

# **Corporate Governance effects on performance and wealth metrics of firms in transition economies**

by Yegor Samusenko,  
2<sup>nd</sup> year student,  
MA program in Economics,  
Kyiv School of Economics  
ysamusenko@eerc.kiev.ua

## **Introduction**

Corporate governance issues have raised public attention since 2001, after collapses of large number of US firms like Enron and Worldcom. In 2002 US Congress passed Sarbanes-Oxley Act in order to assure high level of corporate governance of all firms in US, and major stock exchanges strengthen requirements for listed companies. These actions made corporate governance level almost identically high through US-based and US-listed companies (Bauer et al., 2003)

Transition countries follow another pattern: corporate governance vary much among firms. Although there are laws and stock exchange rules ensuring some level of corporate governance standards in every country, they are weak and easily abandoned. As a result, firms behave at their discretion in determining major components of corporate governance. High variability of corporate governance standards in transition economies makes these markets potentially fruitful for studying effects of firm's corporate governance behavior.

In the research I intend to study two-dimensional effect of corporate governance in transition country Ukraine. The double question I want to answer sounds as "Whether good corporate governance practices influences equity returns and firm's performance of transition companies?"

The answer seems to be utterly interesting since more and more companies consider costs and benefits of applying high corporate governance standards. While accounting costs of good governance for company may be significant (some includes remuneration of independent directors, creating and maintaining investor relation department in the company, paying higher fees for internationally recognized audits etc.), I do not focus on them leaving to field practitioners. In this research I aim to find opportunity cost of being badly governed for firm in transition economy, which should ideally cover accounting costs.

## **Literature review**

The concept of corporate governance raises from well-known principal-agent problem between management of the company and its finance providers. According to classical definition by Shleifer and Vishny (1999), corporate governance refers to the “ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”.

With active development of market for corporate control in 1980s, economic literature began to pay attention to corporate governance (CG) issues. First studies were made on Anglo-Saxon model, where equity ownership is much more dispersed and conflict between management and a variety of minor shareholders is logical. In 1980s literature concentrated mostly on issues of structure of ownership (Demsetz et. al, 1985) and particularly on management ownership (Randall et al., 1988). Last decade of 20th century became a time when researchers made their works on CG quantifiable, but most of them still concentrated on US economy. Using different aspects of CG they studied whether they affect firm’s performance and market valuation of the companies.

Though, conflicts are needed sometimes to burst attention to the topic. That happened particularly with corporate governance – in 2002 after Enron and WorldCom collapses due to manipulations by management, society became concerned by CG in the same way as in 2008 they are concerned with liquidity issue. Independent agencies became active publishing of corporate governance rankings all over world. That allowed researchers to study compound effect of CG on the business, while previous research mostly concentrated on some particular aspects.

In 2003 Gompers, Ishii and Metrick analyzed relationship between overall corporate governance and long-term returns in US equities. They constructed portfolios consisting of companies with bunch of anti-takeover amendments which they name a “Dictatorship Portfolio” and second one with well-governed companies named “Democracy Portfolio”. Subsequently, they consider a long position in Democracy portfolio and short position in Dictatorship Portfolio over seven years. This strategy allowed them to gain average annual return of about 8.5% after adjusting for factor exposures of the portfolios according to Carhart (1997) model.

Similar study in Germany made by Drobetz et al. (2003) found impressionable annual excess return of 16.4% of investment in well-governed portfolio during 1998-2002. To study whether this effect is consistent in transition economies, same Carhart (1997) model is employed in this research.

The McKinsey “Global Investor Opinion Survey” made in 2002 revealed that institutional investors are ready to pay 28% premium to well-governed company in emerging markets.

Furthermore, cross-country analysis made by LaPorta et al. (2001) reveals that market valuation of similar companies is higher in the countries which apply higher overall corporate governance standards. While there are doubts whether cross-country analysis can be meaningful (Klapper, 2002), anyway it is clear that foreign investors tend to pay premium for the equities which are better governed and though more likely to assure them return on their investments.

Before the discussion of corporate governance in emerging and transition countries is started, one should note importance of country-wide CG standards. Both LaPorta et al. (2001) and Klapper and Love (2002) made cross-country analysis on corporate governance. According to their results, standards vary much from country to country, thus CG practice in the company becomes less important than overall country level. In countries like US where CG minimum level is kept on the high level (after restrictions implemented in 2002), we observe less variety of CG standards between companies. Same time governments of emerging countries pay little attention to governance issues, thus it is solely company's discretion to apply any level corporate governance standards.

In transition countries corporate environment is characterized by weak legal institutions and high ownership concentration (Biletsky et al., 2001, Guriev et al., 2004, CEFIR and IET, 2006, and IFC, 2003 and 2005). Absence of dispersed equity ownership changes the principal-agent problem in this context. While in Anglo-Saxon model main conflict is between manager and variety of small shareholders, in transition countries managers are controlled by one or group of major shareholders (Lazareva et al., 2007). Therefore, principal conflict arises between major and minor shareholders, and sometimes between groups of major shareholders. Another source of conflict arises from government and raider's side – weak corporate governance theoretically makes the company vulnerable to raider's attacks and overall weak legal system increase risk of government intersection in the business. Though, example of the Yukos, Russian oil extracting company, which applied high governance standards, shows that possibility of government intersection doesn't depend on the CG standards applied by the company. In case of need, government may create environment where even company from Big Four would withdraw its auditor's conclusion.

Weak legal system is costly for the companies but beneficial for research – because corporate governance standards are low in transition and emerging economies (Denis and McConnell, 2003), variation between companies is higher, and therefore we are able to reveal effect of CG more correctly.

Papers that examine emerging economies always find positive effect of corporate governance on equity returns but differ with results on CG relationship with operating performance. One proof that investor commonly believe positive effect of corporate governance

on equity return is a practice by Deutsche Bank, global investment bank with branches in emerging economies, which publishes reports with stock screening basing purely on corporate governance standards applied in the company. Klapper and Love (2002) using firm-level data mostly from Asian emerging economies found that good governance is positively correlated with market valuation and operating performance.

Bernard S. Black studied corporate governance in series of research. In his article with Khanna (2007) he studied effect of corporate governance reform in India on market valuation. Due to the fact that reform was implemented in two stages: first, for big companies, then for smaller, they were able to measure direct effect of reform. Finally, they found that adopting of the reform accompanied with 4% increase in the price of firms in two-day period, and 10% over two-week period.

In his 2005 paper with Jang and Kim he studied Korean public companies. Motivated by possibility to acquire good governance data, they found 0.47 increase in Tobin's Q for the company during worst-to-best change. Though, specific of the index constructed in this research makes results doubtful.

In his studies of corporate governance in Russia Black's results were also similar – in 2001 he reports 700-fold increase in firm value during worst-to-best change according to governance criteria. 700-fold increase sounds unrealistic, and this research reveals core problem of all corporate governance research around emerging markets – quality of the firm-level corporate governance data. In its “700-fold increase” article Black used data only for 21 companies, and applied similar elements for index construction as he did in developed market studies.

In 2006 using better data Black, Love and Radchinsky found substantial and statistically significant positive impact of the quality of corporate governance on a firm's market valuation in Russia.

In Ukraine, corporate governance environment is similar to Russian, with differences appearing only in the last years. In 2005 and 2006 Zheka studied effect of corporate governance on firms performance of Ukrainian companies, using broad sample of about five thousand companies and constructing own index for corporate governance. However, any other researches do not use so broad samples, and usually do not study effects on small companies, which are included in this case. Because of huge sample size and very few variables taken for corporate governance index construction, one would reveal problem with quality of CG data.

In 2005 article Zheka finds positive correlation between CG and firm's performance and absence of reversal causality. In this study there is positive influence of shareholder rights and transparency of the company, but surprising negative effect of the independence of the board chairman on performance. Author explains this fact by inability of independent chairman to

build effective communication with management and exercise his power appropriately in transition country.

Neither of research made on Ukraine covers the relationship between corporate governance and equity returns.

## **Theoretical background**

Frameworks for analysis of corporate governance differs in terms of subject where they arrived from.

A number of different approaches to analysis of corporate governance evolved in the literature. Each framework is based on the discipline where it erased from. Agency theory evolved from finance and economics, transaction cost theory aroused from economics and organizational theory, while stakeholder theory is grounded on a mix of social disciplines. This research is based on agency theory, though main concepts of all theories will be presented in short. One should note that all frameworks study the same problem and overlap in theoretically, so differences may seem to be only minor.

The agency problem was first explored by Ross (1973) and Jensen and Meckling (1976). They consider shareholders of the company as principal who delegate operational decision making to managers, considered as agents. Agency problem is based on the idea that agents are not necessary doing their best in interests of principal, rather pursue their own goals. Presence of conflict between goals of principal and agent is basic assumption in agency theory. Principal goal is maximization of long-term share value, but agents are selfish and prefer maximization of short-term value which is correlated to their remuneration.

In context of transition countries one should consider minor shareholders as principal while major shareholder and manager are agents (Lazareva et al., 2007). Instead of maximizing share value, agents are motivated to transfer profit (through cost transfer or price transfer) to their 100%-owned firms, in order not to share value with principal. Corporate governance system of the entity should solve the conflict.

Transaction cost theory relaxes an assumption of efficient markets and consider the firm as those unit which determines the allocation of resources in the economy. The firm consists from people with different views and objectives. Cyert and March (1963) argue that firms are so large that they can mitigate effects of market mechanisms like price movements inside their firms. Within companies management co-ordinates and controls production, not the market. The organizational structure of the company determines the extent to which company has control over price and production, thus transactions. Transaction cost economics also assumes bounded rationality of all economic agents and opportunism intrinsic to managers (Williamson, 1996).

Given the problems of opportunism and bounded rationality managers are intended to organize transactions in their own interest, thus they should be controlled (Solomon and Solomon, 2004).

Stakeholder theory is less formal and is based on the mix of law, economics, philosophy, ethics, political theory and organizational science (Wheeler et al., 2002). Theory is backgrounded on the observation that companies are so large and their impact on the society is so extensive, so they should be accountable not only to shareholders but to much broader category of society, namely stakeholders. Though, there is bunch of ways to define stakeholders, all they use exchange relationship between stakeholder and the company as a ground. Stakeholders are affected by the company and in turn they also affect the company. Usually stakeholders include shareholders, employees, suppliers, customers, creditors, communities in close of company operations.

Shankman (1999) argue that there is little conceptual difference between agency theory and stakeholder theory:

- 1) stakeholder theory is the necessary outcome of agency theory and is thus a more appropriate way to conceptualize theories of the firm;
- 2) agency theory, when properly modified, is a best narrow form of stakeholder theory.

## **Methodology**

The structure of methodology description will be following. First, I discuss corporate governance index construction usually used in the research, then I explain the model used in this research, and follow by data description and adjustments needed. The detailed description of Corporate Governance index constructed by Concorde Capital is put in the Appendix 1.

### **Corporate governance index construction**

Corporate governance is not the easiest thing to measure due to its subtle nature.

There are three approaches to corporate governance data in research. First, smallest part of researchers, construct their own indexes basing on publicly available data. In choosing which variables to include they base on codes of best practice, applied locally in the country, or globally in the world (as OECD Corporate Governance Code). Although they exclude any personal bias by using only countable data these attempts content solid measurement bias. This bias increases in countries where official statistics organizations do not measure specifically corporate governance issues. Previous studies of corporate governance in Ukraine by Zheka were constructed according to this approach.

Second approach is to use survey-based assessment of corporate governance. Usually, researchers send questionnaire to about 200 listed companies and put grades according to answers (Black, de Carvalho and Gorga, 2008, Denis and McConnell, 2003). Though, if properly written, this method is more consistent, it is time and money consuming.

Third approach is to use corporate governance indexes issued by independent agencies like Standard and Poors, Deminor or bunch of investment banks. We use in this research data provided by Concorde Capital, Ukrainian investment bank.

I found this data as most appropriate due to the fact that it fits the agency problem at best. Concorde Capital assessed companies by four categories: Reporting/Disclosure, Investor Relations, Minority Concerns and Strategic Risks. The goal of collecting this data was to provide investors with a grade on corporate governance on Ukrainian stocks which they could use in assessment of corporate governance risk. Since most clients of any investment bank are those interested to be only minor shareholder, the index is constructed in favor of transition countries agency problem: where principal is minor shareholder and agent is major shareholder/manager.

Though, personal and measurement biases may exist in data by Concorde Capital, they should be less than in self-constructed indexes. First, analysts of investment bank spend much more time on collecting data than researcher can afford, though measurement bias should be diminished. Second, personal opinions of analysts account not less than for one third of total grade and are used to estimate not measurable things like risk of suboptimal decisions, risk of dilutive actions, management accessibility and informativity of company web-site. Since there is no motivation for analyst to overestimate or underestimate these issues, and probably sector analyst is only person who may estimate them, there should be minimum measurement bias due to including of personal opinions.

Detailed description of Corporate Governance index constructed by Concorde Capital is put in Appendix 1.

Importance of the right choice of the data used in research may be shown on comparison of two rankings. Since for Ukraine there were only two attempt to construct such corporate governance index, one by Vitaliy Zheka (2005) based on publicly available data with data and second by Concorde Capital (2007-2008) based on mixture of publicly available data and analyst`s opinions, we compared both these datasets. After extracting intersection data from both Vitaliy Zheka data and Concorde Capital data (used in this research) we made a correlation analysis. Interesting results appears. First, total correlation is low, at about 8%. Secondly, correlation between similar subindexes of rankings show same low or even negative correlation. For disclosure subindexes correlation is around 9%, while for Minority Rights indexes correlation is at -10%. Though, such low correlation may be partially explained by six years lag

in these dataset, one cannot say that corporate governance is sow unpersistent. Thus, this correlation analysis make a background for interest for results based on investment bank ranking, which is first known attempt to study in research.

## The model

In this research I use Carhart (1997) 4-factor model for assessment of stock returns. In the essence of the model is construction of two portfolios and holding long position in one of them and short position in second. The first portfolio is “Well Governed” portfolio which consist of top twenty percentage of the firms which have best corporate governance index. “Badly Governed” portfolio is built from bottom twenty percentages of the firms according to governance ranking. We hold long position in Well Governed portfolio and short position in Badly Governed portfolio, and call this investment strategy as Zero Investment Governance Portfolio.

Carhart (1997) 4-factor model is constructed for assessing efficiency of any portfolio strategy. In his work, Carhart shows that his model is efficient extension to French and Fama (1992) 3-factor model and works better for explaining mutual funds persistency.

$$R_{LS_t} = \alpha + \beta_1 \cdot (R_{mt} - R_{ft}) + \beta_2 SMB_t + \beta_3 HML_t + \beta_4 MOM_t + \varepsilon_t \quad (1)$$

where

$R_{LS_t}$  is the excess monthly return of the Zero Investment Governance Portfolio,

$R_{mt}$  is monthly return on market portfolio (for Ukraine market local stock market index PFTS is used),

$R_{ft}$  is return on risk-free investment (for Ukraine interbank overnight interest rate is used),

$SMB_t$  is monthly return on size factor portfolio (Small Minus Big),

$HML_t$  is monthly return on portfolio which mimics the market on book-to-price ratio (High Minus Low), and

$MOM_t$  is monthly return on momentum factor portfolio.

## Data description and adjustments

One should mention that Ukrainian stock market can be doubtfully considered as efficient. Having history of only about fifteen years, it began to show sufficient liquidity only in 2004. In 2007 local stock market index PFTS has shown second highest growth in the world at 127%

level, losing only to Chinese index. Year later PFTS plunged 80%, liquidity vanished and 50% spread was not strange in the market. Same time, number of stocks traded increased over 2004-2006 heavily, and around 15 firms chose to issue initial public offering or place depositary receipts on foreign stock markets. Among most popular foreign stock exchanges for Ukrainian firms are Frankfurt stock exchange, Warsaw stock exchange and London stock exchange.

Thus, time interval from October 2005 till September 2008 is chosen for purposes of this research. Around a half of the firms analyzed in corporate governance ranking has been already listed and traded in October 2005 and trade volume is strong in end of 2005. End bound of September 2008 is in the middle of the local stock market fall. A later period is characterized by almost disappeared liquidity, rapid increase in spreads between bids and asks, and inability to evaluate real stock price for most firms traded. It also inappropriate to choose end bound before February 2008, since stock market has shown its peak in this month and it should be non-rational to stop tracking data on the peak. Thus, September 2008 is chosen as a some intermediary date when liquidity still existed but market has already dropped.

Second issue is that not all 170 firms analyzed in the Concorde Capital corporate governance index have sufficient free float which is needed to measure stock returns properly. Thus, we exclude from our universe 20% of the firms that have lowest trade volume over this period.

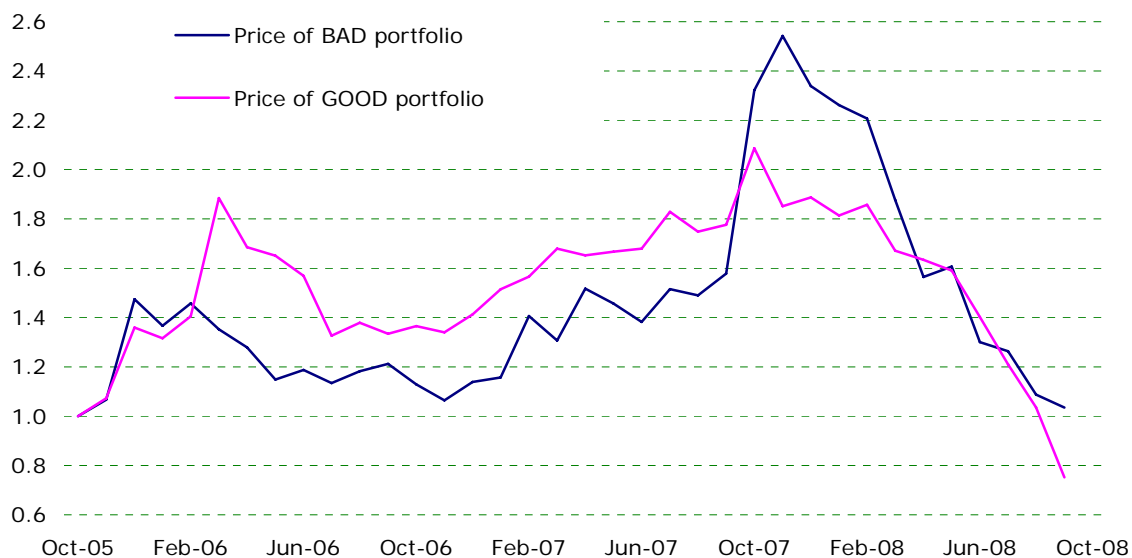
Next, in constructing Badly Governed (BG) and Well Governed (WG) portfolios, the problem of late issuance arises. Only about half of the stocks both in WG and BG portfolios are traded at October 2005. Other appears at the market steadily in this period. Thus, in constructing weights of stocks we choose equal weights for all existing stocks, and when new stock appears we readjust portfolio to include this stock but having all weight equal over stocks. We also do not weight our stocks by market capitalization, value of assets or other parameters, preferring to keep equal weights and not discriminate small-size firms.



## Preliminary results

Considering two equal investments in BG and WG portfolios in October 2005, we may observe some important differences in the movements of prices of these portfolios, before accounting for four Carhart model factors.

### Relative prices for Badly and Well Governed portfolios, base = 1 October 2005



The first difference is volatility of prices for these portfolios. Well governed portfolio is less volatile than Badly governed portfolio, which is consistent with theory. Since investor in Well Governed portfolio has more information about company decisions she can estimate future earnings more correctly and thus estimate stock price more precisely. Also, negative and positive news affect less the company that is well governed which also predict more stability in stock prices.

Second observation is based on the foundation of the growth of Ukrainian stock market in 2006-2007. The common hypothesis is that rapid growth in 2006-07 and fall in 2008 was based on the buying craze of foreign investors in first period and same rapid exit of them in 2008. While this hypothesis can be doubtfully proven with data available (most trades by foreign investors are usually made by Ukrainian local traders on their behalf), among investment bankers it is a common knowledge. Thus, one can reveal from the graph of WG and BG portfolios prices, that foreign investors first prefer to buy well governed firms and only when their growth is exhausted they switch to badly governed firms. Same strategy they follow in exiting from the market: first stocks to sell are of badly governed firms, then well governed ones.

However, the overall hypothesis that investment in well-governed firms yields higher returns is not supported by preliminary analysis. Contrary, WG portfolio is worth less than BG portfolio in September 2008, which implies the need of further analysis by four factor Carhart model.

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## Appendix 1.

### Description of Concorde Capital corporate governance index

In its research Concorde Capital focuses on four aspects of corporate governance – Reporting&Disclosure, Investor Relations, Minority Concerns and Strategic Risks. This description is taken from Initiating research on corporate governance “Ukrainian Corporate Governance” issued in February 2007, while data is taken from recent research published in May 2008.

In **Reporting & Disclosure**, they look at the willingness of companies to be forthcoming with their financial data and ownership structure. With the principle belief that the more willing a company is with its financials and ownership, the more developed in terms of corporate culture and well run the company would be. Three aspects were considered: availability of IFRS accounting, quality of Ukrainian accounting standards reporting and disclosure of ownership. Judgments were based on public sources (f.e. [www.smida.gov.ua](http://www.smida.gov.ua)), the companies’ own publications, and Concorde Capital additionally contacted the top-level management from each of the companies to judge their willingness to provide investors with financial information. Possible scores in this section have a range of [-2;4].

IFRS scoring ranged from 0.0/0.5 depending on whether or not the company prepared financials in accordance with IFRS to 2.0 if they were willing to provide IFRS reports to inquiring investors or made them publicly available. In looking at how closely companies adhered to Ukrainian Accounting Standards, the scoring window ranged from -1.0 for statements that were obviously heavily distorted to zero for those that suggested some manipulation but remained reliable for analytical purposes, and 1.0 if the statements contained little or minor discrepancies. In cases where companies were clearly against sharing financial information, a score of 0 was given. With companies incorporated in foreign jurisdictions which obviously do not use UAS reporting, a score of 1.0 was assigned so as to not punish these companies over a technicality. When looking at ownership structure, the scoring range was - 1.0/1.0. Highest score 1.0 was given only to companies where ownership was common knowledge or provided at a reasonable level.

**Investor Relations.** Concorde Capital judged investor relations using three criteria: management accessibility, public face and the quality of company websites. The total possible score in this section has a range of [-2.0;2.5]. Management accessibility looks at the willingness of top management to meet with investors, arrange site visits, discuss company operations and share business strategies with the financial community - a key factor for giving investor insight into the company. This section allowed a range of scores from -1.0 for companies that provided no access to +1.0 for quality, entailing a willingness to meet and have frank discussions about

the company's business. Public face is the term Concorde Capital devised to encompass a company's efforts to keep the public informed of its activities and present itself to potential investors. Scoring ranged from -0.5 for companies that rarely can be found in the media or at public events, 0.0 for those who appear sporadically and +0.5 for companies that can be regularly found in the news and initiate contact with the investment community.

An examination of websites was included in Investor Relations section of Concorde Capital ranking, as a high quality website serves as one of the easiest and most effective ways to get valuable information including everything from ownership structure to financials. Scoring ranged from -0.5 for companies without a site, 0.5 for sites that contained little useful data for investors, and +1.0 for sites that had a section designed specifically for investors with data including, in particular, financials and ownership information.

With **Minority Concerns**, Concorde Capital looked specifically at factors that are of the utmost interest to minority shareholders, including the risk of dilutive action, the existence of a depository receipt (DR) program, the presence of institutional investors, and the company's use of equity market instruments. The total possible score in this section had a range of [-3;3]. In section on risk of dilution, the top score, meaning low risk, was zero. Companies whose minorities faced a moderate risk of dilution scored -1.0 and those with a recent track record of diluting minorities or with a high chance of doing so received a punishing -2.0. As DR programs generally signal greater interest in attracting investors and equity financing, companies with available depository receipts were given a score of 1.0, equity warrants earned 0.5, otherwise companies received zeros. Concorde Capital gave companies that initially placed their shares on international exchanges rather than locally the maximum score in this section to avoid penalizing them over a technicality.

The presence of institutional investors was considered as a strongly positive factor in instilling exemplary corporate governance standards. Concorde Capital gave companies with a substantial institutional presence +1.0, those with insignificant institutional holdings scored zero, and those without institutional presence -1.0. As plans for private equity placements or IPOs generally entail higher corporate governance and greater openness to minority shareholders, companies that had completed an IPO or private placement were given 1 point, those who had officially announced plans and taken steps to complete them got 0.5 and those without known plans for an equity placement got a zero score.

In **Strategic Risks** section, Concorde Capital looked at risks related to inappropriate corporate governance practices that hurt the business of a company directly or indirectly, or lead to minority shareholders being deprived of their part in the value generated by the company. The total possible score in this section has a range of [-4;0]. One of these risks is the risk of

suboptimal business decisions by management due to abuse of control by majority shareholders. This may involve related-party transactions, transfer pricing, other misrepresentations, asset stripping, unjustifiable acquisitions or divestitures, etc. The best possible score in this section was zero for companies that had normal business risks. Companies where the described risk cannot be disregarded picked up 1.0, and companies with obvious abuses got -2.0.

Additionally, authors looked at the possibility of the company being involved in either internal or external corporate conflicts - with rival business groups, minority shareholders and in some instances, regulators. The highest score possible in this section was zero, while companies that had been or were in danger of conflicts got -2.0.

Total score which company may receive in Concorde Capital ranking is between [-11; 10.5]. For purpose of this research scores are normalized to [0;100] scale.