

# Corporate Governance Best Practice and Stock Performance: Case of CEE Companies

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## ABSTRACT

Corporate governance (CG) becomes a very essential factor to consider prior to investing in the company. A number of studies proved its importance on the developed equity markets. However, intuitively corporate governance should gain more importance due to high degree of uncertainty because of the unstable environment. In order to assess the influence of corporate governance quality on Central and Eastern European companies' stock performance, the CG assessment model, which includes 21 evaluation criteria, was developed. Based on the model rating, the companies with the highest CG quality (top 25%) outperformed companies with the worst CG quality (bottom 25%) by 0.98% on a monthly basis during the period of 2008 - 2010. Study demonstrate that companies with good CG quality are able to offer lower risk.

**Keywords:** corporate governance, information disclosure, board of directors, stock returns, management team

## 1. INTRODUCTION

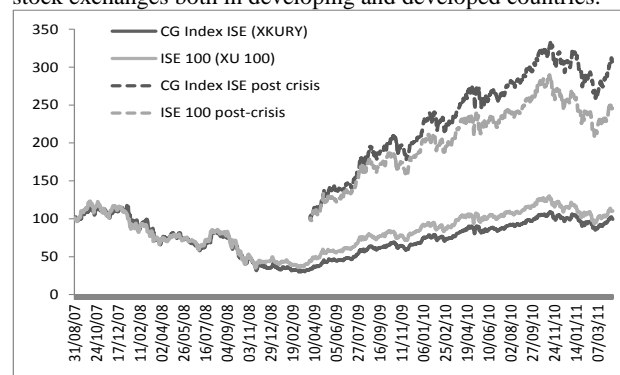
Out of the world's largest 100 economic entities 44 are corporations and 56 are states. The proportion becomes more prominent if to consider 150 largest entities, where the share of corporations increases to 59%, according to Keys and Malnight [14]. The company is like a state with its own regulations, its supervisory and executive bodies, which obviously need to run the company according to the certain rules and procedures that ensure value-based management [7]. Establishment of the quality corporate governance ensures significant limitation of the agency problem and is intended to maximize shareholders' as well as other interested parties' wealth. High quality of corporate governance (CG) is a guarantee of the long-term trust between shareholders and the management of the company.

Corporate Governance and ethical behavior problem and has escalated after the corporate scandals of *Enron*, *Parmalat*, *Worldcom* and was vastly discussed again during the global liquidity crunch with regards to financial entities.

The discussion on Corporate Governance covers mainly the trade-off between the benefits provided by the best corporate governance practice and the tangible and intangible costs for disclosure of information and corporate governance system establishment. As various empirical and theoretical researches suggest in the long-term companies definitely benefit when establishing good corporate governance practice. The tangible positive results of good governance are evident in the booming economy and markets but they appear to be clearer during the economic downturn. Having CG, the company is

able to soften the sharp decline of share price as it was seen during the last global financial crisis.

The evidence of corporate governance positive influence on company's value and stock return has been proved by the various researchers [12]. The topic becoming more popular, there have been created a number of stock indices on various stock exchanges both in developing and developed countries.



**Figure 1.** Performance of Turkish Corporate Governance Index vs. general market (ISE 100)

For example, Istanbul Stock Exchange has created CG index composed of companies, which comply with ISE CG recommendations. Figure 1 shows the comparison of Turkish CG index and Turkish 100 largest companies. Since the period, when CG index was launched, it has underperformed 100 Turkish companies. But if to consider post-crisis period, companies complying with CG recommendations demonstrate better than the market performance.

Though the stock exchanges in Central and Eastern European countries have not created index of this kind yet, the majority of them have published the codes for best practice for voluntary disclosure and implementation for the public companies. Significant number of the companies included in the "blue-chip" indices in this region manage to follow the best practice, but the level of corporate governance is very different from country to country, which is analyzed later in this paper. As several corporate governance experts and market participants state, the quality of corporate governance has massively improved in the past decade.

The question remains still whether good corporate governance by increasing shareholders' trust exerts positive influence on stock return. Therefore, the study's principal hypothesis is that high quality of corporate governance is praised by the superior stock returns. Besides, there were checked minor hypotheses, which were mainly focusing on the separate factors of the corporate governance such as board

independence, information disclosure, frequency of meetings, board and management team turnover etc. Therefore, the aim of the study is to provide an overview of corporate governance level in CEE listed companies and to figure out the relationship between stock performance and the level of corporate governance.

The methods used in the research involve model work-out based on the previous research and exchange recommendation as well as judgment on the quality of CG of CEE companies. The authors have used also quantitative methods (correlation, regression, etc.) to find out the relevance of CG influence on stock prices.

## **2. IMPORTANCE OF CORPORATE GOVERNANCE FACTOR**

A number of studies conducted on the developed markets state that corporate governance has strong influence on the stock market returns. Gompers, Ishii and Metrick constructed "Governance Index" which covered the assessment of shareholders' rights at 1500 companies in 90-ties [12]. Based on the index they have modeled the portfolio strategy that would long companies with strongest rights (lowest decile) and short companies with weakest rights (highest decile). As a result, the investor could earn 8.5% outperformance. The similar study was done by Drobetz in Germany showing the monthly difference in performance of well and poorly governed firms of 1.73% [11].

The significant correlation of such factors as CG index, CEO-Chairman separation and independence of board members with stock performance was found by Bhagat and Bolton [3]. But they did not find any evidence of quality of CG being a proxy for future stock performance. The findings of their study show also that given low quality of corporate governance of a certain entity and given its poor performance there is a high probability of management turnover.

Positive correlation between firm value and quality of corporate governance in case of largest 300 European companies (FTSE Eurotop 300) has been indicated by Dutch scientists Bauer, Guenster, Otten [2]. But when adjusting for country difference the relationship is weakening.

The contrary situation was discovered in Japan by Aman and Nguyen, who discovered that poorly governed firms outperform well-governed firms [1]. However, the results were statistically insignificant, but the study has clearly showed that significantly higher risk is attributed to the poorly governed firms.

Some researches have been made by considering separate factors which determine the quality of corporate governance. The significant relationship was indicated between equity performance and board independence (Hermalin and Weisbach [14, 15], Bhagat and Black [3]), stock ownership of board members (Bhagat, Carey, and Elson [5]), CEO and Chairman separation (Brickley, Coles, and Jarrell [8]).

The story in emerging markets is a bit different: due to often concentrated ownership structure companies have rather low motivation to disclose the information to outsiders. The need in minority shareholders obviously is less compared to the situation in developed markets. The regulations regarding corporate governance are less strict than they are in developed stock markets. In most of the cases these are just the recommendations imposed by the local stock exchanges. Anyway, the question of corporate governance influence becomes more topical. In case of favourable outcome (positive correlation with stock returns), the obtained results proved by the empirical research can be used to persuade the companies to stick to the best practice.

The available related literature provides the evidence of well-governed companies' outperformance also in the emerging markets. Roy Kouwenberg says the corporate governance matters with regards to Thai public companies: stock return of the best 20% companies according to the CG score in the period 2003-2005 was 19% p.a. year better than the stock return of the weakest 20% companies [17].

Indian market represented as NIFTY 50 has been studied by Samontaray, who found significant relationship between share price and in such independent variable as EPS, sales, net fixed assets and corporate governance factors [22].

There have been several studies on CEE stock markets, but the studies were done rather on macro level or considered separate factor which determine CG quality. Research made on 151 CEE companies by Mueller and Peev indicates that the firms' which are controlled mainly by foreign shareholders are overdoing their counterparts with mainly locals represented in the ownership structure [19]. Another study on ownership influence on CEE companies' performance considered mainly the type of ownership structure: strategic, state, financial, founder/family [6]. The results of the study indicated that the best-performing companies have state representation in their ownership, which were followed by the family/founder controlling.

Pajuste has been also researching ownership and shareholders' rights in CEE stock markets for the period of 1994-2001 [20]. Her findings provide the evidence of significant controlling shareholder influence on the performance of the company and that minority shareholders' rights are often abused making the market absolutely inefficient and risks are not justified by the returns, which are lower than average.

## **3. CORPORATE GOVERNANCE ASSESSMENT MODEL**

Corporate Governance evaluation is often done in the developed markets, where several rating agencies provide their scores for the public company's governance. In emerging market and specifically in CEE countries the term of corporate governance has appeared relatively recently so no centralized CG assessment for CEE companies was available at the time the study was made.

Therefore, in order to evaluate the quality of corporate governance of CEE companies, corporate governance assessment model was created (1.Table). The framework for the model was developed according to the CG recommendations to the listed companies provided by the local stock exchanges (Nasdaq OMX, Warsaw, SET etc.). Besides, the list was expanded by adding the most important factors defining CG quality, which are widely recognized and adopted in the mature financial markets.

The model consists of four pillars, where each is dedicated to a certain set of factors (supervisory board, management team, investor relations, information disclosure) defining the quality of corporate governance. The maximum score a company can get is 21, which is obtained by summing up all points in each segment. If the information regarding management team or board of directors was not available, then the neutral rating was assigned to the certain criteria when evaluating CG of a particular company.

### **Supervisory Board/BoD**

Major attention in the model is paid exactly to the board of directors, which is usually representing shareholders' interests and has mitigating role between shareholders and management.

Table 1

## Corporate Governance Assessment Model

	Worst		Neutral		Best	
<b>Supervisory Board/BoD</b>						
Independence of directors	0-50%	0	50-75%	0.5	75-100%	1
Diversified skills of directors	concentrated	0	average	0.5	diversified	1
Frequency of meetings	<4 and >10 meetings	0	4-5 and 9-10 meetings	0.5	6-8 meetings	1
Performance-based compensation	no	0	partial	0.5	for all members	1
Frequency of Elections	once in more than 3 years	0	once in 3 years	0.5	once in 1 year	1
Stability of BoD	30% and more change	0	10-30% member change	0.5	0-10% member change	1
Committee structure	No committees	0	over 3 comm.	0.5	3 committees	1
CEO and Chairman positions are separated	no	0			yes	1
<b>Management Team</b>						
Logical and clear organization	no	0	not very plausible	0.5	yes	1
Organization supports reporting structure	no	0	partly supports	0.5	yes	1
Stability	30% and more	0	10-30% member change	0.5	0-10% member change education and experience	1
CEO Background	irrelevant	0	notvery relevant	0.5	relevant	1
<b>Investor Relations/AGM</b>						
Conference calls, webcasts, presentations	no	0	yes, but not perfect	0.5	yes	1
Dividend policy	no	0	not 100% clear	0.5	yes	1
Information regarding AGM	no	0	not explicit	0.5	yes	1
<b>Disclosure of Information</b>						
Annual Reports	no	0	limited for past years	0.5	yes	1
Quarterly reports	no	0	half-year	0.5	yes	1
Info on mgmt	no	0	not explicit	0.5	yes	1
Info on BoD	no	0	not explicit	0.5	yes	1
SRI report/part of AR	no	0	not explicit	0.5	yes	1
Ownership Structure	no	0			yes	1
<b>Total</b>		<b>0</b>		<b>9.5</b>		<b>21</b>

CG assessment model includes such crucial evaluation factors as board independence, directors' skill diversification rate, CEO and Chairman roles separation, directors performance-based remuneration. Empirical research has proved that these factors influence shareholder's return. Besides, the authors added the model with meeting frequency assessment, election frequency, board stability and committee structure, which intuitively can impact entity's governance and performance.

### Management

Basically all sources providing CG evaluation models pay much less attention (if at all) to the management team organization and so does the model. There are just four points included to make a judgment on the executive team as a part of entity's CG. Organization of the management team is the key in the assessment of the quality of management team. Clear responsibility assignment ensures good governance and process management. Relevance of CEO background becomes crucial in the entrepreneurial environment, which is excessively present in the developing CEE countries.

### Investor Relations

The quality of investor relations gains importance when the company seeks to attract investors as well as support existing ones with up to date information. Shareholders of the particular company are usually curious to understand the

dividend payout policy, be acknowledged with the latest financial results as well as informed about the pending annual general meeting (AGM) and its agenda.

### Information Disclosure

The degree of information disclosure is of utmost importance in order to eliminate the principal-agent problem. Nowadays for the majority of investors only source of information is basically the company's website, where financial reports for various periods are stored. Besides, the authors included assessment of availability of information on management team and supervisory board as well as information on ownership structure and corporate social responsibility. The latter becomes very topical, which is proved by creation of multiple SRI indices (FTSE4Good, Dow Jones Sustainability Index).

### Research Methodology

Relevance of relationship between share price and quality of corporate governance was tested by using the above explained assessment model. The higher the rating the better is the governance of the company, which was put in relation to share price with the help of linear regression. The authors have also tested whether the market recognizes better governed companies, which was tested by looking at company's valuation.

Overall the authors have obtained the data for 116 companies quoted on stock exchanges in 10 CEE countries: Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Poland, Slovakia, Slovenia. The corporate governance assessment was based mainly on the latest available annual report (for FY 2009) and the information published on corporate homepages. The share prices for the last 3 years were extracted from the data provided by the CEE stock exchanges, and two periods were considered in the study: 1 year (2010) and 3 years (2008-2010). Turnover of the executive team and board of directors was not considered for the longer (3Y) assessment period due to data irrelevance. However, assessment of other factors was applied retrospectively.

#### 4. RESEARCH RESULTS

##### General Overview of CEE Corporate Governance

The financial markets in CEE are yet in the development phase and so is the attitude towards corporate governance and best practice implementation. The level of corporate governance is very different from country to country (figure 2). Highest overall score was received by Estonian, Lithuanian and Slovenian companies, which have very good information disclosure and excellent investor relations. The lowest score was obtained by the Romanian companies, which are very weak in providing the information, thus making it almost impossible to consider the company as an investment target for a foreign investor.

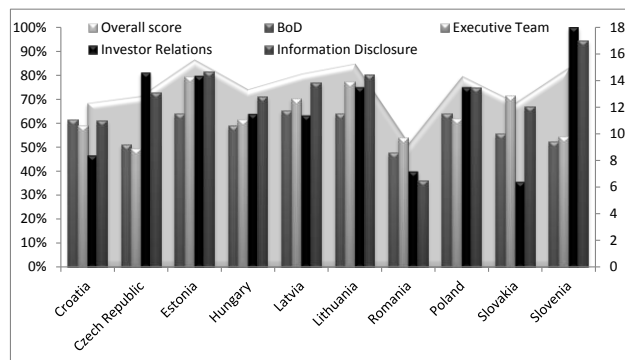


Figure 2. Average CG assessment of CEE companies by countries

It is interesting that in majority of cases Board of Directors (BoD) scores were the lowest compared to other categories. Partial explanation is found in the frequency of elections, where almost all companies were penalized due to not having annual elections (as considered in best practice standards). BoD is being elected once in 3-4-5 years, which makes the assessment of each BoD member's activity and contribution inefficient. Besides, the companies in CEE have established fixed remuneration system for BoD members, while the performance-based remuneration has been proved to be value-creating strategy. Highest scores in executive team evaluation were obtained by the companies from Estonia, Latvia, Lithuania and Slovakia mainly thanks to the high stability of the management team and to its logical organization structure. Surprisingly, Czech and Slovenian companies, though having high overall scores, have rather weak ratings of the executive teams.

The reason for that is unclear executive structure, which often does not correspond with the reporting structure (e.g. regional management organization, while reporting is by

divisions). Moreover, CEO education and experience often is not relevant to the business essence of the company.

Besides, the quality of corporate governance to a great extent depends on shareholding structure. If the company has strategic shareholding of Western European origin (e.g. 51% of *Magyar Telekom* held by *Deutsche Telekom*, 62% of *TEO LT* held by Swedish *Teliasonera*), then the company is significantly influenced by its shareholders and is forced to implement also Western European CG standards. The companies, which have as controlling shareholder local individuals, usually do not bother about complying with recommendations of the local stock exchanges.

Figure 3 chart shows the assigned ratings across the categories. Almost 90% of the companies are disclosing shareholder's structure and have separated roles of CEO and Chairman. The companies are very active in publishing the minimum set of documents (annual and quarterly reports) required by investors, but are not very willing to make additional reporting: presentations, webcasts, CSR reports.

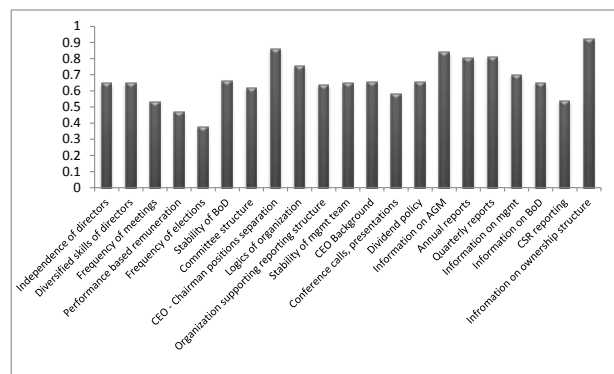


Figure 3. Average CG assessment of CEE companies by criteria

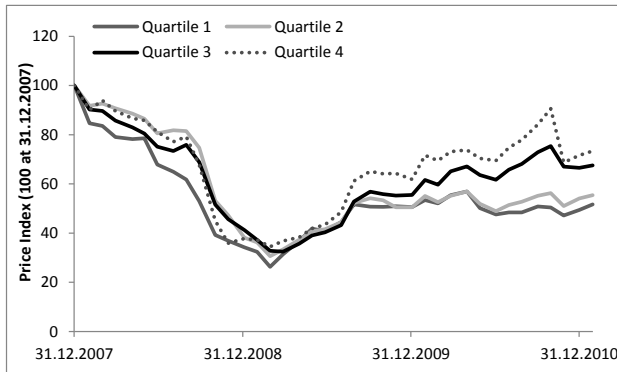
The encouraging trait of CEE companies is BoD independence, its stability and directors skill diversification. Regarding BoD independence it needs to be mentioned, that this factor greatly depends on the shareholding structure: in case of controlling and significant influence of one shareholder, the BoD in most cases represents the interests of this shareholder.

Supervisory board meeting frequency was assessed setting as a best case scenario best practice meeting frequency of 6-8 times a year: not be deeply involved in the business and still manage to understand the company's development and consult executive team. CEE companies tend to have more often BoD meeting, which are usually exceeding 10 times a year with only some rare instances of 3-4 meetings a year. Perhaps, for a dynamic and often uncertain environment which is overwhelmingly felt in CEE countries, often meetings are necessary to be able to timely make decisions.

Management scores for CEE companies are above average in all four categories. One can distinguish also logical and clear organization of the management team, which surely is an advantage of CEE companies.

##### CG Influence on Stock Performance

The companies analyzed have been divided into quartiles according to the Corporate Governance rating. The price index was calculated for each quartile as seen on the chart (figure 4).



**Figure 4.** CEE companies performance according to CG quartiles (1 quartile – worst quality of CG)

The results show that CEE companies with above average quality of corporate governance outperform their peers with weaker CG ratings. As it is seen on the chart, the outperformance starts to be obvious in the recovery phase after the global liquidity crunch. So, most probably during the steep decline on stock markets and high degree of uncertainty CEE region investors recognized the value added of better governed companies and risk associated with poor information disclosure. The same research approach applied to one year period shows that during the last year investor largely praised better governed companies, as top 25% of companies managed to outperform the worst 25% of companies by 0.99% each month. It is also worth noticing that there is a large gap of 1 and 3 year period between stock returns of the best two CG quartiles and worst two CG quartiles. The statistical significance tests show that the relationship between corporate governance quality and stock returns is significant but only for three year time period. Multiple R (correlation) for one year period is 13%, while for three years is 22%, both of which are on a rather level.

Table 2

Regression Statistical Significance		
Regression Parameters	Time Period	
	1 Year	3 Years
Multiple R	0.13	0.22
R Square	0.02	0.05
Standard Error	0.80	0.43
t-stat	1.16	1.98
F test	1.34	3.94

The hypothesis regarding riskiness of investments could be that investing in companies with high CG scores one is exposed to lower risk. The table 3 provides risk measures by beta and volatility for two time periods.

Table 3

Risk Figures of CG Quartiles						
Nr. of Quartile	Price Index		Volatility		Beta	
	1Y	3Y	1Y	3Y	1Y	3Y
1	105.2	51.7	9.7%	15.8%	0.91	0.82
2	109.8	55.5	12.9%	15.6%	0.96	0.93
3	121.7	67.6	11.7%	14.8%	0.92	0.97
4	118.6	73.4	14.7%	16.2%	0.59	0.75

Volatility figures are relatively similar for all quartiles especially if we consider longer period. Beta results, basically,

support the hypothesis about riskiness of investments. Best 25% companies, according to CG rating, have lower beta than the companies with weaker score on CG.

Therefore, both during longer and shorter term well-governed companies offer relatively low risk in relation to the market.

#### Factor Analysis: what is the “Most Profitable” Corporate Governance Practice for Investors in CEE region?

The classical corporate governance practice works well to benefit investors in the countries with the developed economy and financial markets such Western Europe and USA. For example, higher returns are achieved if the board of directors is prevailed by the independent members (Byrd, et al. [9], Cotter et al. [10]), CEO-Chairman positions are separated (Goyal et al. [13], Yermack [23]), executives have stakes in the company’s capital (McConnell et al. [18]) and directors’ compensation consisting of cash and stocks/options (Perry [21]).

However, the situation looks rather different if we consider the economy of the developing markets such as Central and Eastern Europe. Although the results of the present study prove that in the longer term investors win when choosing the companies with overall good corporate governance by reducing the risk (beta) and receiving better performance, more detailed analysis demonstrates that not all key attributes of the ‘best practice’ are significant in achieving better stock performance.

Table 3 provides an overview of the CG factor influence on the stock performance significance. It includes t-tests and the correlation with share performance for all four groups of criteria for two periods considered in the present study (one year and three years). Apart from that the authors selected the most influential factors on the stock performance as well.

Table 3

#### Price Return Correlation with CG Criteria and Regression Significance as Defined by t-test

CG Assessment Criteria	Correlation 1Y	Correlation 3Y	T-test 1Y	T-test 3Y
Diversified skills of Directors	15.5%	17.4%	1.38	1.55
Frequency of Elections	10.2%	16.8%	0.90	1.49
<b>BoD assessment</b>	<b>9.4%</b>	<b>10.0%</b>	<b>0.83</b>	<b>0.88</b>
Logical and clear organization	19.6%	11.8%	1.75*	1.04
Stability	-7.4%	-19.9%	-0.65	-1.78*
<b>Management team assessment</b>	<b>18.7%</b>	<b>-5.6%</b>	<b>1.67*</b>	<b>-0.50</b>
<b>IR assessment</b>	<b>3.6%</b>	<b>11.7%</b>	<b>0.32</b>	<b>1.04</b>
Info on mgmt Ownership Structure	14.9%	18.5%	1.32	1.66*
Structure	5.4%	-18.5%	0.47	-1.66*
<b>Disclosure of Information assessm.</b>	<b>8.8%</b>	<b>2.5%</b>	<b>0.77</b>	<b>0.22</b>

\*-shows that the results are statistically significant at 10% level

It seems that only the management factors have positive significant influence on the share price performance with the correlation of over 18% for the one year period. Strong influence on the share price performance exerts clarity and logics of the management team responsibilities' split, which points to the efficient company's governance and is positively reflected in the price performance. It is interesting that the stability of the management team negatively correlates with corporate stock growth, which means the lower is the stability of the management team, the better is the performance. The authors speculate that this factor can be specific for emerging markets, where the firms' development needs dynamics also in the management team. Besides, the top managers in CEE region often lack experience and, therefore, changes in the management team are regarded positively. CEO background relevance does not add significant value to the positive price performance.

Considering the influence of BoD quality on the stock performance, it does not seem to be significant. In contrast to the companies headquartered in the developed markets [9, 10], there is no any evidence that investors require Board members to be independent. This might be because of the ownership structure and good performance of those companies, where it is concentrated and, thus, major owners are vastly represented in the boards (Bistrova, Lace [6]). There is a very moderate positive correlation of higher frequency of election and diversified directors' skills with the share return. In CEE region there is, basically, no evidence that compensation of directors with cash and stocks/options or that stability of BoD or CEO-Chairman positions separation add positive value to the portfolio performance.

It seems that investors in CEE companies do not really care if the company has quality investor relations or not. They are also not considering carefully how easy it is to obtain the information, and whether annual reports or latest financial results are available on the companies' homepages in English. The only factor that matters for investors, according to the results of the present research, is the quality of information on the management team (team composition, background of the managers), which positively correlates with the share price.

The authors believe that there can be three possible reasons to explain the obtained results on the importance of IR and quality of information disclosure, which, again, seem to be characteristic for the covered region. First, many companies tend to be controlled by the very concentrated group of people, which are often insiders. Second, in case any large financial investor controls part of the company (e.g. 3% or more), it usually has direct access to the CEO, CFO or IR managers and, thus, to the latest company's development trends. Third, if the investors of the company are local citizens, they often lack knowledge to make sophisticated analysis on the company and, therefore, do not require full corporate information disclosure.

Corporate governance factor analysis points to the high importance of the management team quality, when selecting companies to the stock portfolio. While the other key attributes of CG "best practice" are not able to help generating superior returns/.

## 5. CONCLUSIONS

Corporate Governance term is relatively new for the companies operating in Central and Eastern Europe but in a quite short time period lots of companies were able to offer investors explicit information on their governance system. In many cases the process of establishing CG system was strongly influenced by the controlling shareholder either positively or

negatively. Highest CG ratings have been obtained by Baltic as well as Slovenian companies, while Romanian companies are distinguished by very weak corporate information disclosure. The majority of companies analyzed provide extensive disclosure but, it seems, that the institute of BoD is not well understood yet: staggered board elections, high degree of BoD involvement in routine business management, compensation is not linked to performance.

Though the culture of equity investing is still in its development phase in Central and Eastern European countries, the value of good corporate governance is being recognized by the investor. The findings of the present study prove the hypothesis that there is a significant influence of corporate governance quality and stock returns. The results are statistically significant during the longer term period of 3 years. It is also worth noticing that better managed companies are able to offer low risk as measured by stock price beta.

The authors of the study have also checked almost all separate criteria in the model developed (e.g. board independence, meeting frequency). One of the most influential factors on the stock performance is the quality of the management team and information disclosure on the company's management. Skill versatility of BoD members had also significant positive influence on the share performance of the analyzed CEE companies. It is worth noting, that the classical CG factors such as BoD members' independence or CEO-Chairman separation, which demonstrate support to the share price performance within the developed stock markets, do not add value to the performance within CEE equity markets. The same result was discovered for the factors connected with the investor relations quality. This means that, basically, the companies do not have to spend huge money on providing good quality of investor relations, as the market at the current standing does not demand it.

Research findings clearly show that corporate governance in CEE countries cannot be neglected, so the primary recommendation, based on the study, to CEE investors would be consider the quality of corporate governance, transparency and information reliability. CEE listed companies are also advised to pay decent attention to CG, information disclosure as well as continue developing investor relations at high pace as this can improve corporate stock performance.

Undoubtedly, the research should be continued to include the expanded time period, which would cover all phases of the financial markets development. Besides, the corporate governance systems of CEE companies have to be studied historically to make assessment of its development and influence on the shareholder value enhancement.

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