

The Irresistible Case for Corporate Governance

March 2006

Good corporate governance won't just keep your companies out of trouble. Well-governed companies often draw huge investment premiums, get access to cheaper debt, and outperform their peers.

How much is good governance worth to a company? Will good practices raise your bond rating a notch...or two? Will your stock price soar 160%? 70,000%? Will investors pay a premium to own your stock of 20%? 30%?

A commitment to good corporate governance—well-defined shareholder rights, a solid control environment, high levels of transparency and disclosure, and an empowered board of directors—make a company both more attractive to investors and lenders, and more profitable. Simply put: it pays to promote good corporate governance.

Investors Will Pay for Good Governance

Investors say they highly value corporate governance. And they put their money where their mouths are.

In both OECD and emerging market countries, well-governed companies attract premium valuations.

- Well-governed firms in Korea traded at a premium of **160 percent** to poorly governed firms, a study by Korean and US researchers found.¹
- An ABN/AMRO study showed that Brazil-based firms with the best corporate governance ratings garnered 2004 **P/E ratios that were 20% higher** than firms with the worst governance ratings.²
- A study of Russian firms showed that a worst-to-best improvement in corporate governance predicted an astronomical **700-fold (70,000%) increase in firm value**. The study's sample size was small (21 firms), so it's unlikely that such a huge increase would occur in a larger, more representative sample. However, the study still demonstrated a correlation between improved corporate governance and firm value.³
- A study of S&P 500 firms by Deutsche Bank showed that companies with strong or improving corporate governance **outperformed** those with poor or deteriorating governance practices **by about 19%** over a two-year period.⁴
- A Harvard/Wharton study showed that if an investor purchased shares in US firms with the strongest shareholder rights, and sold shares in the ones with the weakest shareholder rights, that investor would have earned **abnormal returns of 8.5 percent** per year.⁵
- In a 2002 McKinsey survey,⁶ institutional investors said they would pay premiums to own well-governed companies. Premiums averaged:
 1. 30% in Eastern Europe and Africa
 2. 22% in Asia and Latin America

Good Governance Makes for Cheaper Debt

Better corporate governance standards make banks and rating agencies see companies in a better light. This means lower borrowing costs for well-governed firms.

- In late 2004, **Romania's Banca Comerciala Romana (BCR) was upgraded** by FitchRatings (individual rating to C/D from D) and S&P (long-term counterparty rating to BB- from B+), citing improvements in corporate governance and risk management as the major reasons for the upgrades. IFC led major changes to BCR's corporate governance, bringing the bank in line with EU standards. The corporate governance improvements IFC spearheaded with BCR will be a model for good corporate governance practice for other financial institutions in the region.

Good Governance Helps Operations, Too

Investors won't just think your company will perform better for being well-governed—it's likely that it *will* perform better.

- A study of the 100 largest emerging market companies by Credit Lyonnais Securities Asia (CLSA)⁷ in 2001 showed that companies with the best corporate governance in each of a large number of emerging market countries **had eight percentage points higher measures of EVA** (economic value added) than firms in their country average.
- A Harvard/Wharton team (previously mentioned) also found that U.S.-based firms with better governance have **faster sales growth** and were **more profitable** than their peers.
- An ABN/AMRO study (previously mentioned) showed that Brazilian firms with above-average corporate governance had **ROEs that were 45% higher and net margins that were 76% higher** than those with below-average governance practices.

Better Access to IFC

It's a reputational and financial risk for IFC to invest in companies that are not committed to good corporate governance practices. IFC staff and management are trained to detect and evaluate governance risk and future opportunities in potential investees. This means that investment officers, their managers and IFC's credit review function are more likely to be convinced to advance with an operation when it can be shown that the company is committed to the continuous process of refining its governance practices. Good governance is a key part of creating a more valuable company for all stakeholders.

Corporate Governance and IFC

Of course, IFC investment officers have always dealt with corporate governance issues. It is part of the business of investing in growing firms. However, by integrating corporate governance into their work with companies, investment officers can add value to both the deal and the company.

For a look at why IFC feels corporate governance is important, visit:

<http://www.stop-winlock.ru/ifcext/corporategovernance.nsf/Content/WhyCG>

For a look at the corporate governance methodology, visit:

<http://www.stop-winlock.ru/ifcext/corporategovernance.nsf/Content/Approach>

Bibliography

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² Erbiste, Bruno. "Corporate Governance in Brazil: Is There a Link Between Corporate Governance and Financial Performance in the Brazilian Market?" ABN AMRO Asset Management, July 2005.

³ Black, Bernard. "The Corporate Governance Behavior and Market Value of Russian Firms." *Emerging Markets Review*, vol. 2, March 2001.

⁴ Grandmont, Renato; Grant, Gavin; and Silva, Flavia. "Beyond the Numbers—Corporate Governance: Implications for Investors." Deutsche Bank, April 1, 2004.

⁵ Gompers, Paul; Ishii, Joy; and Metrick, Andrew. "Corporate Governance and Equity Prices." *Quarterly Journal of Economics* 118(1), February 2003, 107-155.

⁶ McKinsey's Global Investor Opinion Survey, 2002.

⁷ "Saints & Sinners: Who's Got Religion?" CLSA CG Watch, April 2001.

Resources

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