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Drilling down into Asian corporate governance

Why local culture, legal and business knowledge could be key.

by **Lucy Carmody** | March 10th, 2009

Many Asian companies are controlled by a single shareholder grouping, usually an individual or family, and in some cases, the government or military. In 2003 when the most recent OECD study of ownership was completed, around 60% of companies in Asia were still family owned. This is a very different picture to that found in most Western stock markets where shareholdings are commonly widely dispersed, or “atomized”.

To obtain effective control over a company, a dominant shareholder rarely needs to own a 50% stake in a company. Together with passive voters and “allied” shareholders, control can usually be exerted with 30% or less of the voting rights. Many companies still have different share classes with preferential voting rights. Also common are complex holding company structures using pyramid schemes which allow a holding company to control a pyramid of related companies with very small effective stakes in them. On the positive side, controlling shareholders are strongly incentivized to monitor the company and its management and can often have a beneficial impact on the governance of the company. Indeed many investors are concerned when individuals or families reduce their shareholdings significantly as it may indicate a shift in priorities away from the business.

There is frequently a risk, however, that the interests of the controlling shareholders are not aligned with those of the minority shareholders. The controlling shareholder can force a company to operate in its interests to the detriment of minority shareholders. Unfavourable treatment of minority shareholders can be seen in the form of excessive salaries and bonuses to directors and executives (who may be part of the controlling family, for example) and inter-company transactions that favour the interests of the controlling shareholders. The latter might include the acquisition of overvalued or disposal of undervalued assets or the privatization of a company with depressed valuations.

The fact that many companies in Asia do not have independent boards and independent audit, compensation and nomination committees makes it more difficult for minority shareholders to ensure fair treatment. Commonly, so-called independent directors, even though they may not be financially connected to the company, can be former classmates or golf-buddies of the owners, or feel in other ways obliged to act in the interests of the dominant shareholder. It is sometimes quite rare to find non-executive directors who have been selected for their expertise in related areas on the boards of companies.

In some markets, for example, Hong Kong and Singapore, it has been suggested that there is a shortage of skilled and experienced individuals to sit on boards, with the consequence that one finds the same, mostly male, elderly group seated on a large number of boards with interlinked interests. We know of one individual who sits on the board of at least 10 listed companies in Hong Kong as well as several policy making bodies and foundations. Chairmen of some companies sit as non-executive directors in companies run by their own non-executive directors. Nepotism is commonplace resulting in people carrying out senior roles in companies despite being unqualified to do so. Another important issue throughout the region relates to transparency and accountability. The incomprehensive coverage and the timeliness of financial and other relevant business information are often inadequate to support reliable disclosure. This hampers the decision-making of rational investors. It also means that inadequate oversight may lead to more possibilities for fraud and a risk of litigation against the company's directors or management. A lack of transparency can give rise to insider trading and prevents informed investment decision making. This poses a serious risk to the long-term viability of some companies. Consequently, governance issues can have a huge impact on share price performance. Generally there tends to be a trust premium paid for good governance practices and a financial risk discount given to companies with poor governance.

Corporate governance related scandals can destroy a company's reputation for a prolonged period of time although, in Asia, it is rare for company directors to be publicly chastised and kept out of the boardroom for too long. Other corporate governance issues are country specific. In both Singapore and Hong Kong for example the practice of companies asking for a mandate to issue up to 20% of new shares without pre-emptive rights still exists. The maximum discount of the share issuance varies between a maximum 10% in Singapore and up to 20% in Hong Kong.

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In India, inter-company deals, where assets are bought and sold between listed and privately held promoter groups, are widespread and often are structured to the disadvantage of minority shareholders. In China the disclosure of information is still a big issue ranging from lack of any disclosure to selective preferential disclosure of material information. The cumulative effect of these local issues is that we believe traditional investment banking reports, financial models and public information sources can no longer be relied on by analysts. Asset managers require a more detailed review of ESG issues in order to deliver superior returns, without risk of financial penalties for non-compliance with new and stricter regulatory environments.

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