SPECIAL TOPICS

Reflections on the state of Russian corporate governance from a capital markets perspective in early 2019

Operating a successful business in an environment such as Russia, nowadays perceived by investors as being positioned somewhere between an emerging and developed market economy, has ever since been a challenge: In the course of a massive transformation process - stretching over the last three decades - some of the components of what defines emerging markets, such as the absence of specialized intermediaries, regulatory systems, and contract-enforcing mechanisms, have meanwhile been established in Russia. Nevertheless, to succeed, even in today´s environment corporates have to uniquely adapt their business and operative models to certain particularities whilst retaining their core business propositions.

One of the challenges in implementing any emerging markets-related adaption strategy is frequently the lack of development, depth or – by times – sophistication of the banking and capital markets. Whilst Russia has in this regards progressed markedly over the last decades, the current status still leaves plenty of room for improvement: This refers not only to its stock exchanges and government-appointed regulators, but also other reliable intermediaries, such as credit-rating agencies, investment analysts, investment banks, or venture capital firms. Also, access to accurate information on companies cannot always be ensured. And – eventually – can investors, especially from abroad, actually trust investees adhere to laws or agreements? Also, whilst nowadays strong private sector companies actually do exist across numerous market segments, in the meantime the government has either maintained over even reclaimed a dominant role in several of them, such as in financial services.

As a matter of fact, investment professionals do take into account weak corporate governance as well as a poor legal environment: They are simply willing to pay less when considering an investment proposition. And this is especially valid in regards to emerging markets. Or stated otherwise: There is absolute consensus on the global buy-side that good corporate governance positively affects a company's valuation. Naturally, such premium varies from market to market. The inconvenient and proven truth, however, is that the downside risk of poor governance is indeed formidable and it can easily result in discounts of somewhere around a third of an investee´s fundamental value. Therefore, it cannot surprise that governance is always on the minds of global buy-side investors.

Against this background, one should also take into account that in today´s global world investors have a wide range of choices to allocate capital: For instance, should investments be favored in environments with a more solid investor protection regardless of the governance standings of individual companies? Or, should investors consider corporate governance through the same lens, regardless of where an investment is located? – Now, evidence suggests that corporate governance is especially important in countries with weaker investor protection. There, well-governed companies enjoy significant value premiums that can partially offset the negative impact of a poor institutional environment, which in turn suggests that the payoff associated with better governance is quite high. Consequently, firms in countries with weak investor protection can significantly improve their valuations by implementing better governance and upgrading their disclosures practices. – This observation is of utmost relevance for Russia: A country, where investment decisions are far less influenced by macro-economic fundamentals but instead by the ongoing concern in regards to reliability and trust in its institutions.

Also, a quite common view that Western standards of corporate governance - particularly the US and UK models of governance that put maximizing shareholder value at the core of a company's mission - may not apply to emerging markets should be re-considered. This refers also to arguments, such as that "things are different here" with a reference to extensive family or state-related ownership structures or different corporate cultures. They are frequently quoted as conditions that make developed country standards of corporate governance less a priority.

Curiosities remain, though: For example, Russian regulations as well as the Governance Code give boards extensive powers to perform their duty as shareholder representatives. However, in practice real decision making can drift up, down or sideways. As a consequence, it can be a major challenge – especially for an independent director - to ensure that the board performs the function for which it is actually designed for. And, at the same time, failure to do so could only justify the assumption that the board was merely appointed for window dressing purposes.

On a global scale emerging markets have responded to the current trend of activist shareholders incentivizing corporations to improve their governance structures and practices. And, in the aftermath of a cascade of financial crises it has crystallized that publicly stated strategies mean little to investors, if a company lacks disclosure, transparency, management accountability, and ultimately a strong commitment to shareholder value. – One has to be mindful, though, that only very few Russia-dedicated fund managers can be regarded as activist shareholders. However, despite activist shareholders frequently receiving unfavorable press coverage in Russia, they are absolutely necessary for and critical to the governance ecosystem in Russia.

Numerous factors contribute to what is deemed good corporate governance, whereby some of them, such as the relationship between the CEO and the chairman of the supervisory board, are of course difficult to quantify. Having said this, high-quality corporate governance commonly assesses following parameters: ownership structures, shareholder rights, independence and responsibilities of the board and management, disclosures and auditing, responsibility towards the stakeholders.

Accordingly, better firm-level corporate governance not only reduces agency costs, but also enhances an investors' optimism in the firm's future cash-flow and growth prospects. This in turn, reduces the overall risk profile of the corporate, consequently reduces the rate of return expected by the investors, leading to lower cost of equity capital to the firm. Likewise, a reduction in the agency costs is likely to cause improved operating and investment performance of the better governed firms. The reduced cost of equity and the improved operating performance eventually enhance both the firm's ability to access equity finance, and the firm value. This eventually also accelerates the process of capital market development.

The first challenge for an investor in a Russian corporate is to actually identify its ultimate owners: Ideally, a company's ownership structure is transparent, thereby providing adequate public information on the breakdown of shareholdings, the identification of substantial or majority holders, the disclosure on director shareholdings, as well as cross and pyramid holdings, and management shareholdings. – In Russia, however, shares owned by controlling stockowners are frequently registered with numerous formally unaffiliated offshore companies. And, too often minority shareholders have not been offered fair buyout terms in control acquisitions, whilst profit tax optimizations were undertaken at their expense. – In regards to the corporate governance-related principle of accountability, foreign investors in Russia are also concerned with the cluster of takeover rules and regulations: As a matter of fact, Russian law does not generally prohibit acquisitions of significant stakes in public joint stock companies. And, naturally, there are a number of provisions addressing the procedure for an acquisition of a stake of more than 30% in public joint stock companies. However, unlike in Western jurisdictions, there is hardly any specific regulation on defense strategies against hostile takeovers.

A core parameter in assessing the corporate governance-related principle of independence is a firm´s ownership structure. In the Western world firm ownership structures of publicly listed corporates are in general quite widely dispersed. In Russia, however, about two thirds of public company shares are closely held: Hence, a principle source of friction is between majority and minority shareholders. In Western markets, on the other hand, it is therefore the agency problem which is the more common source of concern.

This can have interesting consequences: Therefore in a Russian company the views of one or two individuals representing the majority owner will quite likely drive the overall attitude towards corporate governance. And, hence, directors representing a non-majority should be prepared to debate vigorously with them. It has to be said, though, that many majority owners have by now bought into the benefits of good governance, such as the correlation between good governance and higher valuations or the lower risk and better decision making from board diversity. On the other hand, the consequences of institutional investors exposed to firms whose majorities don't buy into these ideas, are in all likelihood lower share prices, if governance practices fall short of expectations. Having said this, convincing majority shareholders and company management of these basic realities can be a painful process.

Although the presence of a larger or majority block holder is not necessarily a concern, to start with, a more widely spread ownership normally tends to be a more attractive investor proposition. It should be ensured, though, that no single shareholder or group of shareholders has privileged access to the business or excessive influence over the decision-making process. Such constellations, however, one

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will rarely find in Russia. Instead and in addition, despite the fact that one may only assume so, invisible groups and arrangements of holdings as well as shareholder agreements do frequently exist, allowing selected investor parties not only privileged information access but also exercising more influence. Evidence suggests that in Russia in the 1990s high concentration of ownership caused numerous expropriations of minority shareholders by larger ones and consequently a massive transfer of wealth. This environment naturally resulted in low valuations of Russian companies. The following phase of political stability improved corporate governance practices and subsequently made such types of transfers expensive. This new environment consequently resulted in an upwards correction of market capitalizations of Russian firms. Also cross-listings on Western stock exchanges, ownership structures with multiple large shareholders, independent block holding and foreign ownership helped to mitigate agency costs. Meanwhile, however, much of this dynamics has regrettably been lost. – A legacy, though, particular amid the enhanced engagement of foreign investors, seems to be the number of independent directors on boards, which for major corporates is fluctuating somewhere around the forty percent mark.

The supervisory board is at the heart of the corporate-internal mechanism for resolving agency problems: This is because the board is primarily responsible for recruiting and monitoring the executive management to protect the interests of the shareholders and other stakeholders. And, outside directors are expected to assume the essential governance role in relation to the welfare of corporate investors, especially non-controlling shareholders. And, the presence of outside directors should ultimately improve the degree of corporate accountability and create a fair balance of power between the CEO and the board. Interestingly enough, though, it appears that board independence seems a rather low-level concern for emerging market investors, also as far as Russia is concerned.

In exercising their influence, not least in appointing members to the supervisory board, shareholders should be allowed one vote per share: Corporates should therefore only have one class of shares. That means that all shareholders should also receive equal financial treatment, including the receipt of equitable share of profits. – In regards to Russia, we can at the moment observe lobbying towards limiting or potentially even abandoning the one share one vote principle as a basic rule protecting investors of public joint-stock companies. According to latest proposals, public joint-stock companies may be allowed to issue shares carrying super-rights, belong to the founders of businesses, therefore – so the initiators – ensuring a proper development of innovative companies. Of course, this could also have further repercussions for the voting structures of government-held entities, even if future privatizations may result in the government eventually owning less than majority. The outcome of this ongoing initiative is being carefully observed abroad.

As a matter of fact, Russia is known for persistent corporate governance problems, such as non-transparent ownership structures, transfer pricing within corporate groups, boards with limited de-facto power, and the tunneling of cash flows through related-party transactions by dominant shareholders. Nevertheless, over the years the overall level of investor protection and transparency has improved. Still, it is fair to ask why the level of implementation of the domestic Corporate Governance Code - also within larger publicly listed companies - is still to be desired.

Good corporate governance is not only a fundamental precondition for the long-term sustainability of a business: It is a prerequisite for the stability of capital markets as well as sustainable growth. As a matter of fact, corporate governance affects every stage of the investment cycle of a firm and should provide a business with a framework to take risk to grow and create value. And this requires access to funding to subsequently enable an effective allocation of capital. Besides, it should also enhance an optimal allocation of resources.

Despite the international, not domestic though, capital markets appetite for Russian credit and equity is limited, corporates may seriously consider further enhancing corporate governance standards to be prepared for the moment when markets open up again.

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