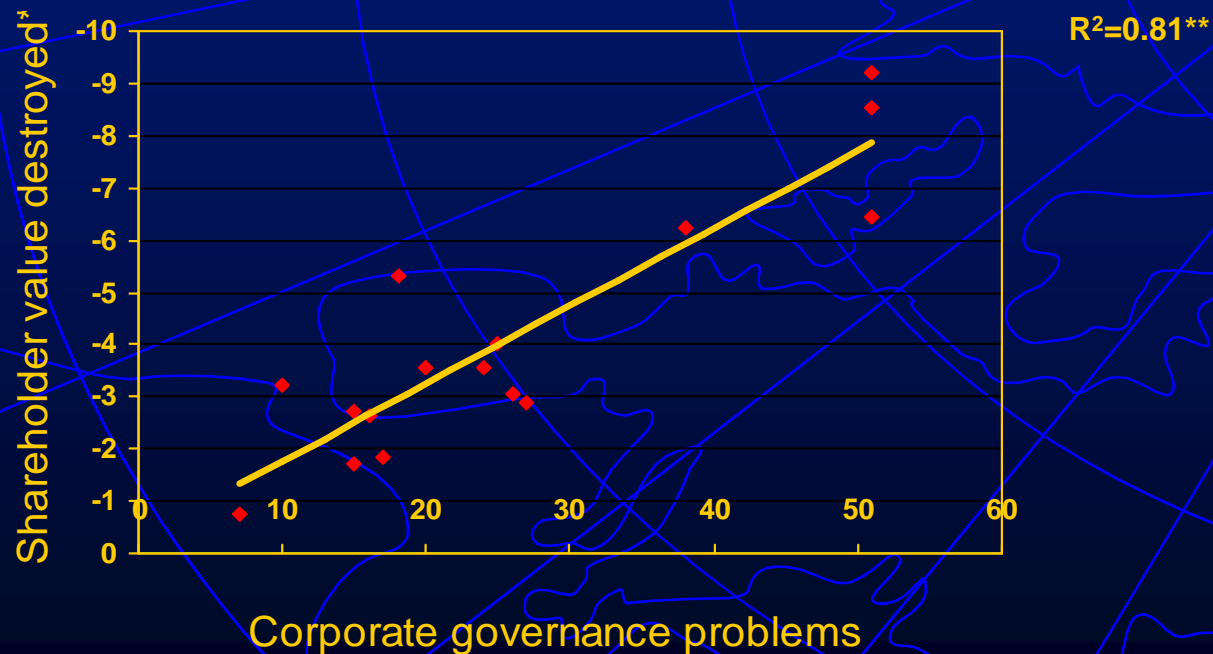
## Corporate Governance and Shareholder Value



Source: OECD Analysis

## Research strongly correlates lack of corporate governance with shareholder value destruction

Regression: Shareholder Value Destruction on Bad Corporate Governance



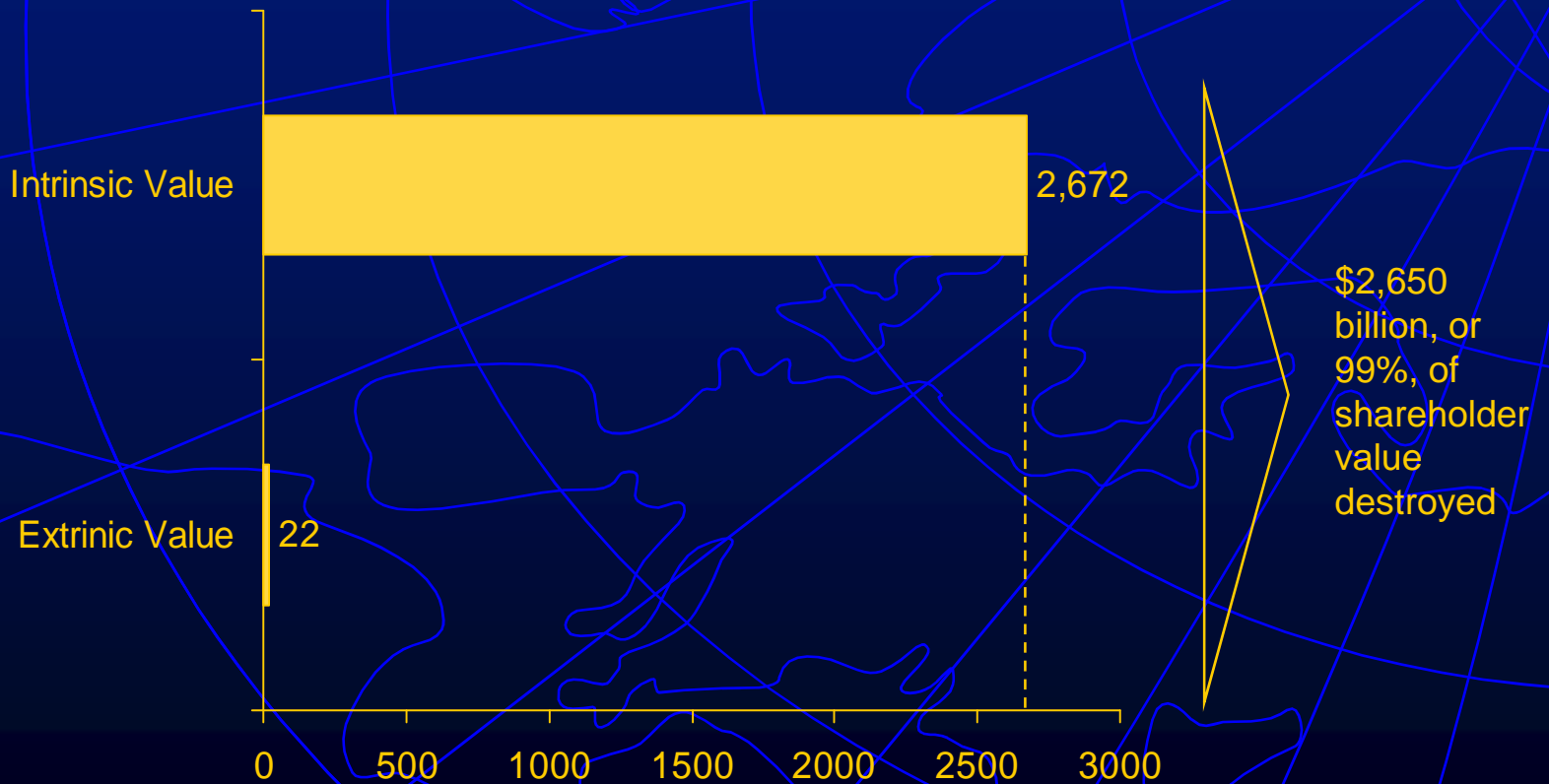
\* In(actual/potential market capitalization)

\*\* Statistical significance (t = -7.63)

Source: Bernard Black, "Does Corporate Governance Matter? A Crude Test Using Russian Data," Univ. of Pennsylvania Law Review, Vol. 149 (2001), pp. 2131-2149 (SSRN Release)

# Shareholder value destruction from bad corporate governance can be substantial

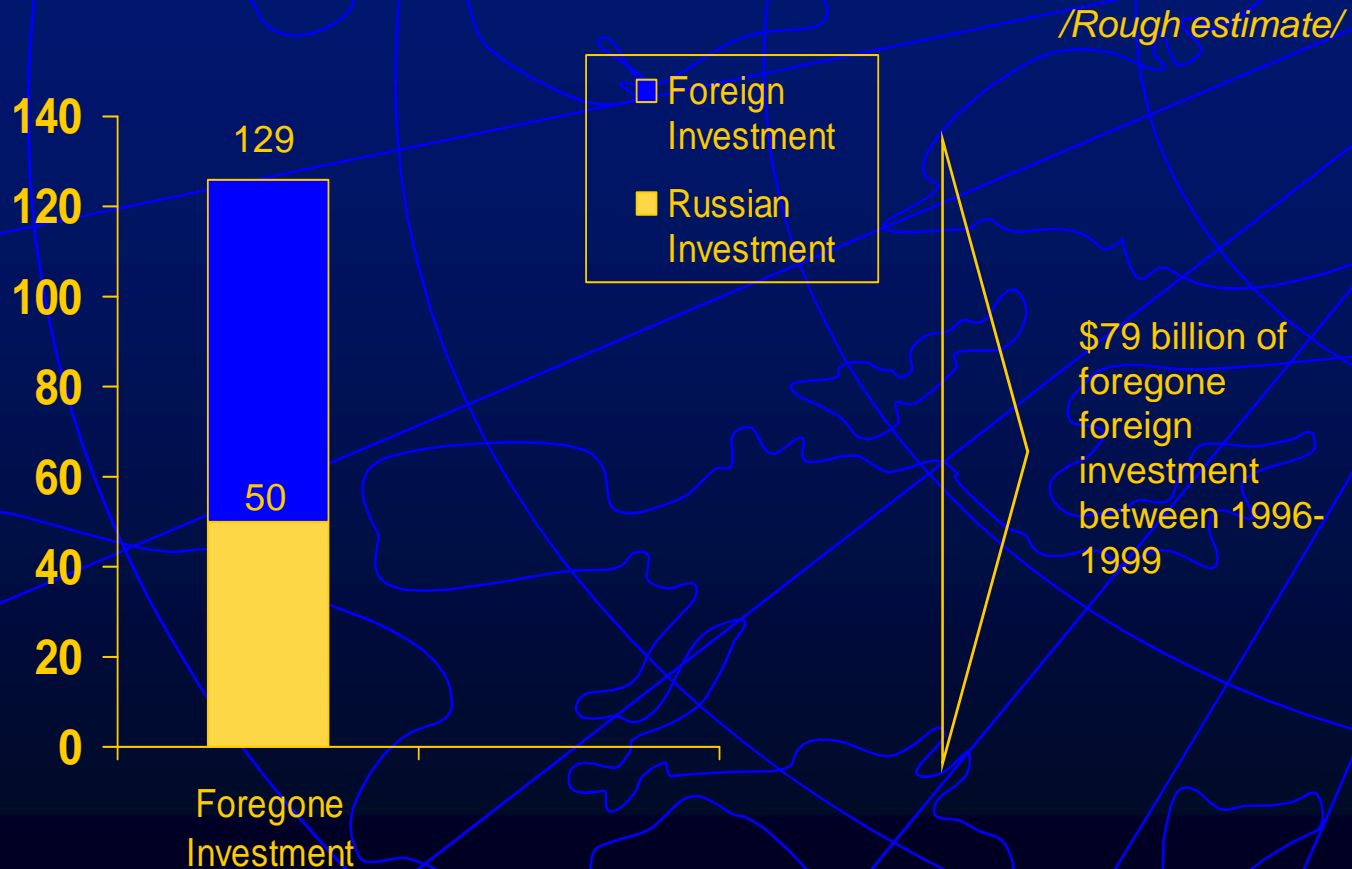
Shareholder Value Destruction in 16 Leading Russian Companies 1999\*  
US\$ billions



\* Adjusted for political risk  
Source: Bernard Black

# Destroying shareholder value also means missing out on large amounts of foreign investment

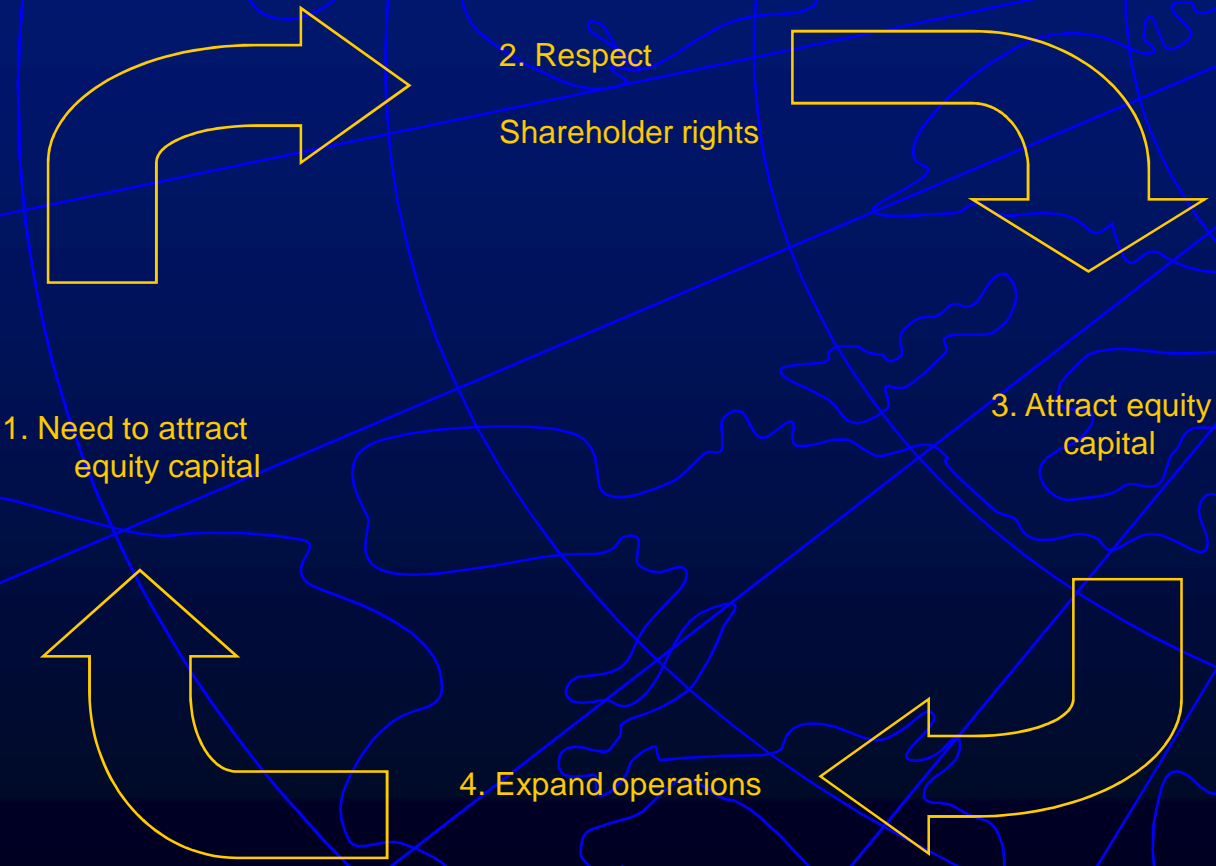
Foregone Investment Opportunity in 16 Leading Russian Companies, 1996-1999\*  
US\$ billions



\* Assumes P/E of 20; ROE of 20%; accumulated depreciation/depletion of 27%; reinvestment through 75% equity capital; investment of half of all Russian capital flight (\$25 billion/year) in 16 companies  
Source: Bernard Black, Preliminary OECD analysis

# Respect for shareholder's rights is driven by the continuing need to attract equity capital to finance expansion

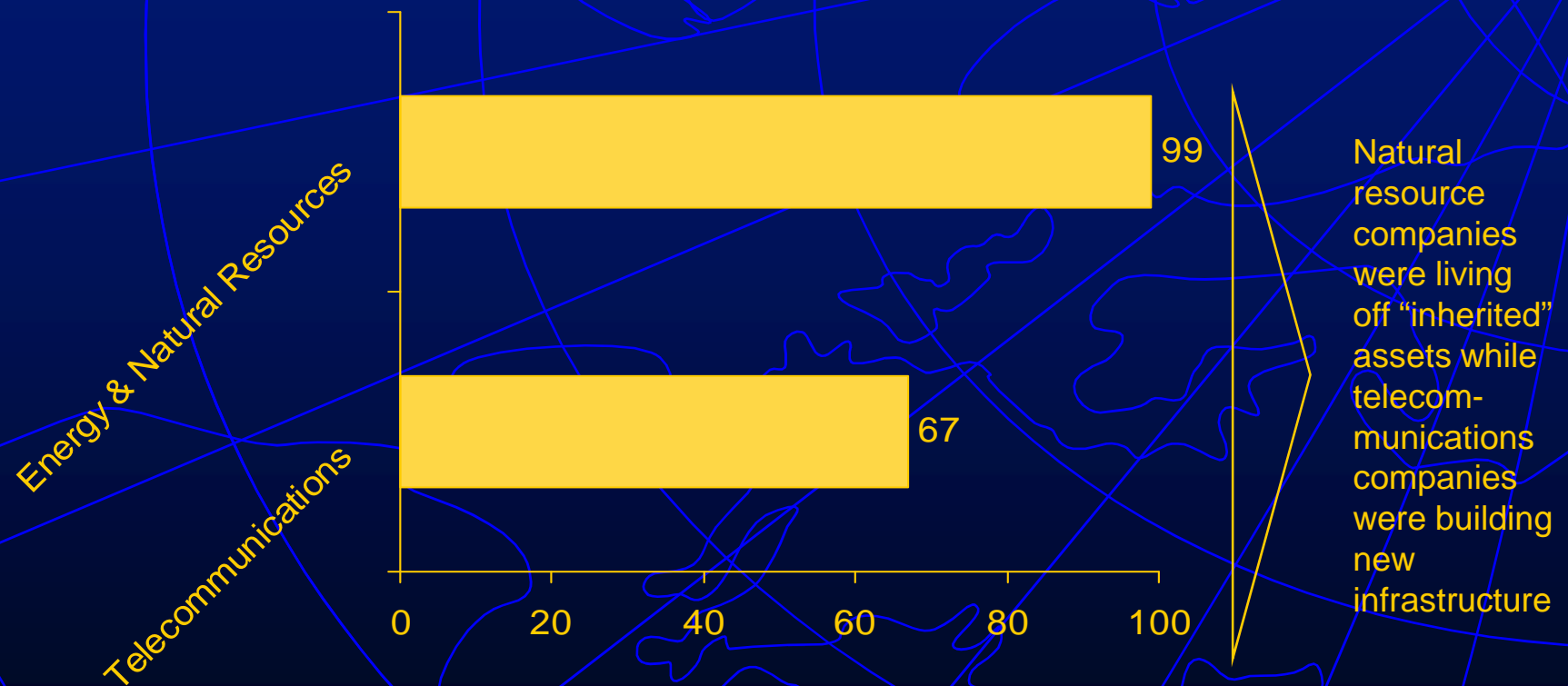
Virtuous Cycle?



Source: OECD Analysis

# In the short term, destruction is greatest -- and corporate governance is worst -- where the need for equity capital is least

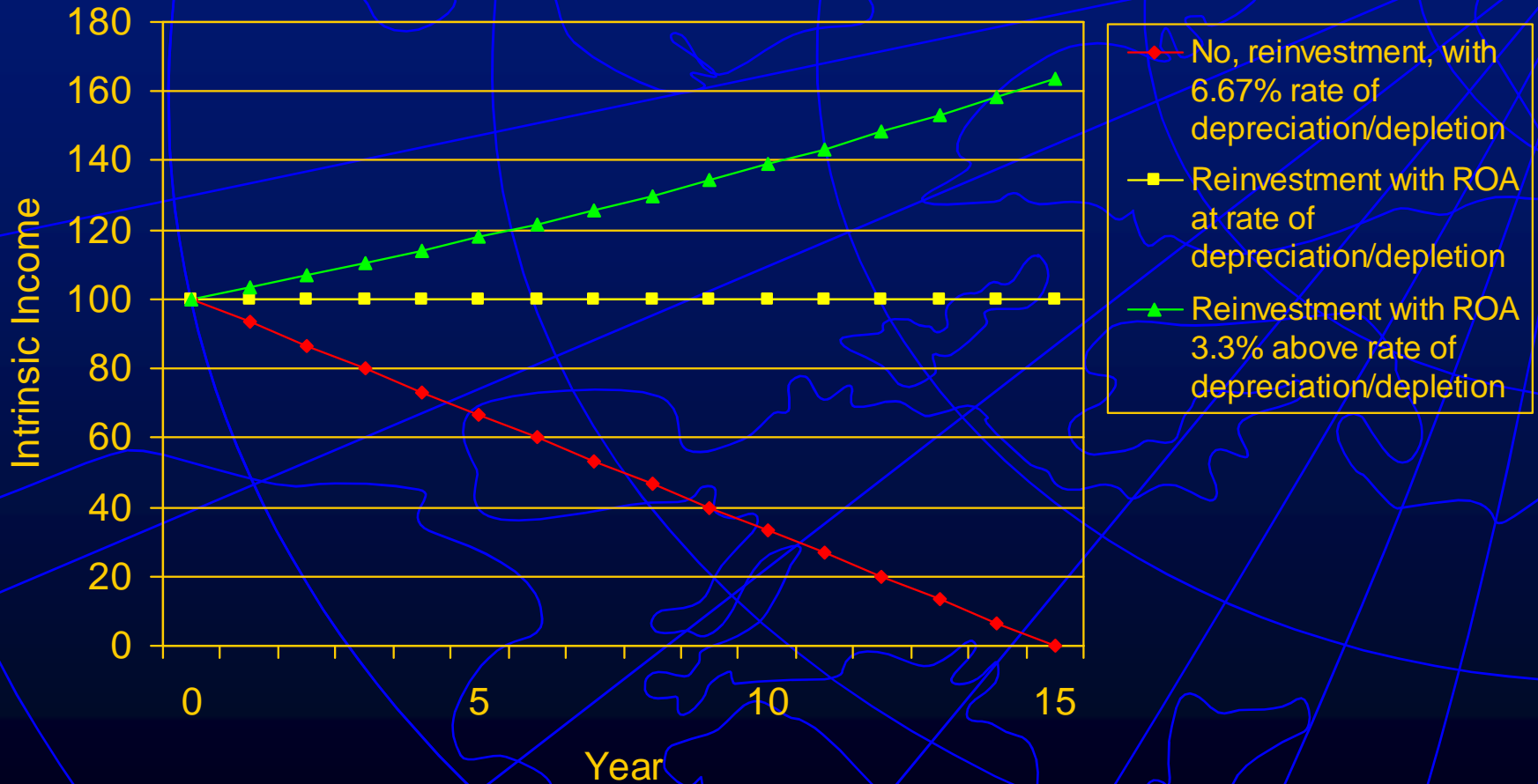
Shareholder Value Destruction in 16 Leading Russian Companies by Sector, 1999\*  
Percent



\* Adjusted for political risk  
Source: Bernard Black

# In the longer term, however lack of re-investment or new investment will diminish the cash flows that can be diverted

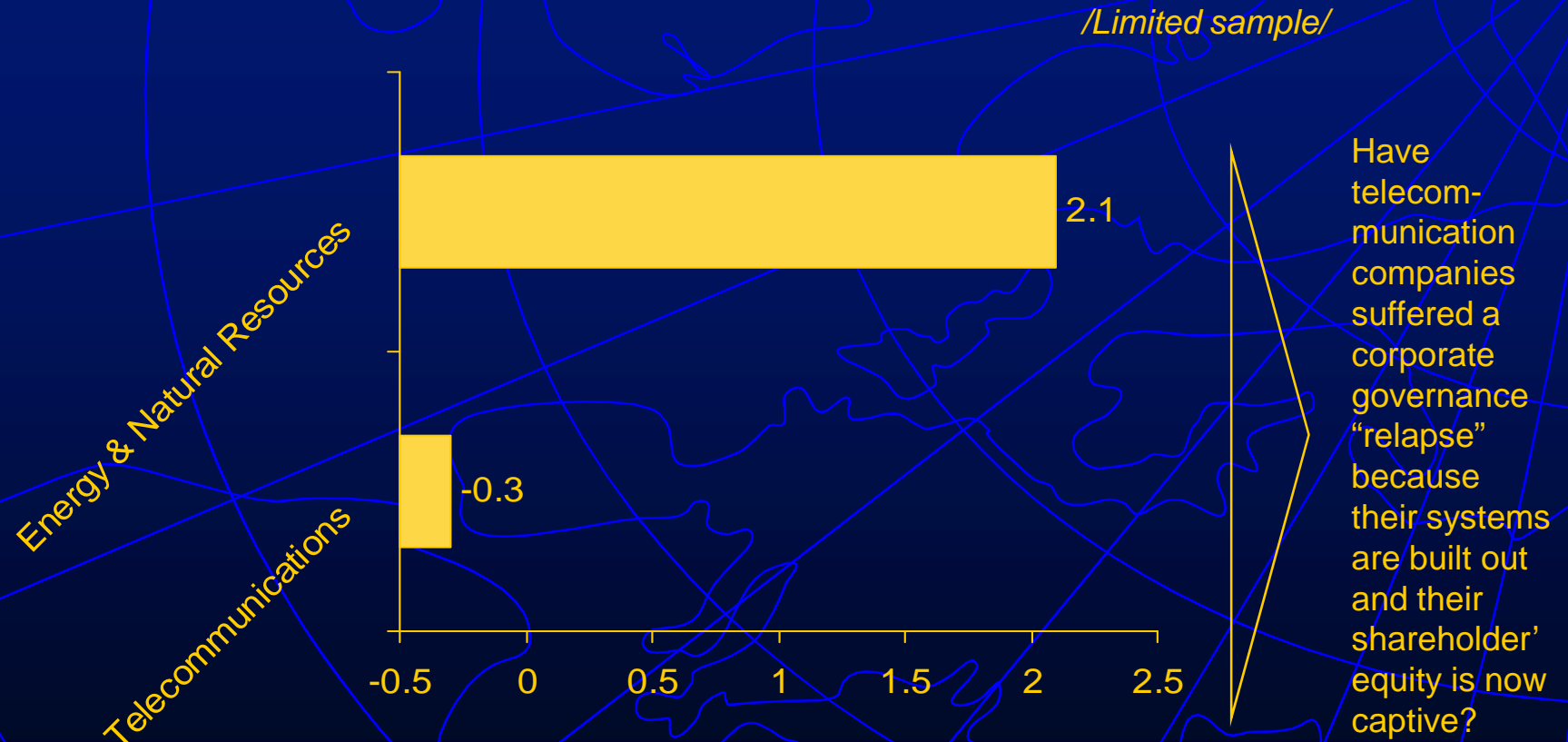
Hypothetical projection\*  
Percent of base year's intrinsic income



\* Assumes 6.67% annual depreciation/depletion; 10% return on assets ("ROA"); no new debt financing  
Source: OECD Analysis

# Consequently, as companies face the need to reinvest earnings and/or to attract new equity capital, corporate governance improves, but...

Change in Corporate Governance Ratings among Leading Russian Companies, 2000-2001  
Percent



Source: Institute of Corporate Law and Corporate Governance

# ...The virtuous circle can be broken when a company can fully fund operations/expansion from retained earnings...

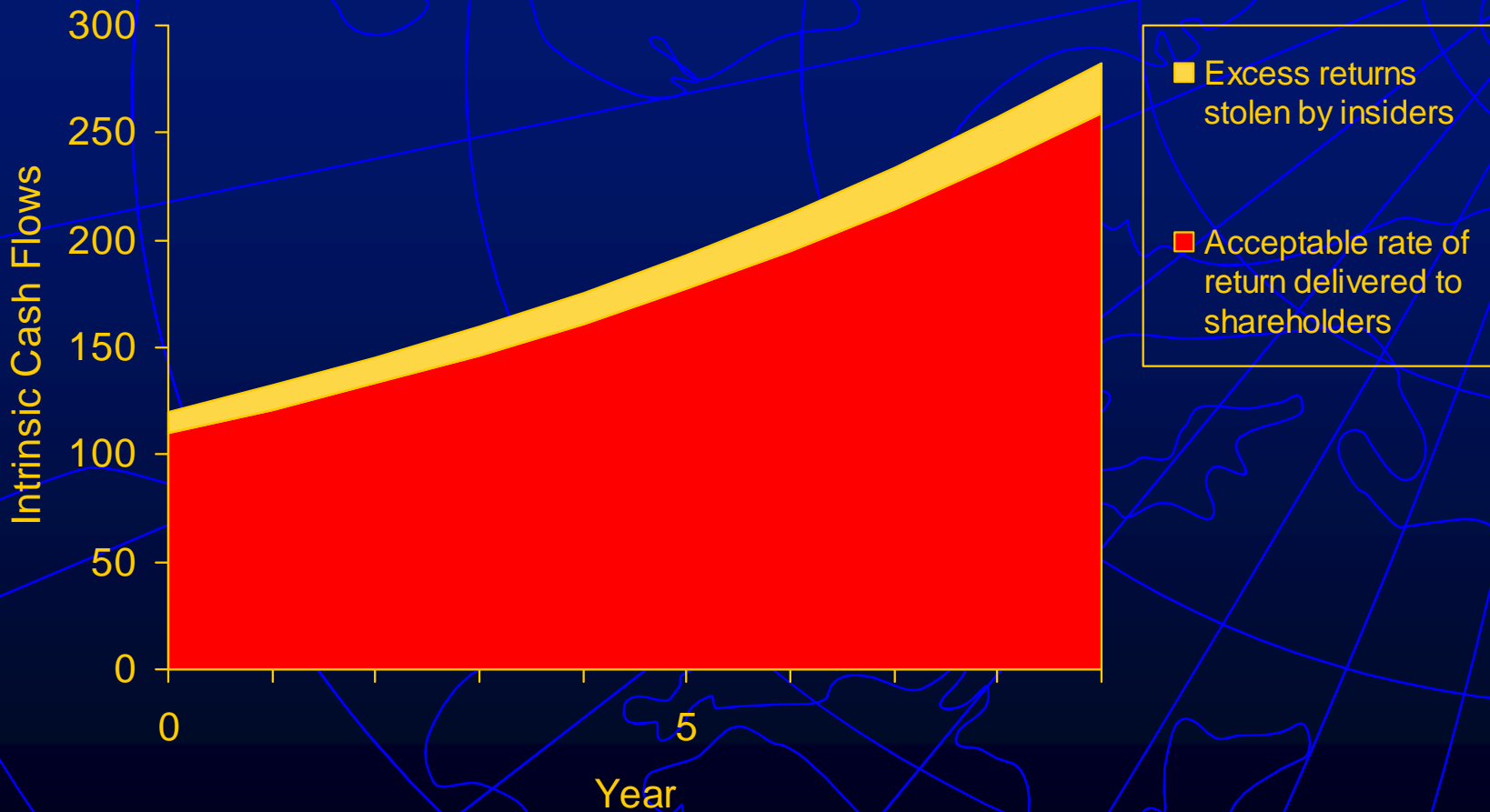
Virtuous Cycle?



Source: OECD Analysis

**Or where, as in state-owned (or subsidised) enterprises and “hot” private companies, insiders can provide an acceptable rate of return to shareholders (including the state) while “skimming” excess cash flows.**

Hypothetical projection\*



Source: OECD Analysis

# To promote shareholder rights and equitable treatment, policy makers must therefore understand the economic incentives that drive corporate governance and focus in particular on situations where these incentives break down

## Challenges for Policy Makers

### Situation

State Ownership

Subsidised non-equity capital

Fully funded, "hot" and potentially failing companies

### Ideal Responses

- Privatised
- Require market rates of return
- Establish independent board oversight
- Eliminate state credits
- Improve banking oversight
- Phase out trade protections
- Strengthen auditors and outside directors
- Encourage market for corporate control
- Strengthen insolvency law and quality of investigations

### Practical Responses

- Encourage cumulative voting
- Prohibit related party transactions
- Prohibit sales outside the ordinary course of business to companies whose ownership cannot be traced
- Use transfer-pricing rules to identify potential abuse
- Train/develop auditors, judges and investigators

Source: OECD Analysis

# While egregious transparency and disclosure failures hid Enron's true condition, its demise resulted from bad business decisions that even a diligent board might not have prevented

## Enron and Shareholder Value Destruction



\* Assumes residual value of 50%  
Source: OECD Analysis