

# Survey Says...

## Corporate Governance Matters to Investors in Emerging Market Companies

By Vikramaditya Khanna and Roman Zyla

Financial crises have a way of bringing corporate governance to the foreground. For interested parties wanting to know more, there is an impressive body of research that looks at companies and the connection between strong governance and better performance. However, the existing literature only goes so far. It does not look at whether the level and quality of firm-level corporate governance plays a role as large-scale investors consider investment decisions in emerging markets.

This study of emerging market investors sheds light on this issue and reveals that emerging market investors care deeply about corporate governance.

The findings have significant implications, not only for the emerging markets business and finance community, but for policy makers, academics, the media, as well as for development finance institutions focused on sustainable economic development in these countries.

### KEY FINDINGS:

#### At a global level

- 1 Recent financial crises have elevated the importance of good governance.
- 2 Specific corporate governance-related reforms could make countries more attractive investment destinations.

Emerging market investors believe that better firm-level governance can make up for country weaknesses in corporate governance.

#### For emerging market fund investment decisions

- 3 Corporate governance is a critical factor in emerging market investment decisions.
- 4 Investors are willing to pay a premium for better-governed emerging market firms.

#### Company specific

- 5 Investors often do not invest in emerging market companies with poor governance.
- 6 Lack of transparency is a red flag for emerging market investors.
- 7 Board independence is a low-level concern for emerging market investors.

### ABOUT THE EMERGING MARKET INVESTOR SURVEY

- Twenty-nine respondents, culled from a total universe of 1,000 emerging market investment firms.
- Respondents included decision-makers at institutional investment firms, private equity funds, hedge funds, pension plans, and investment advisors.
- Respondents included firms investing in publicly-held companies in one or more emerging markets.
- The interviews with investment decision makers were off-the-record and were conducted through face-to-face and telephone interviews in New York and London.
- Interviews took place in April–May 2010.

## BACKGROUND

“The literature has grown to include studies of how governance reforms and practices in specific countries have influenced firms in those countries.”

Increasingly, emerging markets are becoming important engines of global growth. Many have become the focus of the investment community and the average investor. In fact, business publications around the globe are spotlighting a number of these countries, particularly in the aftermath of financial crises, because some of these nations, such as India and China, represent the few bright spots in an otherwise moribund global growth outlook.

There is a vast literature on corporate governance, and specifically corporate governance in emerging markets. Connections between better governance and firm market value and performance, especially in emerging markets, are captured. Additionally, there are also studies that explore whether the investment decisions of foreign investors are connected to governance concerns, and how these investors may change the governance and performance of the firms in which they invest.

Some “law and finance” studies examine the connection between better governance and greater dispersion in ownership structures, and deeper equity markets.<sup>1</sup> The literature has grown to include studies of how governance reforms and practices in specific countries have influenced firms in those countries. For example, a series of recent papers have found that better governance in Indian firms correlates with higher firm market valuations, and that the governance reforms promulgated in India caused higher firm market valuations for those firms subject to the reforms.<sup>2</sup> Further, studies on other emerging markets, in particular Russia and Korea, found that better governance is associated with higher valuations and that the relationship may be causal (from governance to performance).<sup>3</sup> More recent studies of emerging markets have attempted to explore what features of governance matter most in enhancing firm value, and through what channels do they operate with reducing tunneling being a factor of prime importance.<sup>4</sup> These findings are now being amalgamated into various governance rankings, which are being adjusted to reflect the unique concerns in certain markets and ownership structures.<sup>5</sup>

Despite the relative plethora of studies, there are few that explicitly inquire from investors what importance they place on corporate governance arrangements when making investment decisions. However, it seems important to explore this question because governance, which is a form of investor protection, might be expected to influence how investors behave; this will be critical for understanding the role of governance. This is especially so in the context of emerging markets where many of the institutions protecting investors in more developed markets may not be fully present. In light of this, it is important to obtain a better appreciation of how

<sup>1</sup> See La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997); La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998); La Porta, Lopez-de-Silanes, and Shleifer (1999); and La Porta, Lopez de-Silanes, and Shleifer (2006).

<sup>2</sup> See Balasubramaniam, Black and Khanna (2010); Dharmapala and Khanna (2010); Khanna (2009); Black and Khanna (2007); and Khanna and Mathew (2010).

<sup>3</sup> See Black (2001) (Russia); Black, Love, and Rachinsky (2006) (Russia); Black, Jang, and Kim (2006) (Korea); Black, Jang, and Kim (2006a) (Korea); Black, Kim, Jang, and Park (2006) (Korea); and Black, Kim, Jang, and Park (2008) (Korea).

<sup>4</sup> See Bertrand, Mehta, and Mullainathan (2002); and Atanasov, Black, Ciccotello, and Gyoshev (2010).

<sup>5</sup> See Bebchuk and Hamdani (2009); Khanna (2009); Gilson and Gordan (2004); and Aggarwal, Erel, Stulz, and Williamson (2009).

emerging market funds use governance in their investment decisions, what governance attributes matter most to them, and if these attributes vary with the country, the size of the firm, its ownership structure, or its industry.

Other studies examine whether the investment decisions of foreign investors are connected to governance concerns, as well as how these investors may change the governance and performance of firms in which they invest. At a conceptual level, if governance is important for any set of investors, then it should be for this set of investors (as they may have enough invested and enough expertise) to be able to overcome collective action and information asymmetry concerns. The studies to date provide evidence that governance is important to these investors, but these studies do not focus on the largest emerging markets nor do they uncover the kinds of governance factors investors look at when deciding where to invest in emerging markets. Given that emerging market firms may raise certain kinds of governance concerns in a more prominent manner than developed market firms (e.g., controlled versus dispersedly held firms governance concerns), and that the background institutional structures are less consistent across emerging markets, one might expect that the behavior and optimal governance of emerging market funds could be different than the behavior of similar investors in more developed markets.

Along with the heightened focus on emerging market investment opportunities has come an increased attention to corporate governance considerations. There has been a considerable amount of research conducted, but a comprehensive review of this research revealed a significant information gap: most of the studies look at developed markets, with little in-depth research on the role of governance in the investment decisions of funds and blockholders in the major emerging markets.

Until now, that is.

The Emerging Market Investor Survey directly addresses this information gap, focusing on the specific corporate governance issues of importance for investors in emerging markets. To explore this issue, this paper engages in a series of interviews with funds investing in emerging markets. Engaging in interviews allows one to obtain a more textured and qualitative assessment of the role of governance in the decisions of investors in emerging markets. Moreover, by examining these qualitative assessments one obtains a better appreciation of what attributes of governance matter most in emerging markets, and why and how these attributes might differ from those relied upon in developed markets.<sup>6</sup>

<sup>6</sup> See F&C study (2009) (discussing that sovereign credit ratings of the major emerging markets may be ranging into investment grade category, but their corporate governance characteristics are very mixed, with Russia and China trailing behind Brazil, India, and Korea).

One also begins with a few priors in this study. In particular, firms in emerging markets may suffer from greater concerns associated with minority expropriation than firms in more developed markets due to the ownership structure in emerging markets. Thus, it seems that one might expect investors in emerging markets not to rely on the same kinds of governance attributes as in developed markets, but perhaps only some of them or different ones altogether. Second, funds investing in emerging markets also face a different enforcement and institutional structure than funds investing primarily in more developed markets (e.g., slower and more inconsistent enforcement at times). This suggests that investors in emerging markets cannot expect to use litigation as easily (if at all) in the home countries of their target firms. Thus, self protection measures (perhaps in the form of greater due diligence, larger discounts on price, or greater focus on firm level governance attributes) may be more important. Both of these matters, and others are difficult to assess by relying on financial data alone. Detailed and informed interview responses can provide a better sense of these matters and add a broader context to other studies. Moreover, this study also provides firms and policy-makers in emerging markets with a sense as to what investors in emerging markets focus on and how good practices corporate governance plays a role in that equation.

## STUDY APPROACH

The approach involved talking directly with the people whose business is to make investment decisions about opportunities in emerging markets.

Engaging decision-makers in conversation and using a standardized set of questions enabled a more nuanced assessment of the role of governance in their investment decisions than other approaches. The approach also helped develop a deeper understanding about the aspects of governance that matter most in emerging markets, along with why and how these aspects might differ from what matters most in developed market investment decisions.

The approach allows a tightly targeted focus on emerging markets: out of a universe of several hundred firms that have investments in emerging markets, a surprisingly small number (35) have business exclusively in emerging markets. From the 35 firms identified, 29 agreed to participate.

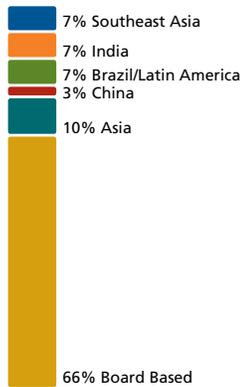
### DEFINING CORPORATE GOVERNANCE

For the purposes of this study we assumed IFC's view that corporate governance refers to the structures and processes for the direction and control of companies; a definition very similar to that of the OECD. During the interviews we consciously did not define corporate governance per se, but took the Funds representatives' use of the term to assume any aspect of corporate governance, hence several references to issues of ethics or honesty are not included in IFC's definition.

## PROFILE OF RESPONDENTS

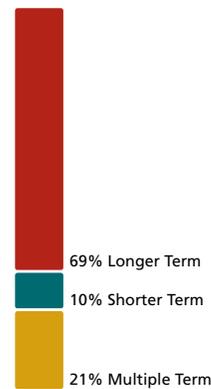
Respondents included individuals who made investment decisions for their firms or who advised others on such decisions.

**FIGURE 1. WHERE DO RESPONDENTS INVEST?**



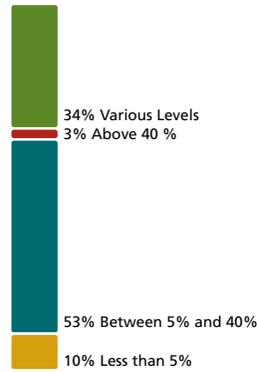
*Range of countries suggests that governance concerns are not driven by issues in a single market.*

**FIGURE 2. INVESTMENT HORIZONS**



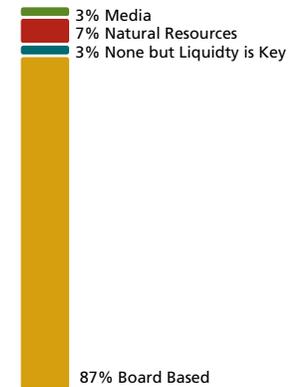
*Different time horizons might influence governance considerations and response strategies if problems arise after investment: depending on duration of investment, investors might sell their shares, try negotiating with management, or take the litigation route.*

**FIGURE 3. OWNERSHIP STAKES IN TARGET FIRMS**



*The percentage of the fund's own ownership stake could influence their approach to governance.*

**FIGURE 4. INVESTORS' INDUSTRY PREFERENCES**



*Respondents are focused on investments in a broad range of industries. Their responses likely represent the views of a broad section of emerging market investors.*



“There are certain triggers that alert us to potential areas of concern, such as the ratio of derivatives to total assets and the loan-to-deposit ratio.”

—Emerging Markets Investor Survey respondent

### A DETAILED APPROACH TO GOVERNANCE ASSESSMENTS

One investor described his organization’s approach to assessing the governance of target firms as follows. Target firms are assigned three separate ratings:

- Quality of governance: internal proprietary governance rankings based on thorough due diligence, including assessment of objective and subjective factors such as overall ethical standards, responsiveness to institutional investors, conflicts of interest, and general levels of trust in management.
- Directional indicator: to signal whether the firm’s governance is improving, getting worse, or staying the same.
- Investment position: target firms receive “buy,” “sell,” or “hold” rating.

Target firms are assigned a grade (1, 2, or 3) based on country-level and firm-level factors.

“We find that the subjective factors within the governance indicators are more closely tied to stock price movements than the objective factors,” the investor noted.

## KEY STUDY FINDINGS

The key findings of this study fall into two categories:

- Overall importance of governance considerations in emerging market investment decisions, and
- Specific governance factors that influence emerging market investment decisions.

In this section, the findings are detailed in turn.

### 1. CORPORATE GOVERNANCE IS A CRITICAL FACTOR IN EMERGING MARKET INVESTMENT DECISIONS

All 29 respondents said that governance is an important factor in making their investment decisions. They all said that governance was part of their pre-investment due diligence on a target firm.

Still, respondents reported different approaches to conducting governance assessments, ranging from the very formal to the more informal. The larger the investment—and the more resources the firm has—the more formal and standardized the approach.

All reported a process that includes learning about the firm, its controller, and its management; and it often involves traveling to the country and spending time at the firm. This is particularly the case for investor organizations with less formal assessments, which tend to rely on the opinions of their locally-based employees who visit the firms.

On the other hand, groups with more formal assessments tend to rely on both objective and subjective governance factors, and often purchase assessment services from an outsourced service provider. The number of firms spending more money on such outsourced services since the financial crisis has significantly increased.

More than one-quarter of the respondents reported that they conduct background checks on the firm and its key players.

Others noted the value of a relationship with native-born professionals from the country of interest who also had experience working in developed markets. Respondents said that such individuals are valuable assets who can offer deeper insight into the local business culture and how things work.

Some of the surveyed investors said that their approach to governance was associated with a staged investment strategy. First, the investment firm decides on a country and gathers information about a specific industry that tends to generate higher returns. Before making a direct investment in a company, the investor tests the waters by purchasing shares in a fund active in this country.

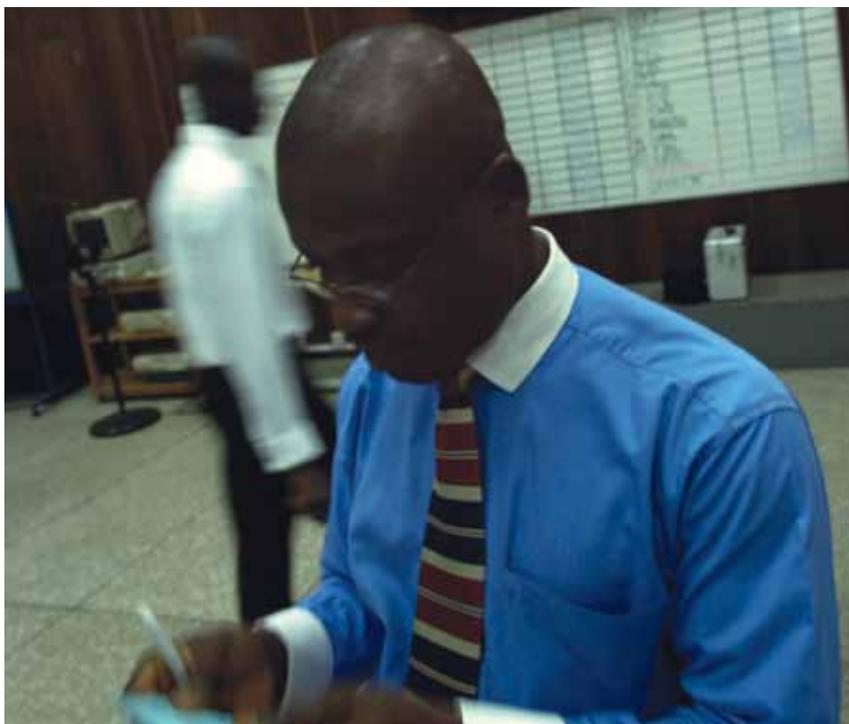
“This gives us some say in governance, and helps us find out more about a particular firm and its environment before we risk too much,” explained one respondent.

More than half of investors surveyed said they would pay at least 10 percent more for a better-governed firm compared to a similar, poorly-governed firm in the same emerging market.

## 2. INVESTORS ARE WILLING TO PAY A PREMIUM FOR BETTER-GOVERNED EMERGING MARKET FIRMS

Investors interviewed said they would pay more for a better governed firm in an emerging market than they would for a firm that came with some governance gaps. Although it was difficult to put an exact number on the value of governance given the range of other country and firm-level factors to consider, all surveyed investors expected to pay a higher premium for better governance in an emerging market firm than the premium they might pay for a firm with better governance in developed markets.

What is the reason for this variance? There is an assumption that more developed markets come with stronger institutional frameworks and better institutional governance. The perception among investors is that a well-functioning governance framework in a country can help minimize their concerns. The reverse also appears to be a strongly-held perception among investors.



The data (see Table 1) clearly show that investors will pay more for emerging market companies with good governance.

However, in response to a question about the exact size of the premium they would be willing to pay for better governance in an emerging market firms, survey respondents were divided.

Of note: more than half of the investors surveyed said that they would be willing to pay at least 10 percent more for a better-governed firm, compared to a similar firm in the same emerging market that lacks strong governance.

While 38 percent responded that they would pay at least 20 percent more for shares in such a company, some few suggested that would pay even more—closer to a 40 percent premium.

**TABLE 1. THE INVESTMENT PREMIUM FOR GOOD GOVERNANCE IN EMERGING MARKETS**

Statement read to 29 emerging market investment decision-makers	Percentage of respondents who agreed with statement
My firm would pay a larger governance premium for emerging market companies than for developed market companies	100%
My firm would pay a premium of at least 10 percent for good governance in an emerging market company	55%
My firm would pay a premium of at least 20 percent for good governance in an emerging market company	38%
My firm considers governance a threshold for an emerging market investment decision, and for how much of a premium we would be willing to pay	41%

One hundred percent of the investors interviewed said they would pay a higher premium for good governance in an emerging market firm than what they would pay for a similar firm in a developed market.

**EMERGING MARKET INVESTMENTS VERSUS DEVELOPED MARKET INVESTMENTS: A CORPORATE GOVERNANCE COMPARISON**

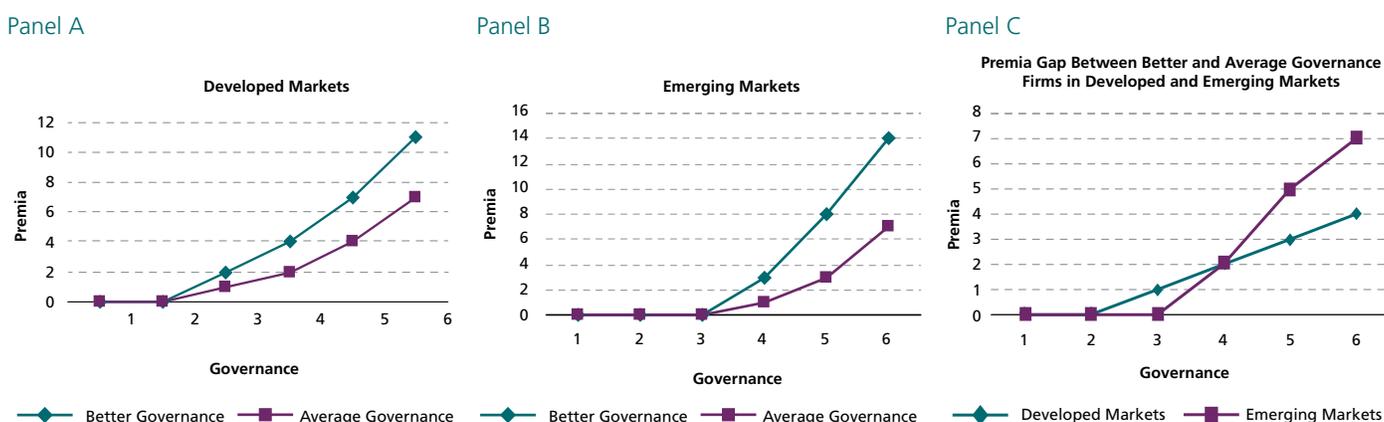
Investors surveyed said there were differences in the way developed markets investors think about corporate governance compared to how they approach the issue. Here are some highlights:

- “Developed markets investors tend to focus on governance as a way to avoid risk while emerging markets investors often focus on governance as a way to enhance profitability.”
- “Developed markets investors often look at governance later in the investment cycle, but they could benefit from the due diligence approach used by emerging markets investors, for example, to look at management quality early on.”

The combination of a threshold effect and then a higher premium in emerging markets relative to more developed markets raises interesting questions about the impact of governance. If this is an accurate description, then the following graphs (Figure 5, Panels A to C) provide a view of the impact of governance.

This visual depiction of the impact of governance shows its importance and opens up areas that should be explored further. For example, how far would firms need to go in improving governance before investors would be willing to invest? What determines these thresholds? What are the key corporate governance attributes that would influence the decision?

**FIGURE 5. IMPROVED CORPORATE GOVERNANCE IMPACT ON PREMIA**



### 3. EMERGING MARKET INVESTORS BELIEVE THAT BETTER FIRM-LEVEL GOVERNANCE CAN MAKE UP FOR COUNTRY WEAKNESSES IN CORPORATE GOVERNANCE

More than 40 percent of the investors surveyed said that well-governed firms in emerging markets could mitigate some of their concerns about investing in certain countries. Investors would look positively on firms that outperform governance practices in the market in which they operate.

Respondents also agreed that it is important to understand the country’s context and local business customs:

“In some Latin American countries, the best way to make things move more quickly was to court the local church bishop and get him to advocate for your cause, rather than relying on other typical community outreach methods to encourage locals to support your venture,” one of the interviewed investors said.

Another investor shared this story about doing business in Russia:

“In Russia, it is essential to have at least one Russian citizen involved in your venture, and to let it be known widely that at least one Russian was involved. This is partly for familiarity reasons. It is also a preventative: sometimes, local Russians might attempt to forge the articles of association and file them with the registrar without informing other shareholders. The presence of the local Russian as an investment partner can help reduce this risk, or ensure more effective policing.”

#### **4. INVESTORS OFTEN DO NOT INVEST IN EMERGING MARKET COMPANIES WITH POOR GOVERNANCE**

Survey respondents also said that they expected steep discounts for shares in emerging market companies that lack strong governance practices.

All of the surveyed investors said that they would not invest in a firm with deeply problematic governance.

Trust plays an important role here, they said:

- Can investors trust that management is speaking the truth?
- Does management demonstrate clear commitments to better governance by working to institute basic corporate formalities, a code of ethics, a governance officer and the like?



While this finding—and the finding that investors are willing to pay more for better governance—is significant, some questions still remain:

- What is the corporate governance threshold for investment?
- How do investors determine these minimum thresholds?
- What specific governance factors influence the size of the premium paid for shares in a better-governed firm?

Such questions could form the basis for future research.

## 5. LACK OF TRANSPARENCY IS A RED FLAG FOR EMERGING MARKET INVESTORS

Investors surveyed noted that the corporate governance factors they would prioritize for emerging market companies might not be the same as the factors that are important for developed market investments.

Of critical importance to emerging market investors: transparency and disclosure.

All of the investors surveyed said that willingness to disclose factored heavily into their decision making. All emphasized the importance of information on the motivations of a target firm's controlling shareholder. All said that a target firm's reluctance to provide information or meet with shareholders would represent significant causes for concern.

Several respondents elaborated on these concerns. Here is what one respondent said:

“The opacity of disclosure at a firm we were looking at, related to payments made to government officials for licenses to conduct business, led us to be concerned not only about the general bona fides of the other representations being made, but also about the potential for being caught in violations of the U.S. Foreign Corrupt Practices Act.”

In fact, nearly 40 percent of respondents expressed concerns about compliance with this law, and observed that they look carefully at investment targets with this issue in mind.

One investor pointed out that lack of disclosure could be indicative of additional problems. For example, a management team that did not want to discuss financial results with shareholders is not in itself a reason for change in the firm's stock price. However, this cluelessness on the part of the management team would not reflect well on the company or how it is run. As a result, investors might think twice before purchasing a stake—or they may decide against making an investment in the firm altogether.

These findings are consistent with prior research suggesting that better disclosure helps attract foreign investments, and that increased disclosure appears to make firms more attractive investments.<sup>7</sup>

**TABLE 2. IMPORTANT GOVERNANCE CHARACTERISTICS FOR EMERGING MARKET INVESTORS**

Governance characteristics	Very important	Moderate importance	Little importance
Disclosure	100%	0%	0%
Related party transactions	90%	10%	0%
Board structure/ board independence*	3%	48%	48%
Shareholder rights, such as “tag-along rights”	83%	17%	0%
Board process	0%	3%	97%
Separate Chairman and CEO	52%	41%	7%

\*Does not sum due to rounding.

**TABLE 3. SPECIFIC GOVERNANCE CHARACTERISTICS OF IMPORTANCE TO EMERGING MARKET INVESTORS**

Governance Characteristic	Very important
Disclosure in general	100%
Disclosure in English	31%
Quarterly disclosure	59%
Willingness of senior management to meet	100%
Motivations of controlling group/management	100%
Succession planning and compensation structure	59%

<sup>7</sup> Increased disclosure appears to make firms more attractive investments. See Hermalin and Weisbach (2009). Further, the recent study by Leuz, Lins, and Warnock (2009) suggests better disclosure helps attract foreign investors. Although their study does not focus on the major emerging markets (with no firms from India, China or Russia and only 16 from each of Brazil and Turkey out of their 4,409 firms), their results are consistent with the findings in this paper. This suggests that disclosure in particular may be a governance factor that is significant across jurisdictions whereas board independence may matter more in some contexts (e.g., dispersely held firms) than in others (e.g., controlled firms).

## 6. BOARD INDEPENDENCE IS A LOWER-LEVEL CONCERN FOR EMERGING MARKET INVESTORS

Respondents expressed less concern about board composition. Specifically, they said that the presence of a board with a majority of independent directors was not as important as other factors. It is not that this feature is undesirable in a target firm. Rather, there are other, more pressing issues to consider, most said.

Investors surveyed pointed out that most emerging market firms have a controlling group—a family or a government—unlike firms in developed markets. And since the controlling group appoints directors, the independence of the board itself is questionable, even if the directors are not associated with the controlling group.

“Governance features such as independent directors have less meaning when the independent directors are selected by the controlling shareholder.”

—Emerging Market Investor Survey respondent

## 7. THE GLOBAL FINANCIAL CRISIS HAS ELEVATED THE IMPORTANCE OF GOOD GOVERNANCE

Another key finding from the survey: in the wake of the global financial crisis of 2008–09, investors are more cautious about investing in firms in countries that have problems with corporate governance.

When asked about China, more than 40 percent of investors surveyed responded with one of the following:

- “We are concerned about our investments in China because of corporate governance issues.”
- “We have slowed down our investments in China because of corporate governance issues.”
- “We need a higher rate of return to invest in Chinese firms because of corporate governance concerns.”
- “We have pulled out of China because of corporate governance concerns.”

In particular, they pointed to opacity of ownership structure and general disclosure concerns as reasons for their more cautious approach to Chinese investments.

Respondents had similar thoughts about their Russian investment portfolios.

Of note, investors surveyed said that they were more inclined to look seriously at targets in countries with improving governance:

- 48 percent expressed increased interest in India
- 45 percent expressed increased interest in Brazil
- 26 percent expressed increased interest in South Africa
- 24 percent expressed increased interest in Turkey

## 8. SPECIFIC CORPORATE GOVERNANCE-RELATED REFORMS COULD MAKE COUNTRIES MORE ATTRACTIVE INVESTMENT DESTINATIONS

Investors who were interviewed discussed reforms they hoped to see in the emerging markets where they invested or where they were thinking of investing. Respondents suggested that reforms focus on improved and more consistent enforcement, specifically in:

- Investor protection laws
- Contracts

Respondents also highlighted a number of country-specific corporate governance-related changes that would improve the investment climate and increase the attractiveness of investments in these countries:

- Less opacity in China
- Fewer judicial and bureaucratic delays in India
- Reduction in the number of multiple class structures in Brazil
- Improvements to the rule of law in Russia



## Why this study matters

The Emerging Markets Investor Survey provides clear evidence that corporate governance plays an important role in the decisions of emerging market investors. Some are steering clear of firms in countries where governance remains problematic, or they are demanding higher returns from such investments.

The information comes first hand from the investors themselves, and offers insight into how corporate governance considerations impact their decisions. While an admittedly small sample set, the frank and honest commentary can offer a road map for where improvements and reforms should be focused. Such information can help inform policy reform agendas of emerging market nations, as well as provide guidance for emerging market companies that are seeking financing.

The study also points to future avenues for follow up investigation, to identify more specifically the kinds of governance changes that would be of value, and how to implement the changes at the firm level and at the country level, with the goal of expanding the private sector and supporting economic growth.

### ABOUT THE AUTHORS:

Vikramaditya Khanna is a Professor of Law at the University of Michigan Law School. S.J.D. Harvard Law School 1997. Email: [vskhanna@umich.edu](mailto:vskhanna@umich.edu)

Roman Zyla is a Corporate Governance officer at IFC.  
Email: [rzyla@ifc.org](mailto:rzyla@ifc.org)



2121 Pennsylvania Avenue, NW  
Washington, DC 20433 USA

The material in this publication is copyrighted. IFC encourages the dissemination of the content for educational purposes. Content from this publication may be used freely without prior permission, provided that clear attribution is given to IFC and that content is not used for commercial purposes.

The findings, interpretations, views, and conclusions expressed herein are those of the authors and do not necessarily reflect the views of the Executive Directors of the International Finance Corporation or of the International Bank for Reconstruction and Development (the World Bank) or the governments they represent, or those of the companies interviewed for this survey.