



HERMITAGE CAPITAL MANAGEMENT

CORPORATE GOVERNANCE AND EFFICIENCY OF RUSSIAN COMPANIES FROM STOCK MARKET PERSPECTIVE

Vadim Kleiner

PhD (Econ.)

Senior Researcher

Central Economics and Mathematics Institute of

Russian Academy of Sciences

Hermitage Capital Management

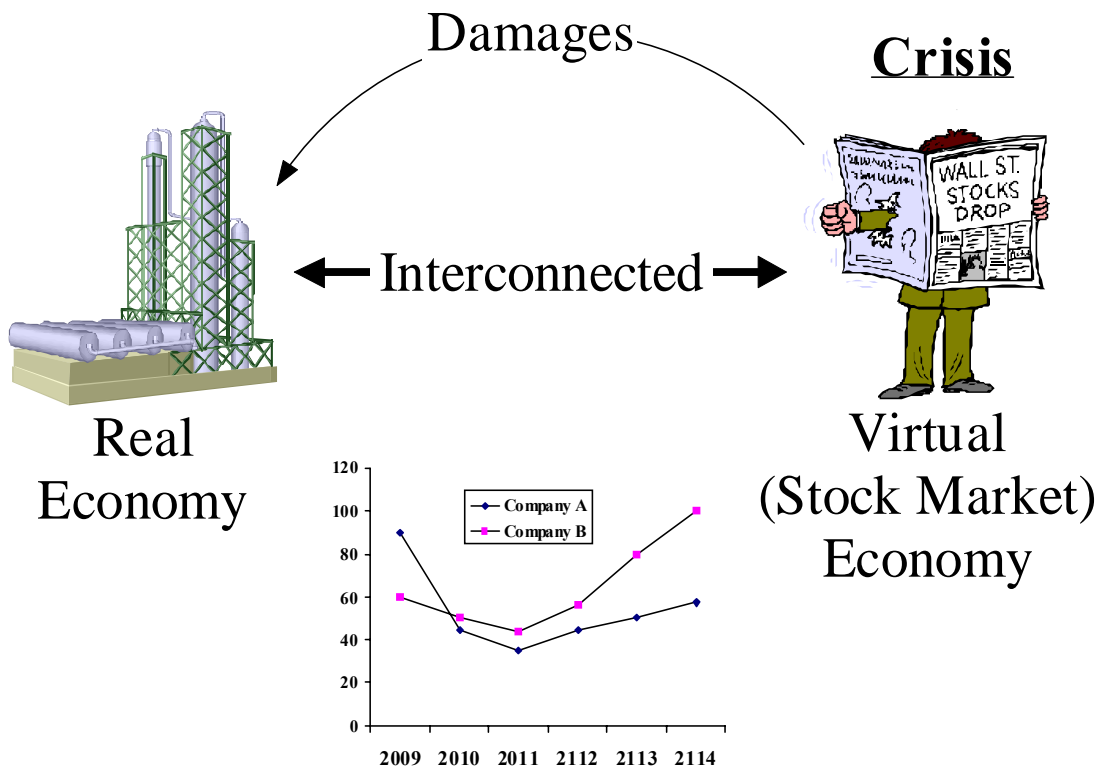
March 2009

Corporate Governance in New World of Crisis



HERMITAGE CAPITAL MANAGEMENT

Global Economic Crisis strengthened the dispute between the proponents and opponents of virtual (stock) economy and as a result bring to the agenda discussion on whether Corporate Governance is needed at all



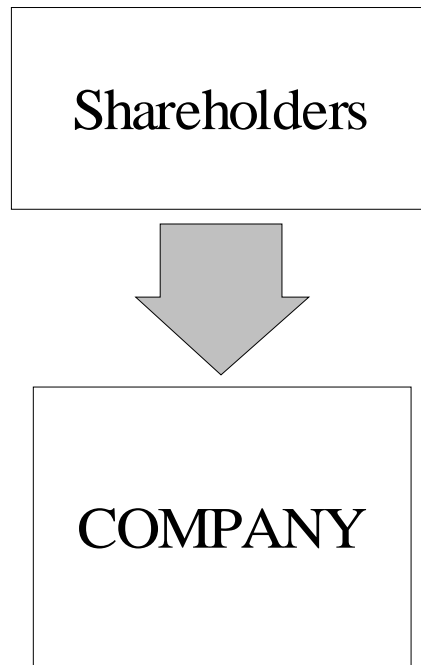
1. Virtual Economy damages real one
2. They are interconnected and have mutual influence
3. Companies with better corporate governance will recover faster

Classical definition of Corporate Governance and its drawbacks



HERMITAGE CAPITAL MANAGEMENT

“The system by which companies are directed and controlled for the benefit of shareholders*”



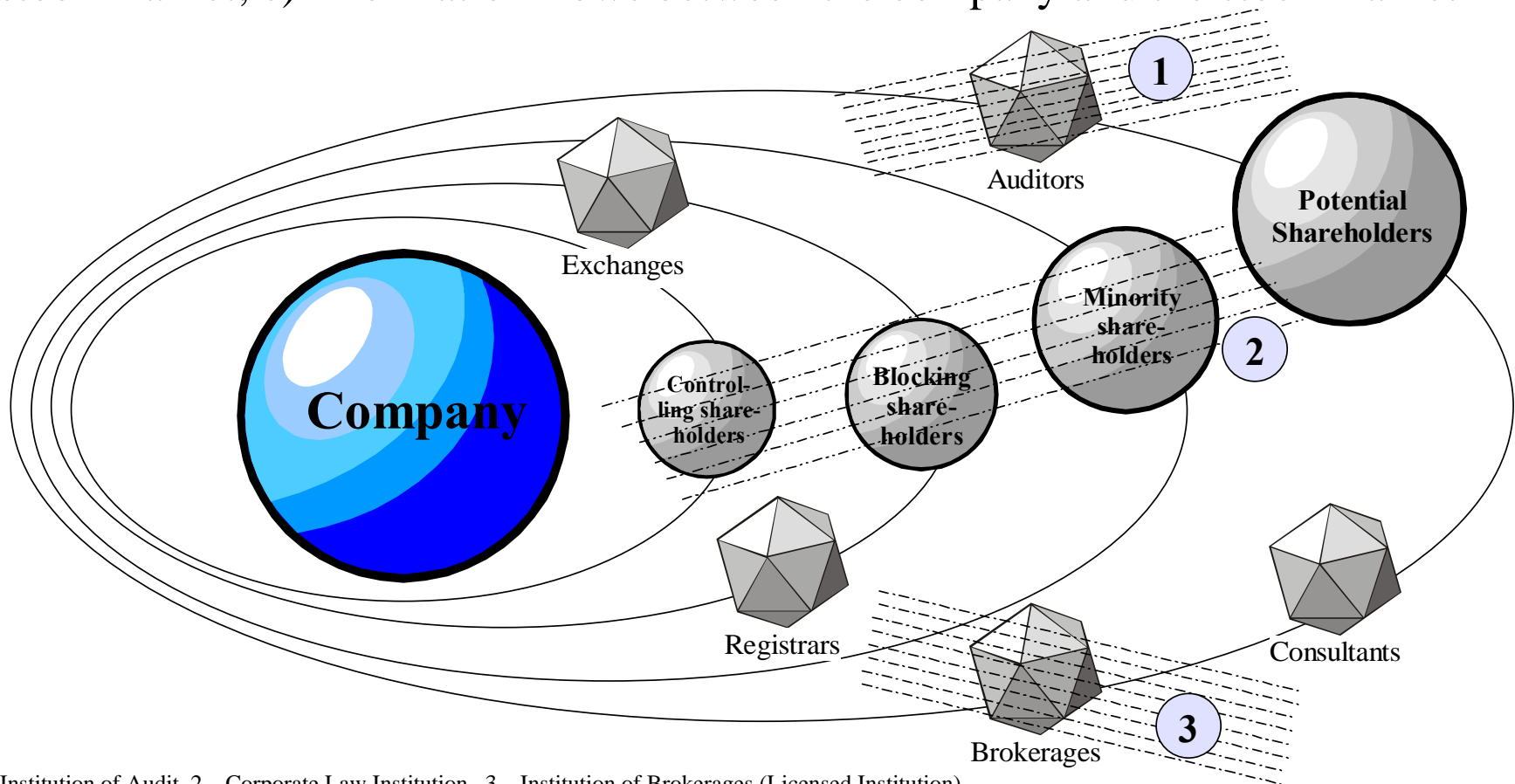
- What is the role of market intermediaries?
- What is the role of market institutions?
- How the dynamic nature of shareholders (today shareholders, tomorrow – not) is reflected?

New Definition of Corporate Governance



HERMITAGE CAPITAL MANAGEMENT

Corporate Governance is a system of relationship between a public company and the stock market which defines: a) managerial efforts directed from shareholders and their groups to the company; b) financial flows between the company and the stock market; c) information flows between the company and the stock market



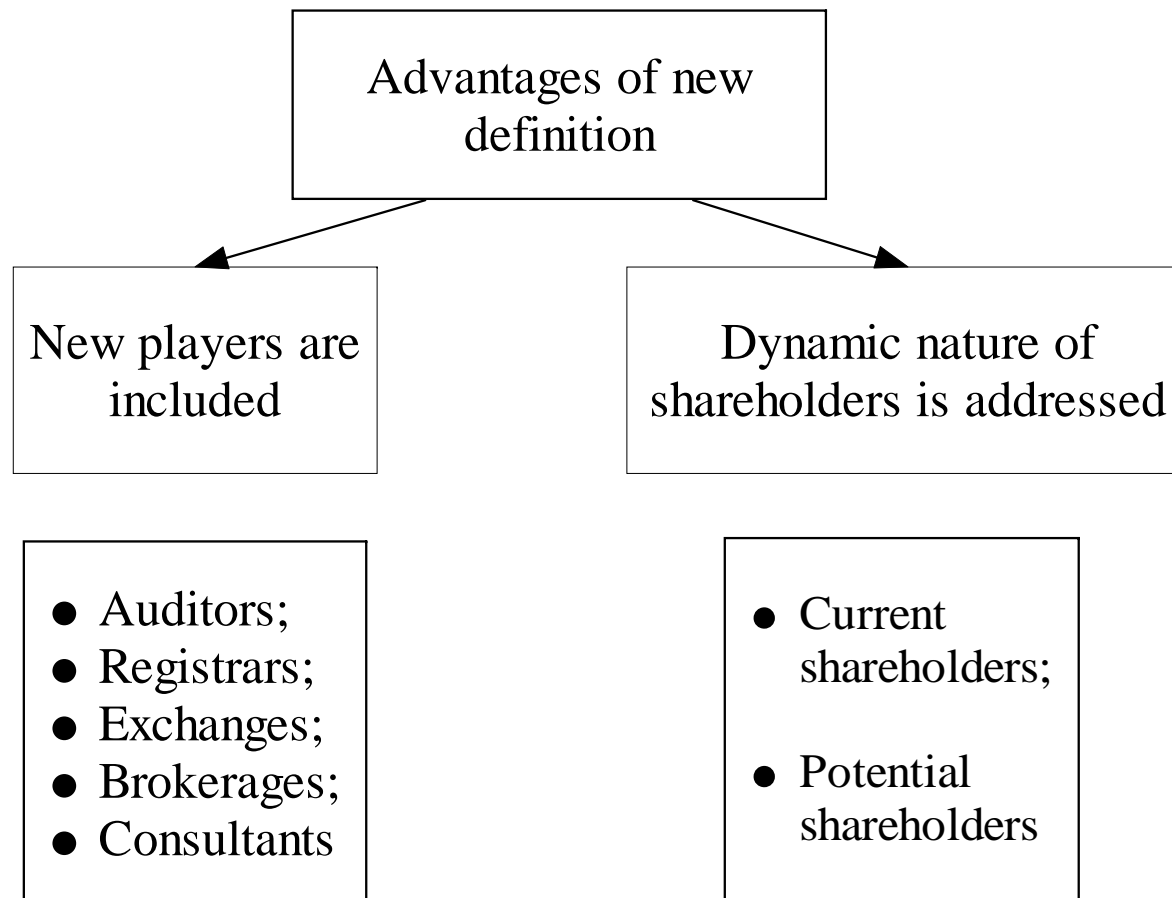
* 1 – Institution of Audit, 2 – Corporate Law Institution , 3 – Institution of Brokerages (Licensed Institution)

Major advantages of New Definition of Corporate Governance



HERMITAGE CAPITAL MANAGEMENT

New players found their legitimate place in new definition: like auditors, registrars, exchanges, etc. Both current and potential shareholders are subject of company's interest

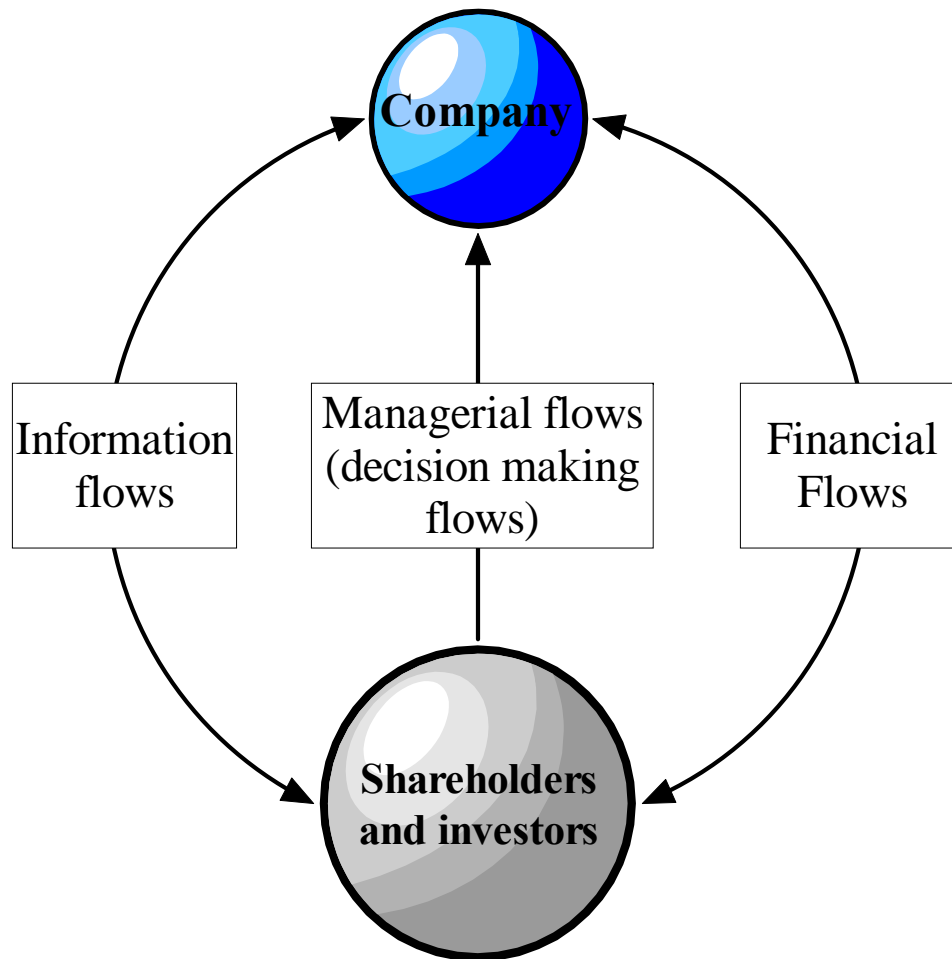


Nature of relationship between the company and stock market



HERMITAGE CAPITAL MANAGEMENT

There are three major flows exist in “company-investors” relationship



- **Managerial flows**, from shareholders to the company (hiring the management, nomination and election of Board members of the Board of Directors, etc)
- **Information flows**, bi-directional (financial and economic performance reporting, market perception and expectations)
- **Financial flows**, also bidirectional (dividends, equity and debt financing)

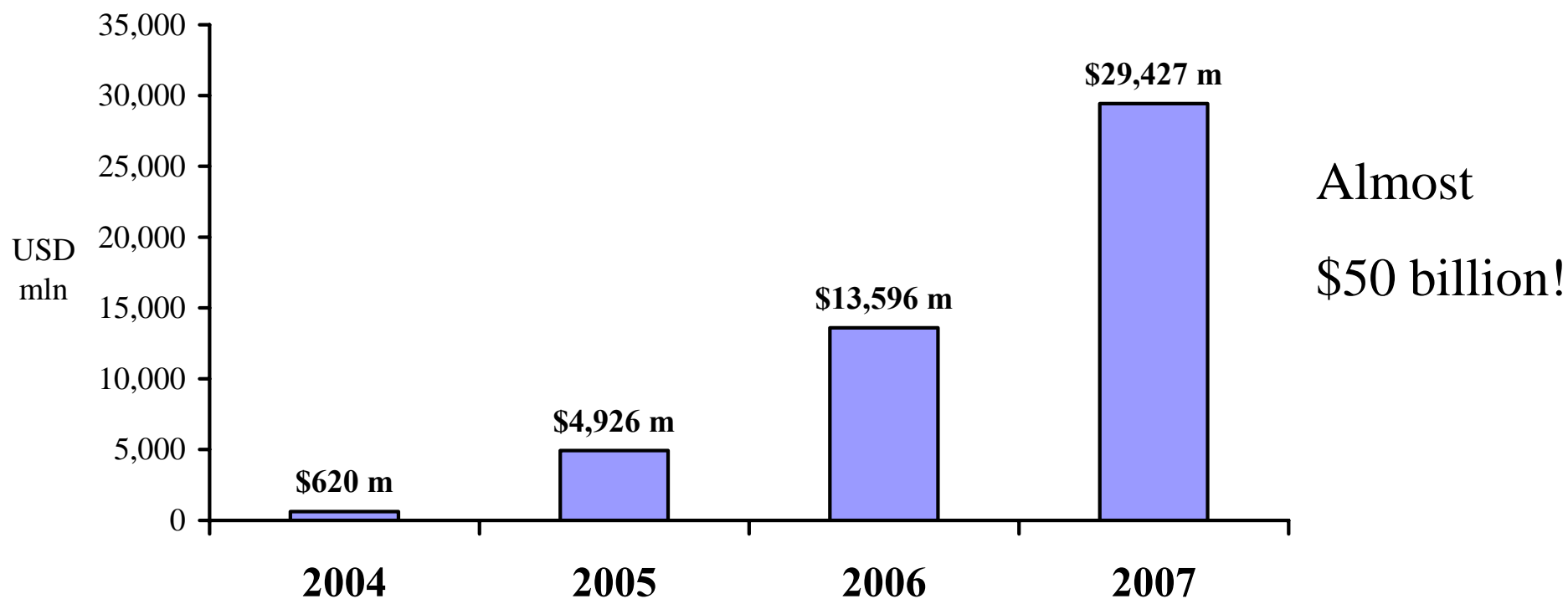
Why good Corporate Governance is beneficial



HERMITAGE CAPITAL MANAGEMENT

In 2004-2007 stock market proved to be strong source of investments to Russian companies

The Amount of IPO and secondary offerings of Russian companies



Major Corporate Governance Processes



HERMITAGE CAPITAL MANAGEMENT

The development of Corporate Governance in Russia was defined by appearance of market economy in Russia, privatization, transition to a new formation and shadow of global problems



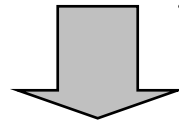
Research on Corporate Governance problems in Russia



HERMITAGE CAPITAL MANAGEMENT

So far the majority of researches analysed the following issues:

- ◆ State vs private ownership and its influence on companies performance;
- ◆ Ownership concentration and its consequences;
- ◆ How corporate governance of Russian companies elaborates over the time;
- ◆ Influence of corporate governance models on strategy of the company;
- ◆ Role of the state in corporate governance;
- ◆ Conflicts between management and shareholders (“principal-agent” problem);
- ◆ Conflict between majority and minority shareholders



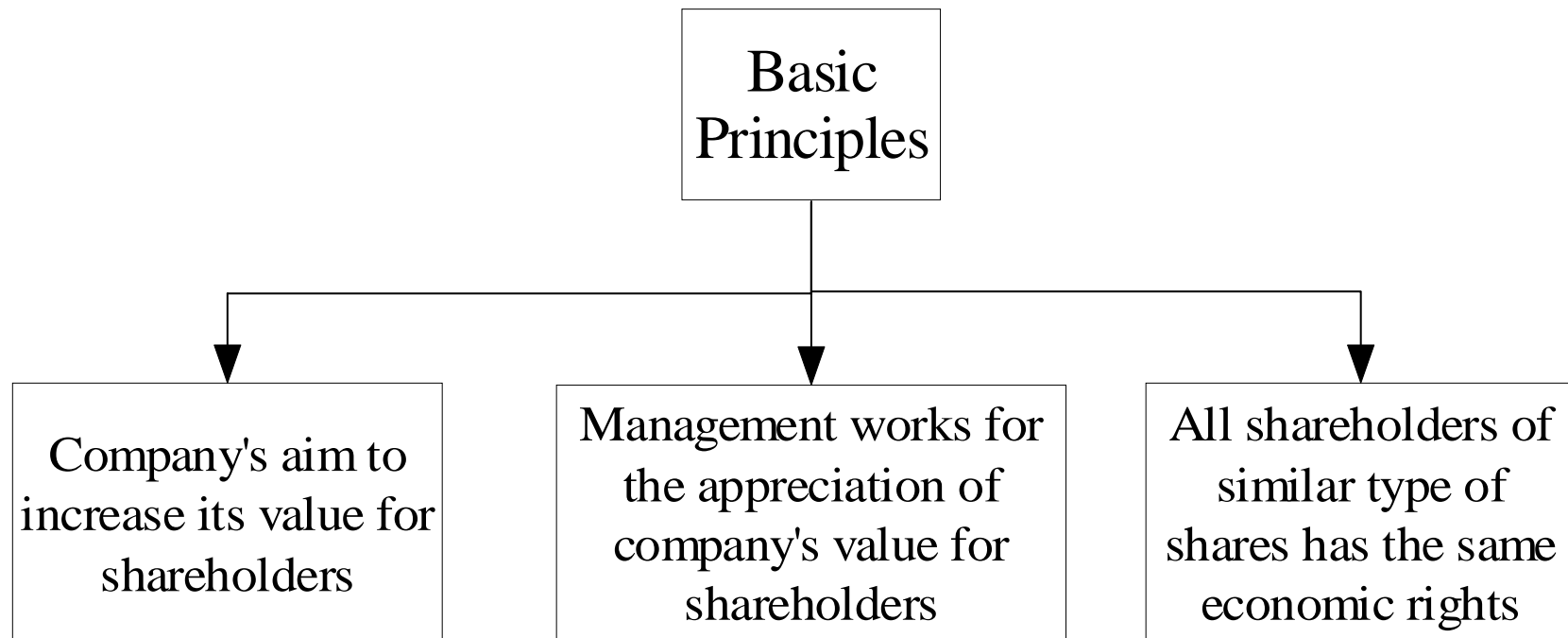
The issue which was not thoroughly analysed is:

Is there any interrelationship between quality of corporate governance and economic efficiency of the company?

Basic Principles of “good” Corporate Governance



HERMITAGE CAPITAL MANAGEMENT

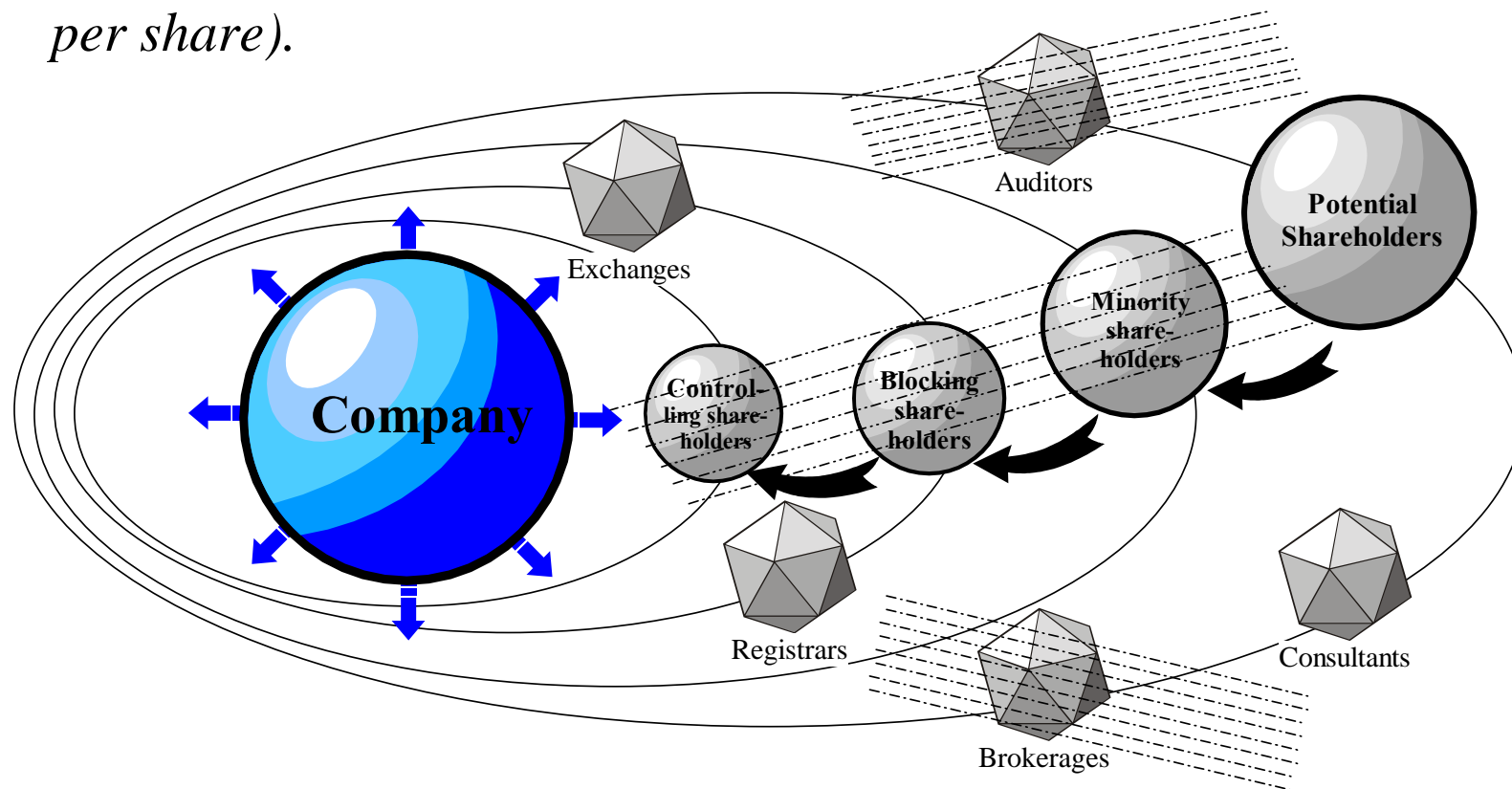


Basic Principles of “good” Corporate Governance



HERMITAGE CAPITAL MANAGEMENT

Basic Principle 1. A company seeks long-term appreciation of its expected value per share on the stock market. The expected value per share is the liquidation value of the company divided by the number of shares (value per share).



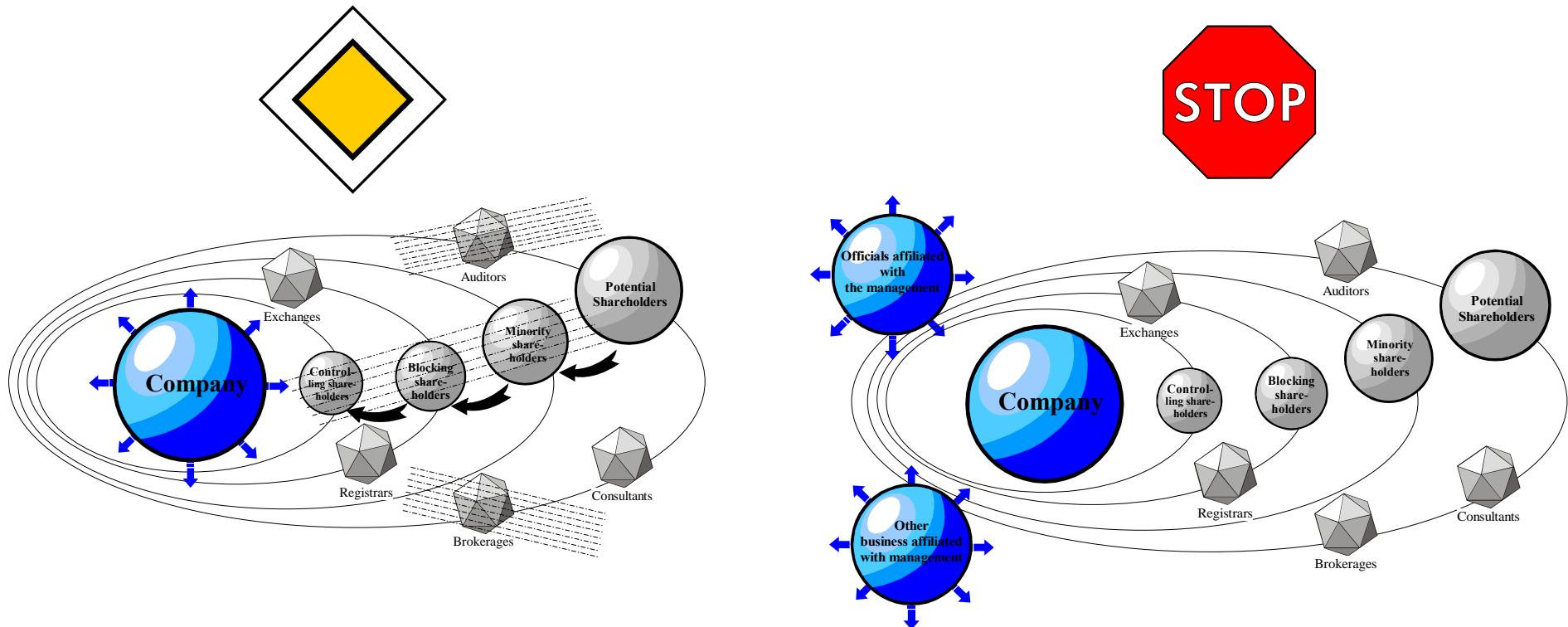
* Blue arrows reflects the target of growing expected Company’s value, Black arrows – reflect growing investors interest in the Company, wiliness to get more involved 11

Basic Principles of “good” Corporate Governance



HERMITAGE CAPITAL MANAGEMENT

Basic Principle 2. A company’s management is interested in the appreciation of expected long-term value per share of the company for investors and does not have incentives different from this target

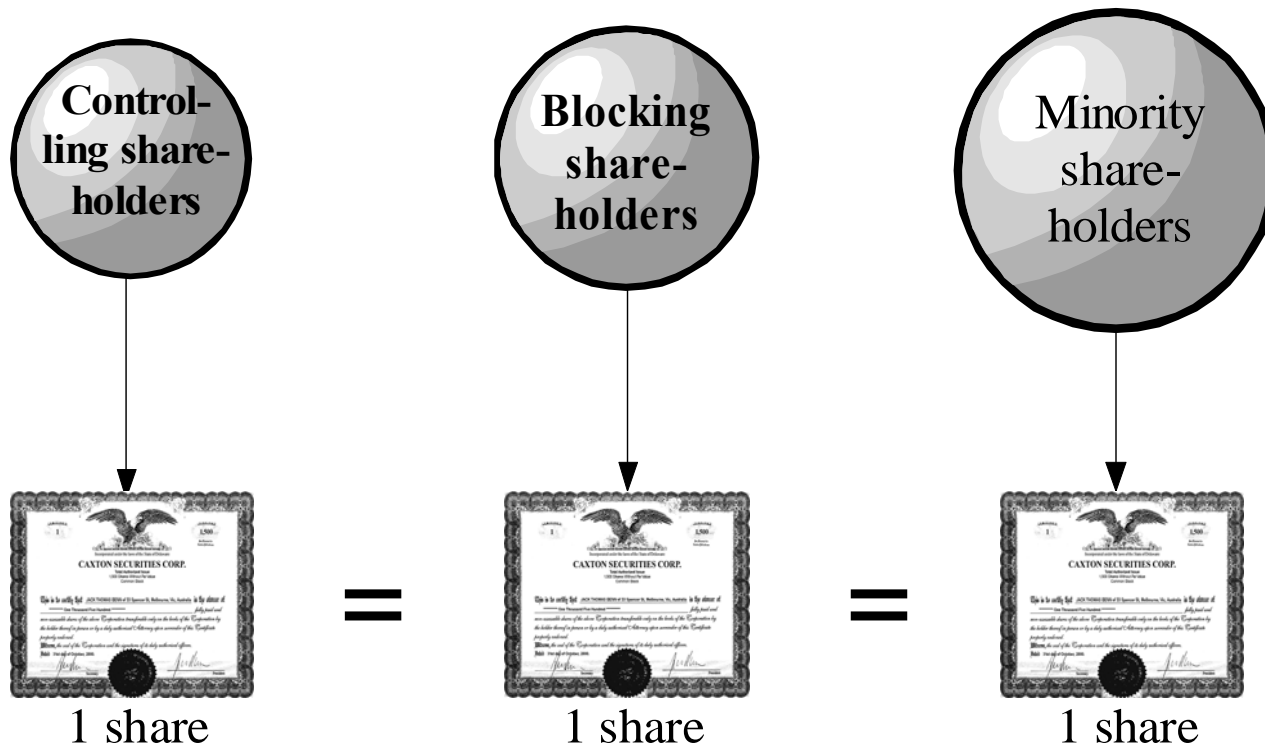


Basic Principles of “good” Corporate Governance



HERMITAGE CAPITAL MANAGEMENT

Basic Principle 3. A company’s shareholders have equal rights per share. The controlling shareholders and the management should not make decisions which will disfranchise any other categories of shareholders. They also should not disfranchise potential investors

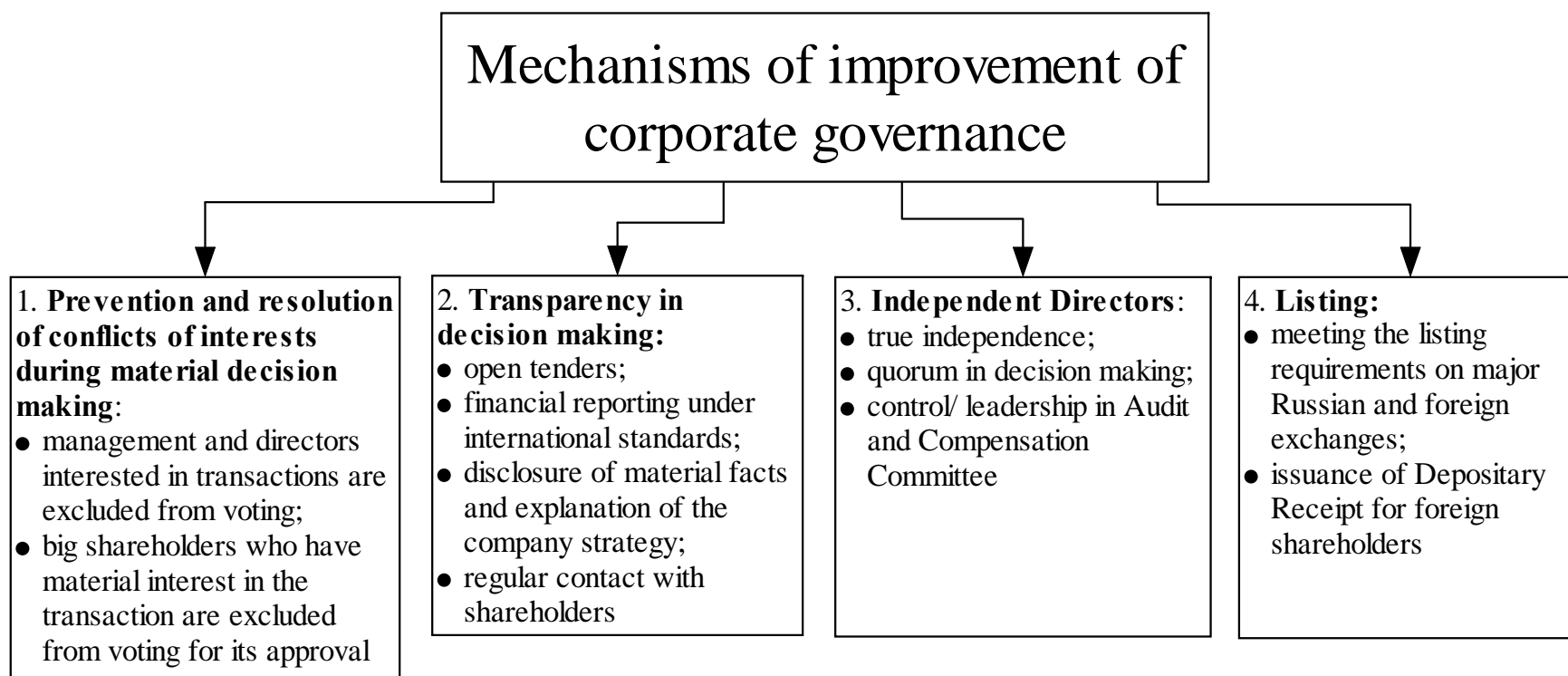


Ways to improve Corporate Governance



HERMITAGE CAPITAL MANAGEMENT

There are several mechanisms which being employed sincerely by the company could significantly improve its corporate governance



Influence of ineffective corporate governance on economic performance



HERMITAGE CAPITAL MANAGEMENT

Let's consider what happens in case of inefficient corporate governance with economic efficiency of companies

“Gazprom”



“Volzhanka Confectionary”



“Apatit”



Oil companies

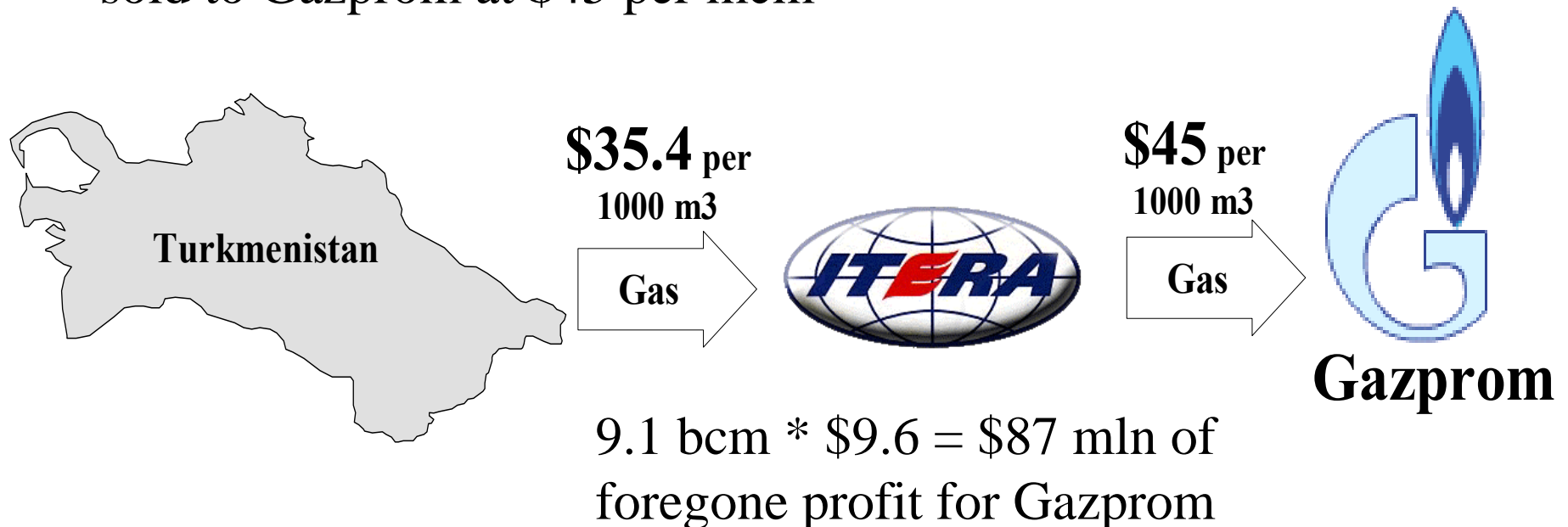


Gazprom: purchase of gas from Turkmenistan in 1999-2000



HERMITAGE CAPITAL MANAGEMENT

- In December 1999, during the trip of Gazprom's CEO to Turkmenistan and his meeting with the then President Niazov a long expected contract for supply of 9.1 bcm of Turkmenistan gas
- The chain of gas supply looked as follows. Turkmenistan gas was first acquired by Itera at \$35.4 per mcm and then immediately re-sold to Gazprom at \$45 per mcm

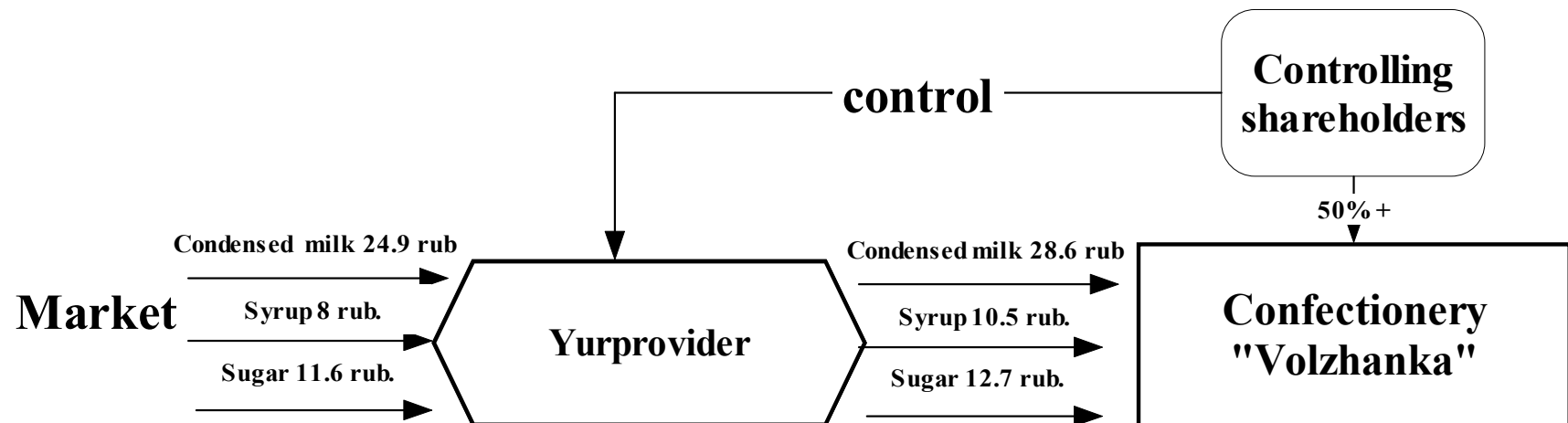


Volzhanka: purchase of procurement through affiliated intermediary



HERMITAGE CAPITAL MANAGEMENT

In 2001 major shareholder of Volzhanka confectionery forced it to buy the procurement via intermediary



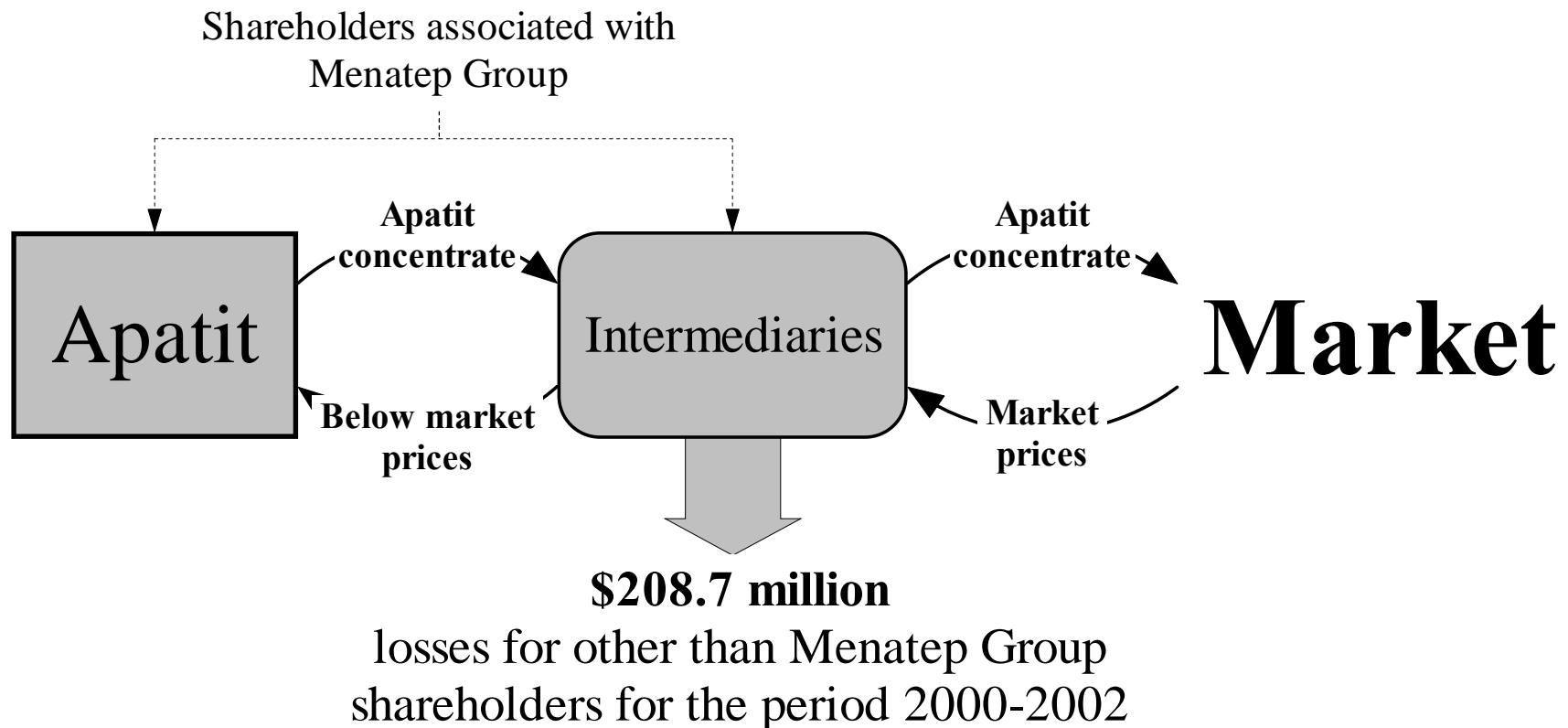
As a result the company was losing monthly \$110,000 or \$1.3 mln in annual terms

Apatit: sale of main output via intermediary



HERMITAGE CAPITAL MANAGEMENT

As it was shown by General Prosecutor Office investigation, control shareholders of “Apatit” used intermediaries for selling its products to the market



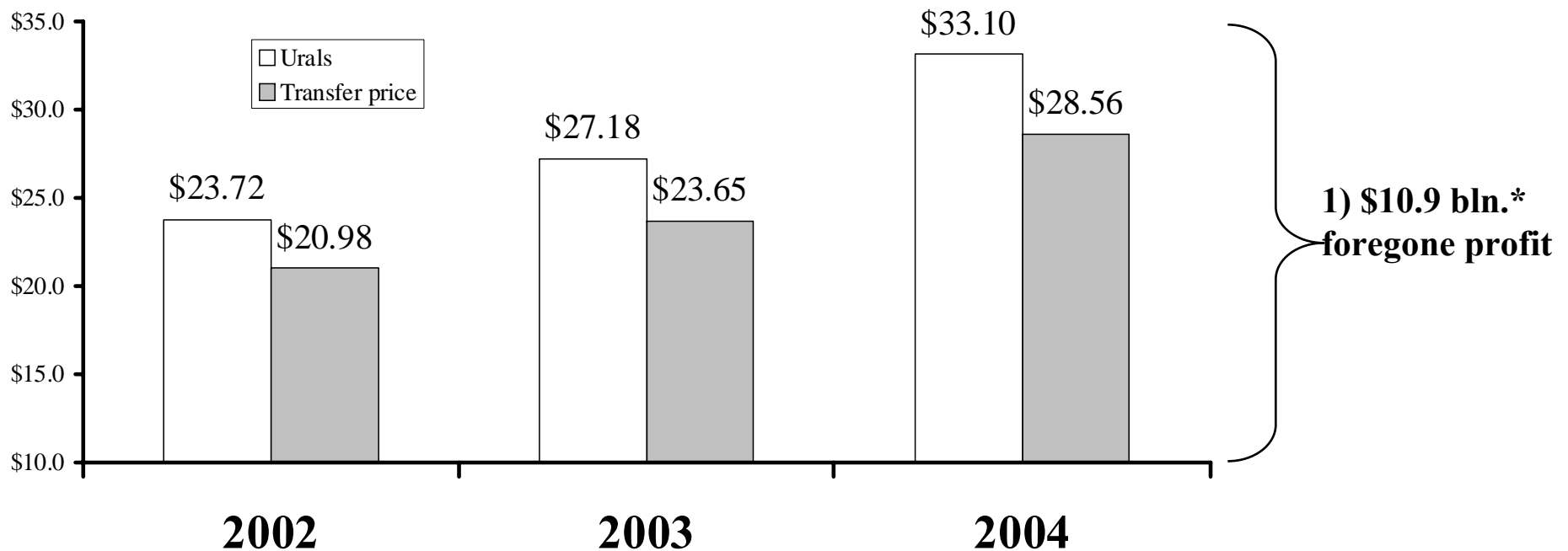


HERMITAGE CAPITAL MANAGEMENT

Oil companies: transfer pricing

During 2002-2004 Russian oil companies foregone more than \$10 bln of potential income because of usage of intermediaries

Urals (market) crude oil price vs average transfer price of Russian companies per barrel



Source: Customs Committee of RF; * While calculating the difference the freight and insurance costs were taken into consideration

Why these examples of poor corporate governance exist



HERMITAGE CAPITAL MANAGEMENT

Lack of positive incentives and lack of negative consequences



Doesn't function properly:

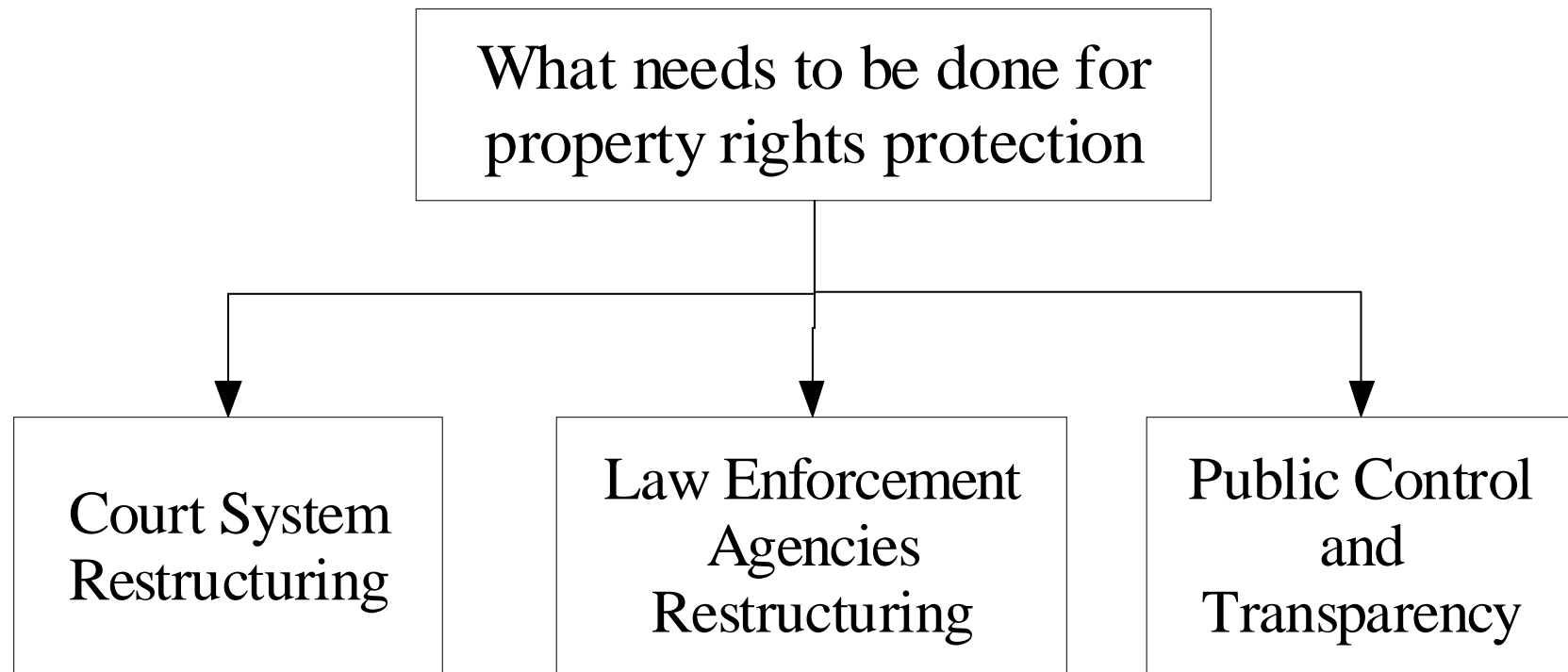
- legal system does not pursue major shareholders/management for damaging their own companies;
- the only two cases where major shareholders suffered (Yukos and TollyattiAzot), appears to be redistribution of property rather than lawful legal consideration;
- law enforcement agencies became either agents or principals of corporate conflict without any interest in following their legitimate duties

- (+) Last years of IPO flood and redundant debt financing gave strong incentive to behave;
- (-) Widening financial crisis seriously damages perspectives of raising new capital for many companies



What needs to be done

Long-term, stable investments are impossible with proper property rights protection



What needs to be done: Court system restructuring



HERMITAGE CAPITAL MANAGEMENT

- Independence of the court, introduction criminal liability for putting any pressure on judges, including unofficial pressure of chief judges:
 - any state official proved to be instructing the judge need to be disqualified from his position for 3 years and bear financial penalties;
 - any judge proved to be pressuring other judges should be disqualified for 3 years;
 - any private individual who tries to influence the judge risk criminal prosecution and financial penalty
- Undue enrichment of judge or its relatives could result in disqualification for 5 years;
- Professionalism, timely training, ensuring modern facilities and equipment;
- Open public access to court hearing, court documents;
- Open statistics on courts and judges activity on annual basis;
- Open database with access to court decisions and rulings

What needs to be done: Law Enforcement Agencies Restructuring



HERMITAGE CAPITAL MANAGEMENT

- Law enforcement agencies should be precluded from pursuing businesses without professional judgement and solid ground:
 - Tax authorities should grant their approval for opening any criminal investigation regarding the tax matters;
 - Financial Market Regulator should grant its approval and should have the right to appeal to law enforcement on all securities markets fraud including those related to corporate governance;
 - Prosecutor office grant its approval for opening any criminal case;
 - Prosecutor office handle supervision over any opened criminal case and is required to address all the complaints of participants of criminal investigation;
 - Disregard and not consideration of merits and essence of public complaints by law enforcement officials or prosecutor officer should result first in financial penalty, than disqualification for 3-5 years;
- Breach of the Criminal Code by law enforcement/prosecutor officer should be sentenced with the term 1.5 longer than for the similar crime committed by an ordinary citizen

What needs to be done:

Public control and transparency



HERMITAGE CAPITAL MANAGEMENT

- Public Chamber should have set up special department for considering corporate governance abuses;
- Public press should devote enough space for describing both bad and good examples of corporate governance and minority shareholders should have access to them to share their views;
- Financial Market Regulator should put on its agenda as one of the key tasks – the protection of high standards of corporate governance and prosecution corporate governance abuses;
- Prosecutor offices should be accessible for public complaints;
- Prosecutor should bear responsibility for not timely response or answers without any grounds;
- University should make case studies on bad corporate governance in order for the public to avoid it in the future

What needs to be done

Morality of Society



HERMITAGE CAPITAL MANAGEMENT

- Morality of Russian society was historically biased towards quick enrichment;
- Significant part of oligarch capital was earned illegally;
- During the last 6-7 years major shareholders (quite often oligarchs) redistribute wealth out of public (minority shareholders) to themselves;
- Public media was put under control of the same oligarchs or affiliated officials;
- A lot of business built criminal ties with officials

However,

- Those businessmen should now start care about protection of their property rights, which first of all means respect towards other people property rights, especially minority shareholders;
- Society should not appreciate cases of poor corporate governance and should condemn them



HERMITAGE CAPITAL MANAGEMENT

Disclaimer

The information is based on data obtained from publicly available sources, which have not been verified. As a result of the difficulty in obtaining reliable data in Russia, no representation is made that this information is accurate and complete and no responsibility for the reasonableness of any conclusions based upon such information is assumed.