

Giving new life to the corporate governance reform agenda for emerging markets

McKinsey Emerging Market¹ Investor Opinion Survey 2001 - summary of preliminary findings²

Emerging market governance reform has not progressed substantially despite the willingness of policymakers and investors to press for change. McKinsey & Company's new Emerging Market Investor Opinion Survey 2001 of private equity investors highlights some ways to give new life to the reform agenda by focusing on the fundamentals for good corporate governance.

First, governance reformers need to devote more emphasis to driving change through institutional reform of capital markets - and the underlying structure of property rights - to complement practical improvements to governance at the corporate level.

Second, the importance of family owned businesses in emerging markets should be recognized more explicitly. Without incentives to change, they could continue to act as a major obstacle to reform. Institutional reform could provide some of these incentives. Enabling family owned businesses to adopt a sequence of incremental changes could help them share in the benefits of reform.

More fundamentally, however, the Survey highlights that the emerging market corporate governance model is markedly different from that which prevails in the U.S. and U.K. Any transition from the former to the latter requires substantial reform not only at the corporate level, but also at the

institutional level. The complexity of this transition has for too long been underestimated.

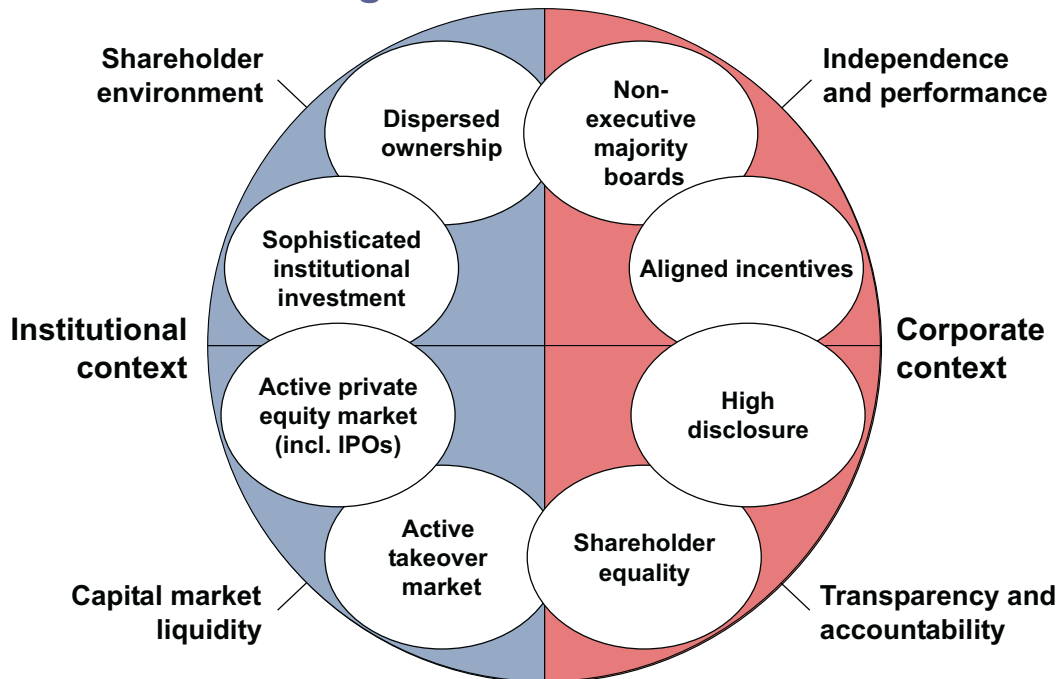
The context

Corporate Governance continues to be of major concern in emerging markets. Across many countries policymakers have begun efforts to encourage companies to adopt higher governance standards. For most, state regulators or legislators have driven reform, for example in markets as diverse as Brazil, China and Malaysia. In some, this has been reinforced by shareholder pressure, for example, as in Russia. In South Korea, it has been both, with the government taking the lead and local shareholder activists pressing for effective implementation.

International organisations have played their part. The International Monetary Fund has argued that governance improvements should be included in its debt relief programs, most noticeably in Malaysia. The World Bank has worked hard at raising the profile of governance reform, particularly in its work with the Organisation for Economic Cooperation and Development (OECD). Its private sector investment arm, the International Finance Corporation, has taken up the reins by encouraging its private equity funds to promote improved practices.

Yet corporate governance standards in emerging markets are still far behind those in the U.S., U.K., and continental Europe. The responses to last year's McKinsey Investor Opinion Survey³ suggest that investors are well aware that in emerging markets governance is more in need of reform than is true in other regions.

The market model governance chain*



* Examples can be found in Australia, Canada, U.K. and U.S.
Source: McKinsey

Generally, much of the corporate sector in emerging markets remains uncommitted to reform. Initiatives to promote better practices, principally related to board reform, have either been ignored, or perhaps even worse have been applied with a spirit of compliance to the letter of the law, rather than driven by a performance mentality. For example, while most companies in South Korea that have been compelled to appoint more non-executive directors to their boards have done so, few have proactively implemented steps to ensure these new appointees are truly versed in the requirements of their new roles.

More fundamental institutional reform

The reasons for the lack of progress are complex, and deserve more discussion. One of the main problems is that the overall focus of reform has to date been too limited. Reform has focused on promoting the adoption of practices such as greater disclosure, improved shareholder rights and board reform. Together, these could be called the corporate context of governance reform.

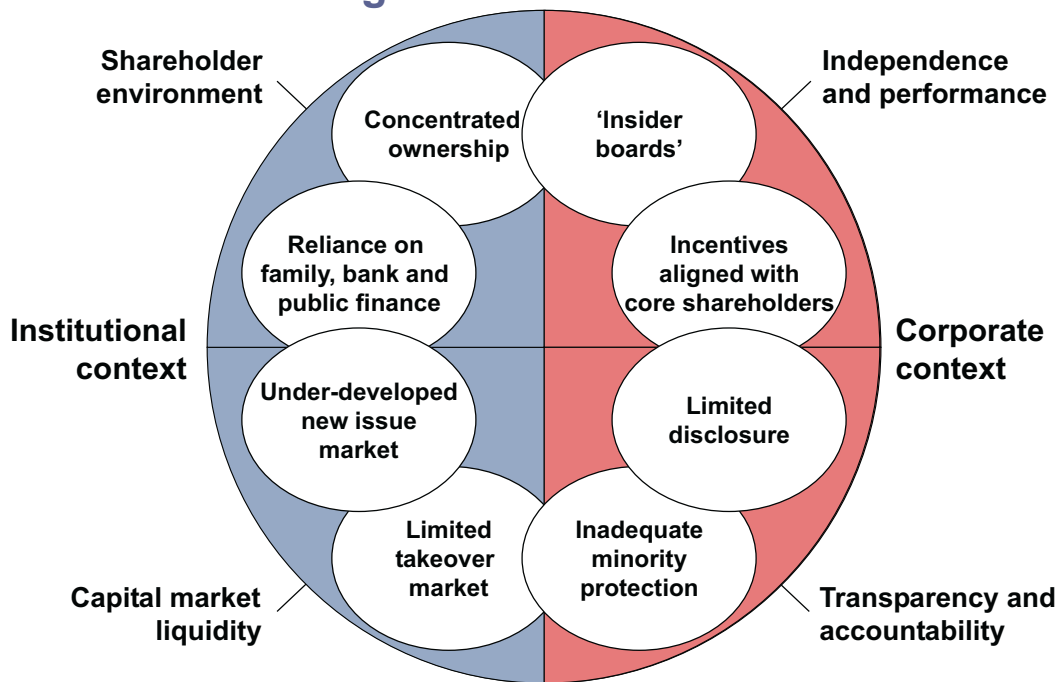
The corporate context should, however, be seen as part of a much larger

governance model that depends heavily on a particular institutional context, one that has efficient equity markets and dispersed ownership. Together, these contexts characterize the 'market model' of corporate governance with which international fund managers are most comfortable (Exhibit 1).

The corporate and institutional context in emerging markets differs markedly from that in the market model. Typically, corporate governance practices are tailored to suit the needs of core shareholders. Equity markets are less developed and consequently ownership is more concentrated. A distinct - and internally consistent - 'control model' of corporate governance is in operation (Exhibit 2, over page).

A more holistic perspective of corporate governance suggests that fundamental institutional reform is needed to support any proposed corporate level change. Such reform could provide a platform from which to encourage emerging market companies to reform their governance practices, particularly family owned businesses. For example, improving the efficiency of equity and private equity markets provides more external financing options for local businesses.

The control model governance chain*



* Examples can be found in Asia, Latin America and many continental European countries
Source: McKinsey

More fundamental reform to enhance value could look beyond corporate governance to include such levers as efficient financial linkages to the global capital hubs, as well as legal and regulatory leverage that utilizes more favourable environments for conducting business. Different countries are at different states of development, and the choice of corporate lever used is highly dependent on the country of domicile. In Mexico, for example, additional analysis undertaken by McKinsey & Company suggests that legal and financial levers are valued more highly, while in certain Asian countries corporate governance, especially corporate board reforms, is more highly valued⁴.

The direction of reform is key. It is often accepted without question that emerging markets should immediately adopt all the major elements of the market model of corporate governance. Yet as has been seen over the last century in many continental European countries and in Japan, alternative institutional and governance arrangements are possible; ones that rely more heavily on debt (bank) not equity (investor) finance.

However, as many countries have prioritised the need to attract external equity investment into emerging markets, it appears that investors feel more assured by the market model of corporate governance. The market model is therefore a natural goal or target for any reform process.

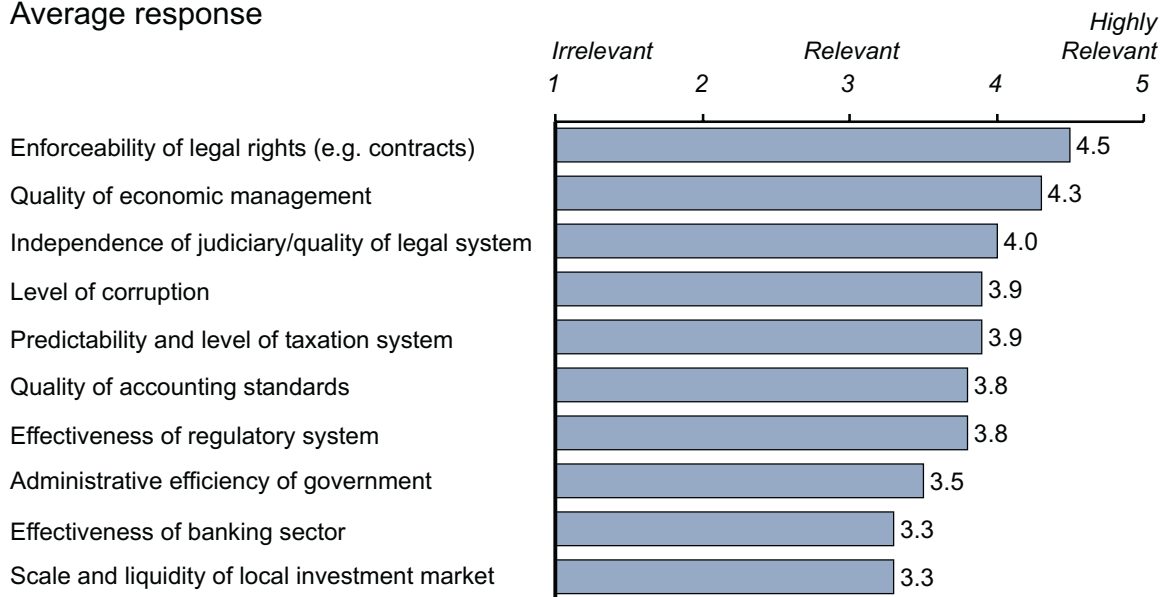
The emerging market investor opinion survey

In McKinsey & Company's new Emerging Market Investor Opinion Survey, we surveyed 46 private equity investors for their views on corporate governance. The respondents are invested in a range of emerging market countries, including those in Asia, Eastern Europe and Latin America, and manage approximately US\$4.1 billion in these regions.

Over half (55%) of the survey respondents believe that institutional reform is at least as important as corporate level reform. From their perspective institutional reform provides a greater level of security for their investments.

Importance of institutional factors when selecting emerging market countries in which to invest

Average response



Source: McKinsey Emerging Market Investor Opinion Survey 2001

There are three areas the respondents highlighted where reform needs to be prioritised (Exhibit 3):

- Enforceability of legal rights. This needs to be strengthened by improving the integrity of the judiciary and the legal system.
- Macro-economic stability. The effectiveness of the regulatory system needs to be improved.
- Accountancy standards. The *accuracy* of accounts is the first priority of investors, with timeliness and coverage of accounts taking second priority.

These reforms are not merely a matter of establishing formal market structures and rules; their nature highlights the need for a fundamental change in attitudes towards markets, property rights, and the security of contracts. Russia, for example, has relatively advanced legal requirements to protect share-holder rights; the problem is getting these rights enforced.

Institutional reform is, however, only part of the solution. Governance reformers need to consider more explicitly how to encourage the corporate sector to commit to reform.

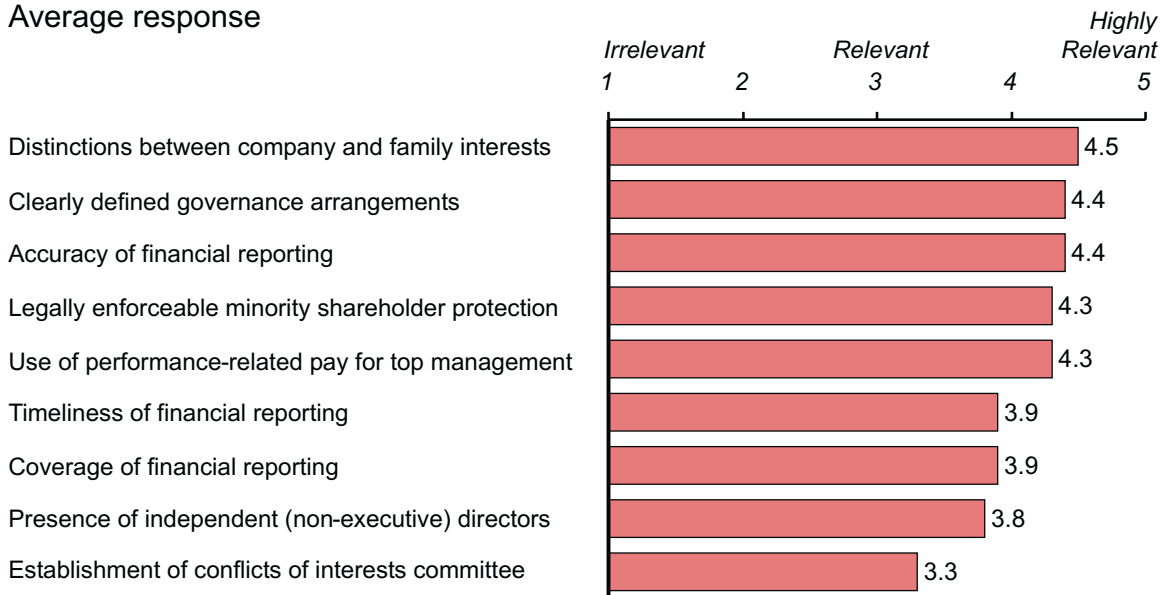
Gaining corporate sector commitment to reform

The prevalence of family owned businesses within emerging markets is well known. Their significance in governance reform is, however, often ignored. The corporate sector's lack of enthusiasm for reform in emerging markets is compounded by three issues related to family owned businesses:

- Family owned businesses play a significant role in most emerging markets. In Mexico and Venezuela, for example, family owned businesses account for over 56% and 34% respectively of sales of the top 100 companies. Recent research on East Asian countries suggests that families are even more influential in this region⁵.
- It is not surprising that family owned businesses tend to resist intrusions from outsiders, particularly when these impact adversely on the family's power within the business, as with corporate governance reform.

Importance of corporate level factors when selecting emerging market companies in which to invest

Average response



Source: McKinsey Emerging Market Investor Opinion Survey 2001

- Since it is likely that family members will remain significant shareholders in their businesses for at least the medium term, there is a need to prioritise governance reform such that they feel able to control their businesses and share in the benefits of reform. To date, there has been no effort to articulate how best to accomplish such reforms.

Investors are aware that family owned businesses are a potential blockage to reform. The two top corporate issues that respondents to our Emerging Market Investor Opinion Survey feel are most in need of reform are ensuring that there is greater distinction between the company and family interests within family owned business, and the need for more clearly defined governance arrangements (Exhibit 4).

Institutional reform could help this transformation as family owned businesses, particularly those managing the difficult transition between generations, may well opt for alternative financing options created by

such reforms, for example, to access an expanded pool of external equity investment. To do so, they would need to improve their governance practices, not least their disclosure practices and shareholder rights, to meet the concerns of outside investors.

In the short term, most emerging market family owned businesses remain unconvinced that governance reform is in their interest. Individual governance changes do not appear beneficial, and together they create an almost overwhelming change program for family owned businesses that start out with 'control model' governance practices.

Perhaps the most effective way to encourage family owned businesses to change would be to allow them to do so gradually and not expect wholesale change. A staggered approach to reform makes change more manageable and enables family business leaders to retain sufficient control over the process.

Our Emerging Market Investor Opinion Survey suggests the order in which reform measures might be pursued. The many possible corporate reforms were grouped into five main headings, and respondents were asked to prioritize them:

- Most important of all was greater transparency.
- Adoption of internationally recognized legal standards and enhanced shareholder rights were in second and third place.
- Board reform, so often the focus of reform initiatives, only came fourth, whilst a listing on a major stock exchange was least important⁶.

A prioritised approach to governance reform within family owned businesses provides an opportunity for such businesses to realize the benefits of governance change for themselves. For example, in allowing businesses to focus first on improved disclosure practices, they will begin to see the benefits of more accurate reporting

practices *within* the business (a prerequisite for more accurate external reporting). This would be most noticeable in the ability to track individual performance and enhance personal accountability. Similarly, once board and top management evaluation and compensation is addressed as part of board reform, the benefits of introducing a performance ethos into the business will become apparent.

We are convinced that following through such priorities in governance reform will yield sustained rewards for emerging economies. As the benefits of specific governance changes become self-evident to the family members of family owned businesses, they are likely to become convinced of the need for further reforms. In such an environment it is quite probable that family owned businesses could throw off their overly cautious stance towards governance reform and come to be seen as the prime engine of change in emerging markets.

End notes

¹ For the purposes of this article, the term 'emerging markets' covers Asia, Eastern Europe and Latin America. While countries within and between these regions vary enormously in many ways, we consider them as comparable when discussing corporate governance reform.

² The McKinsey Emerging Market Investor Opinion Survey 2001 was undertaken by the corporate governance team within McKinsey & Company's Global Leadership and Organisation Practice. We surveyed attendees at the International Finance Corporation's Global Private Equity Conference (May 10–11 2001). The 46 respondents, all of whom are private equity investors, manage approx. US\$5 billion assets under management, 90% of which is invested in emerging markets. Individual fund country allocation ranged from one country to 80.

³ McKinsey & Company's Investor Opinion Survey 2000 surveyed institutional investors on their views of corporate governance, and, in particular, their willingness to pay for well-governed companies. (This was defined as those

having a majority of outside directors on the board, ones that are truly independent of management. Directors have significant stockholdings, and a large proportion of their compensation would be stock-related. Formal director evaluations would be in place, and in general the company would be very responsive to investor requests for information.) In aggregate, respondents managed approx. US\$3.25 trillion in assets. The Survey results are available on the McKinsey global website (www.mckinsey.com).

⁴ Part of an internal project, "Using a Global Standards Strategy to Enhance Value", currently being undertaken by McKinsey & Company's Global Strategy Practice. Contact Gregory Wilson on +1 202 662 3117 or Roberto Newell +1 305 961 8914.

⁵ See, for example, The Separation of Ownership and Control in East Asian Corporations, Claessens, Djankov and Lang, (Oct. 2000), which highlighted the significant domestic equity holdings of the leading families in the region. For example, using sample data, the authors estimated that the top 15 families in

Indonesia, Thailand and Malaysia owned 62%, 53% and 28% respectively of all domestic listed equities in their countries.

⁶ Respondents ranked the five options, from 1 most important to 5 least important. The most common rank for the five options was: Rank 1 - greater transparency (51% highlighting this ranking); Rank 2 - adoption of internationally recognised legal standards (31%); Rank 3 - enhanced legal rights, (30%); Rank 4 - more effective board practices (45%); Rank 5 - listing on a major international stock exchange (55%).

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