

Governance to Value: Evidence from Brazil and Other Emerging Markets

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Ongoing research on Brazil

- Ongoing work with Antonio Gledson de Carvalho and Erica Gorga:
- Surveys of Brazilian corporate governance:
 - 2005 (analyzed), 2008 (completed), 2009 (planned)
 - **Thanks to GCGF and Phil Armstrong for support !!**
- Papers based on initial survey:
 - *The Corporate Governance of Privately Controlled Brazilian Firms* (working paper 2009) (full survey details, for Brazilian audience)
 - *Corporate Governance in Brazil* (working paper 2009) (shorter version for international audience)
 - *What Corporate Governance Elements Predict Firm Value: Evidence from Brazil* (working paper 2009)

2005 Survey

- 116 responses
 - 88 from *private* Brazilian firms
 - not controlled by state or foreign firm
 - 28% of publicly traded firms
 - ~ 63% of market cap of actively traded firms

Highlights of Survey Results

Small boards:

No. of Directors	No. of firms	percentage
3	14	16%
4-5	22	25%
6-7	26	30%
8-11	21	24%
12 or more	5	6%
Mean = 6.8		Median = 6

Few independent directors:

No. of Independent Directors	No. of firms	Percent
0	31	36%
1	16	19%
2	17	20%
3	13	15%
4 or more	9	10%
Mean = 1.6 (23%)		Median = 1.0 (18%)

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Even for large firms. Top size quartile:

- 28% of firms have zero independent directors
- mean = 24%; median = 20%

Control of financial reporting

Brazilian institution: fiscal board

- Can be permanent, or chosen annually at demand of minority shareholders
 - controlled by majority shareholder, but includes minority representative
- If permanent or chosen 4 or 5 times in 5 years, call this “near permanent”

Results:

- Audit committee and fiscal board are substitutes
 - 63/86 firms (73% have audit committee or near-permanent fiscal board)
 - Only 10% have no audit committee, never appoint fiscal board

	Near permanent fiscal board		Occasional fiscal board		No fiscal board		Total
	Firms	Percent	Firms	Percent	Firms	Percent	
Audit committee	9	10%	2	2%	3	3%	14
No audit committee	49	57%	14	16%	9	10%	72
total	58	67%	16	17%	12	14%	86

Related Party Transactions

Are they really this rare?

- Weak disclosure rules, some firms don't disclose
- Weak approval requirements
 - approval by board means little, because few or no independent directors

Existence and Disclosure of Related Party Transactions	Yes	% Yes
Has the company lent money to related parties	4	5%
Does the company rent property from related party	3	4%
Company buys or sells significant goods or services to or from related party	7	8%
Are details of significant related party transactions disclosed to shareholders	59	69%
Approval of Related Party Transactions with Controller		
No special approval	15	17%
Approval by the board of directors	56	65%
Approval by nonconflicted directors	10	12%
Approval by shareholders	11	13%
Approval by nonconflicted shareholders	8	9%

Locking up Control

- Almost all firms have controlling shareholder or group
 - Most (72/86) issue preferred shares (basically nonvoting common shares)
 - Many use shareholder agreements to lock in family control

Shareholder agreements	Yes	% Yes
One or more agreement(s) among family or other shareholder group	36	42%
For firms with a shareholder agreement:		
Control is ensured through the agreement(s)	24	67%
The agreement governs the election of one or more directors	22	61%
The shareholder agreement(s) are registered with the company	33	92%
Shareholder agreements are not registered with the company, but are disclosed to minority shareholders	1	33%

Governance to Value

- Does firm level governance predict firm market value (Tobin's q is usual measure)?
- Two broad ways to ask this question
 - Cross-country studies (broad and shallow, largest firms, crude indices)
 - Country studies (narrow and deep, all public firms in country, tailored index, but generalizable?)
- Our research: country study of Brazil
 - will discuss other country studies later
 - prior Brazil study: Carvalhal-da-Silva and Leal (2005); Leal and Carvalhal-da-Silva (2007)

Subindices

- If broad governance index predicts Tobin's q :
 - What components of governance explain this result?
 - We address this question as well, with surprising results.

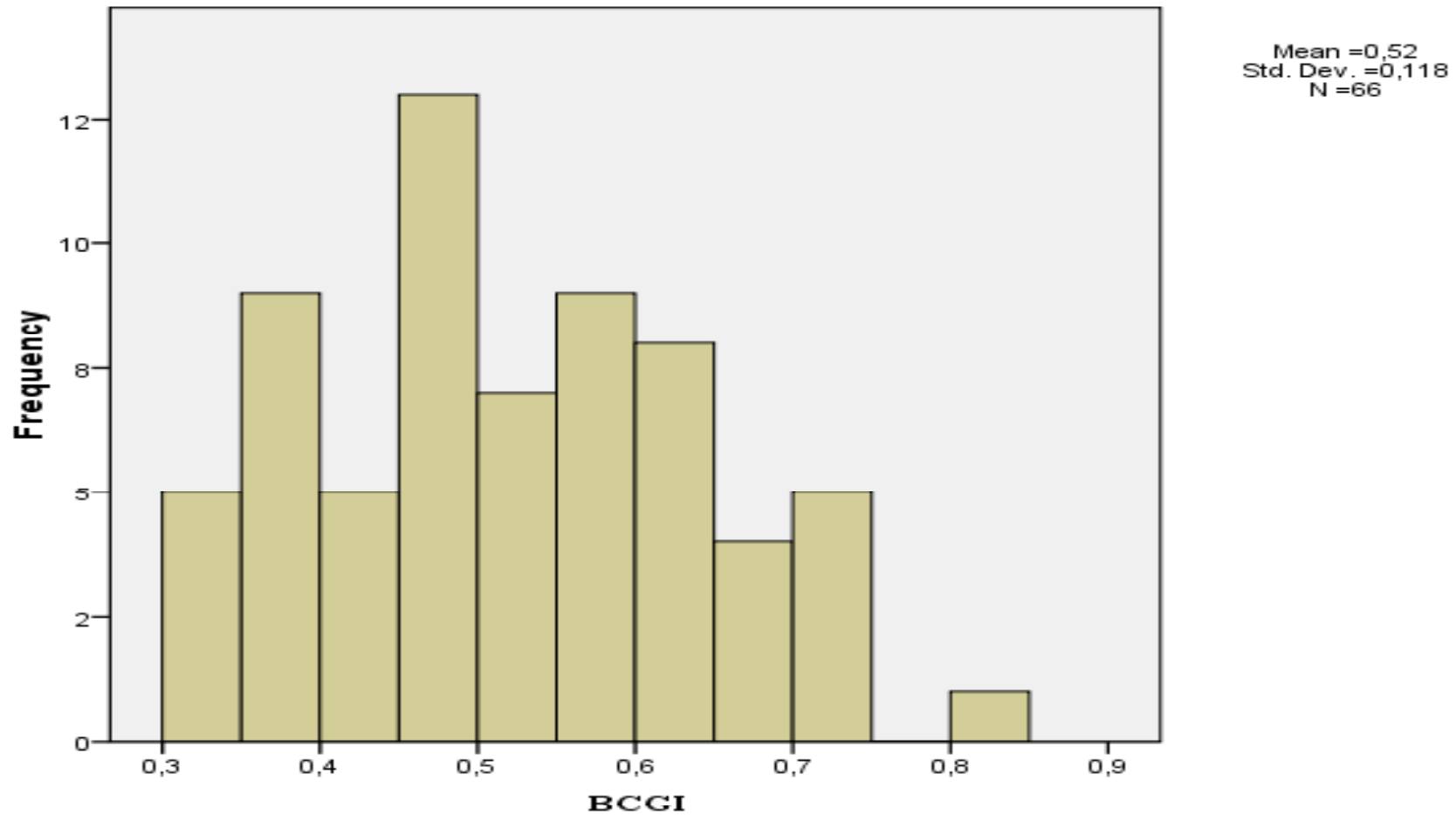
Caveat: Endogeneity

- Caveat: Association between governance index and Tobin's q could reflect:
 - reverse causation
 - omitted variables
 - optimal firm governance choice
- We have only cross-sectional data and no instrument, so don't claim causation
 - with repeated surveys, we will develop panel data, which helps

Brazil Corp Gov Index (BCGI)

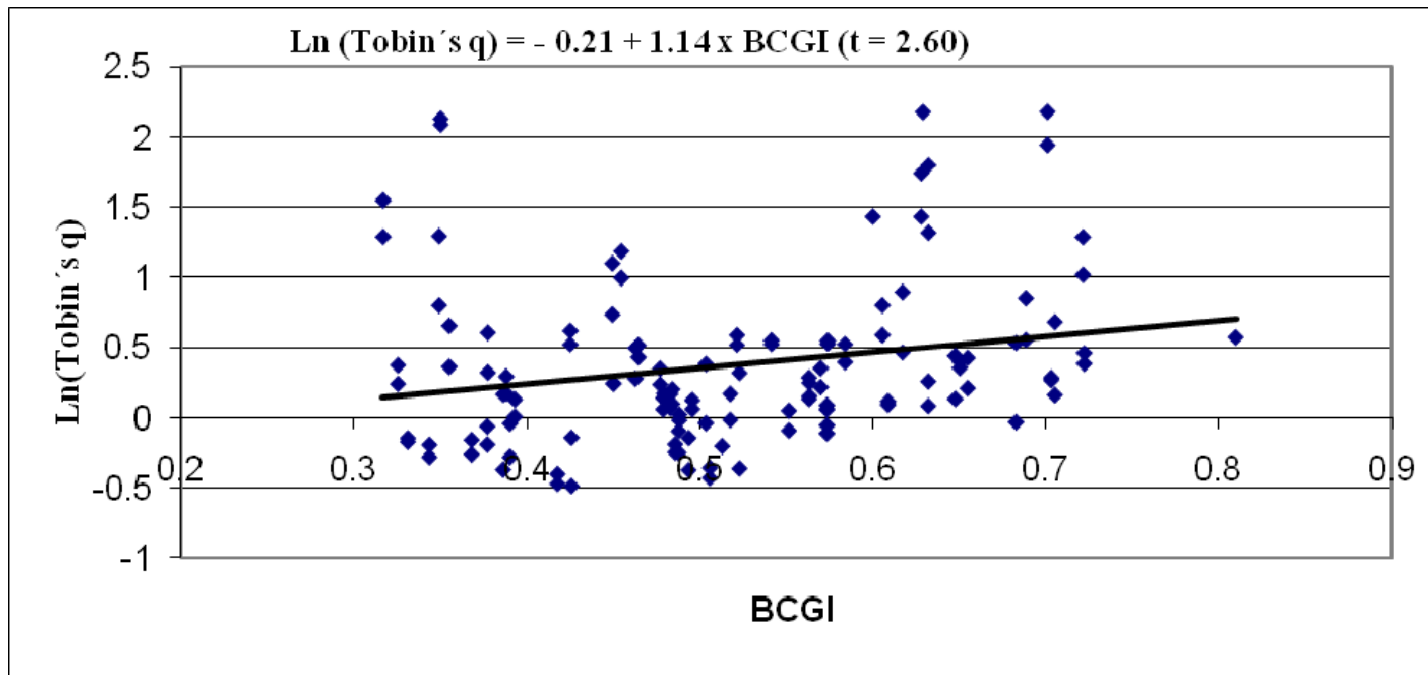
- Subindices (each 0 ~ 1) for:
 - Board Structure (7 elements)
 - Ownership Structure (5 elements)
 - Board Procedure (6 elements)
 - Disclosure (12 elements)
 - Related Party Transactions (5 elements)
 - Minority Shareholder Rights (7 elements)
- $BCGI = [\sum(\text{subindices})/7]$ (min 0.32 ~ max 0.81)
- Sample = 66 private, non-bank firms with available data

BCGI histogram



Scatterplot: BCGI vs. $\ln(q)$

- Survey 1H 2005, measure BCGI \sim year-end 2004
- Measure Tobin's q at year-ends 2005 & 2006
 - Use $\ln(q)$ because of high- q outliers
- Forward looking; doesn't solve endogeneity problems, but helps



Economically large effect: worst-to-best in BCGI \rightarrow q from 1.16 to 2.03

Add controls

- Best set of controls we can create, to reduce omitted variable bias:
 - $\ln(\text{assets})$; leverage; years listed; sales growth; net income/assets; EBIT/sales; PPE/sales; share turnover; largest shareholder % owned; (voting shares/total shares); ADR dummy; industry sector and year dummies
 - financial variables averaged over 2001-2004

Main results for BCGI

Dependent variable	<i>Ln</i> (Tobin's <i>q</i>)		
	Firm random effects, clusters	Pooled OLS, firm clusters	Mean of 2005 and 2006
Overall Index (<i>BCGI</i>)	1.22 (2.75)***	1.12 (2.58)**	1.23 (2.53)**
<i>Ln</i> (assets)	-0.03 (-0.75)	-0.03 (-0.64)	-0.04 (-0.76)
Leverage	0.54 (2.21)**	0.55 (2.20)**	0.54 (2.01)**
Years listed	-0.01 (-2.12)**	-0.01 (-2.25)**	-0.01 (-1.96)*
Sales growth	0.14 (0.34)	0.15 (0.35)	0.15 (0.32)
Net income/assets	2.53 (5.10)***	2.54 (5.08)***	2.49 (4.58)***
EBIT/sales	0.96 (2.30)**	0.99 (2.39)**	0.94 (2.08)**
other controls	yes	yes	yes

Coefficient on BCGI almost unchanged from scatterplot

How about Subindices?

Dependent variable	Ln(Tobin's q)		
	Firm random effects with:	subindices together	one at a time
Board Structure	-0.61*** (2.69)		-0.32 (1.11)
Board Independence subindex		-0.39*** (2.76)	-0.18 (1.07)
Audit Committee & Fiscal Board subindex		-0.21 (1.15)	-0.43 (0.21)
Ownership	0.50** (2.42)	0.51** (2.49)	0.79*** (2.90)
Board Procedure	0.64*** (3.65)	0.62*** (3.52)	0.46** (2.47)
Disclosure	0.07 (0.34)	0.07 (0.31)	0.42** (2.09)
Related Party	-0.25 (1.03)	-0.27 (1.23)	-0.50 (0.16)
Minority Shareholder Rights	0.57*** (3.10)	0.59*** (3.22)	0.48** (2.35)
Control variables	yes	yes	yes

Compare other country studies

Does Governance Index Predict Firm Value?	Black, de Carvalho and Gorga (2009)	Balasubramanian, Black and Khanna (2009)	Black, Kim, Jang and Park (2009)	Black, Love and Rachinsky (2006)	Cheung Connelly, Limpaphayom and Zhou (2007)
Country	Brazil	India	Korea	Russia	Hong Kong
Type	Cross-section	Cross-section	Panel	Panel	Cross-section
Dependent variable	ln(Tobin's q)	ln(Tobin's q)	ln(Tobin's q)	ln(Tobin's q)	market/book
Time period	2005-2006	2006	1998-2004	1999-2005	2002
Overall index	***	***	***	***	**
Board structure subindex	Sig. neg: ***	not sig.	***	***	not sig.
Board procedure subindex	***	not sig.	not sig.		
Disclosure subindex	not sig.	*	$f = **; r = ***$	**	*
Related party transactions	not sig.	not sig.		***	
Shareholder rights subindex	***	not sig.	not sig.		not sig.
Ownership subindex	**		$r = **$		

Subsample results

Study	Black, de Carvalho and Gorga (2009)	Balasubramanian, Black and Khanna (2009)	Black, Jang and Kim (2006))
Country	Brazil	India	Korea
Type	Cross-section	Cross-section	Cross-section
Dependent variable	$\ln(\text{Tobin's } q)$	$\ln(\text{Tobin's } q)$	$\ln(\text{Tobin's } q)$
Time period	2005-2006	2006	1998-2004
Large firms	***	not sig.	*
Small firms	not sig.	*	***
Smallest firms			not sig.
More profitable firms		***	
Less profitable firms		not sig.	
Manufacturing firms	not sig.	not sig. different	
Non-manufacturing firms	***		