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Reforming corporate governance

Investors need to understand interaction between underlying business model dynamics and those running the enterprises

By KEE KOON BOON

Snatch. The action undertaken by Harpies, the spirits of sudden, sharp gusts of wind in Greek mythology who would snatch away (harpazô) things from the earth. They had plagued the old blind King Phineus such that whenever a plate of food was placed before him, the winged Harpies would swoop down and snatch it away, befouling any scraps left behind.

CORPORATE governance, as elucidated by leading finance researchers Andrei Schleifer and Robert Vishny, "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do they make sure that managers do not steal the capital they supply or invest in bad projects?"

A formerly popular group with retail and institutional investors of around 150 Singapore-listed Chinese companies, the worth of the S-chips has dwindled significantly from around S$40 billion in market value by more than half due to the continuous gust of cold wind in mis-governance and accounting scandals blowing across these firms.

Attention and discussion on corporate governance reforms in minimising managerial agency costs and to align managerial interests with the shareholders had centred, perhaps narrowly, on the "agents" or the "chess pieces", some of which include the independence and quality of the independent directors in their monitoring efforts.

We need to step back and look instead at the "chess board", the rules of the game in Asia that influences ownership behaviour and the accounting mechanism, in order to avoid the plight of Phineus with managers or controlling owners leaving defiled returns for the minority shareholders and an awful mess for the authorities to clean up.

Wedge. The word to understand the Game. That sharp divergence between cash-flow or equity rights and control rights in the typical Asian firms. Controlling owners are tempted to tunnel assets out of firms where they have low cash-flow rights but high controlling rights to firms where they have both high cash-flow and controlling rights, oftentimes their closely held private firms in which they are the dominant shareholders.

Let's take the case of Satyam to understand the Wedge.

Ramalinga Raju tunnelled out US$1 billion in cash and assets from his listed vehicle Satyam, where he and his family held around 8 per cent equity rights, to his 100 per cent owned private property firm Maytas, to participate in Hyderabad's property market. With Maytas, they can get 100 per cent of the cash flow as compared to 8 per cent in Satyam.

REUTERS

Averting disaster: *We need to look at the rules of the game in Asia that influence ownership behaviour and the accounting mechanism, in order to avoid a situation where managers or controlling owners leave defiled returns for minority shareholders and an awful mess for the authorities to clean up*

When the credit crunch started to melt away the prospects faced by his private firms, especially as Hyderabad's property market cooled with prices and rents falling more than 30 per cent, he could not bring the dwindling money back to Satyam from his 300-odd private business vehicles for accounts-keeping and maintenance of a competitive dividend yield.

Raju decided to raise cash from investors to make up for the bogus US$1 billion in cash and assets by injecting some of his private assets into the listed Satyam. The price tag of the acquisition to "de-risk" the business? US$1.6 billion.

Minority shareholders rejected his plan, decrying a "woeful misuse of cash". Past enamoured investors abandoned Satyam one by one, and share prices fell, which triggered the margin call in Raju's personal pledged shares. Bankers force-sold his shares, resulting in the price to plunge further.

Like Raju, many of the S-chip controlling owners have multiple private business interests, property development in particular, outside of their listed vehicles.

How did the distorted incentives in the Wedge work its way to be manifested in the accounts?

First, the controlling shareholders will engage in "propping" activities to artificially inflate the sales and assets of the listed firms through related-party transactions (RPTs) to entice the funds of investors who did their "fundamental analysis" of the firms. Artificial accrued sales are booked under "other receivables", while the bogus cash-based sales stay hidden in the "cash & cash equivalents".

After "propping", "tunnelling" or expropriation of these assets out of the listed firm follows, engineered through related-lending and transfer activities which are rarely paid back by the controlling shareholders. These cash transfers are done artfully, often in short-term transactions in order to be qualified as "cash equivalents". That explains why most of the artificial cash balances in these firms typically earn low average interest rates, at below one per cent, when the typical bank rate in China varies between 5 and 10 per cent.

In other words, there is left-side in via propping, and right-side out via tunnelling.

Take the case of the high-profile and "highly profitable" S-chip Sino-Environment. Footnote 12 of their 2008 *Annual Report* revealed that the average interest rate earned from their 728 million yuan (S$143 million) cash in the balance sheet is merely 0.56 per cent. In Footnote 13, the amount due and dividend receivable from its subsidiaries in the company accounts is 282 million yuan. In their group accounts, the amount of non-trade receivables is 240 million yuan out of the 276.5 million yuan in total receivables.

From Footnote 12, Sino-Environment possibly made dubious related-party acquisitions, financed by the IPO and secondary equity offerings, to cancel the artificial receivables that were created in collusion with the related parties, and booking the set-off as goodwill and intangible assets which stood at 228 million yuan.

In a Raju-déjà vu fashion, property was involved. According to news articles reporting about the firm's situation, its chairman Sun Jiangrong reportedly tried to siphon away a 100 per cent stake in Chongqing Daqing Property, which owned properties in China worth 10 billion yuan, to his Hong Kong private firm called Top One Property Group, and later to a Chinese firm owned by his brother.

Thus, rather than hearing again that inevitable lament why boards – often skin-deep installations – work so poorly so often, regulators should thrust the corporate governance stake right into the heart of perverse behavioural incentives where it matters most: by having mandatory disclosure of the ultimate unseen ownership and private business interests of the controlling owners at these Asian firms to hopefully curb the growing opaqueness in the Wedge between ownership rights and cash-flow rights disguised under the increased usage of nominee shareholdings and non-disclosure.

While controlling owners may view the tunnelling of that $1 out of the firm to be enhancing or protecting their own interests – albeit at the detriment of the minority shareholders – particularly in bad times when they fear losing the value of what they have built, they need to appreciate that they are putting to risk the going concern of their companies to enjoy that elusive valuation premium of a multibagger that usually comes from putting that $1 – and more – back into a single, focused business vehicle, and riding through the ups and especially downs of the business cycles with their reputations intact.

Investors should take heed of the rules of the game, and pay due respect in seeking to understand the interaction between the underlying business model dynamics and the people running the enterprises. It would be premature to speak of "fundamental" analysis using possibly rigged or incomplete accounting numbers due to propping and tunnelling to fashion elaborate, but garbage-in-garbage-out, valuation models, or "technical" analysis of possibly manipulated prices and volume.

When value investing is applied properly and rigorously in Asia to identify the right entrepreneurs and managers who are serious in building their business model into a legacy, and to protect, to guard, to preserve the assets of the investors, the rewards can only be bountiful, especially in a tempest-tossed environment.

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