RRC IV-008

"Corporate Governance, Ownership Dynamics and Firm Performance in the Central and Eastern European Countries: An Empirical Investigation"

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June 9, 2005

SUMMARY

Executive summary

The project has generated two papers – one being submitted to the *Economics of Transition* and the other already accepted for publishing in the *Oxford Review of Economic Policy*. In this context, the project can be regarded as a success. However, there have been deviations from the initial proposal, and the second part of the initial proposal is completed only partly. We will elaborate on the reasons behind these deviations below.

The study aimed at collecting data on corporate ownership, financial performance, and competition, as well as constructing a corporate disclosure index for up to 300 companies listed in the official and second lists of the Central and Eastern European (CEE) stock exchanges. The data on financial performance was obtained for most of the companies. Historical ownership data (from 1997) caused some problems and was obtained only for a sub-sample of 125 firms. Information on firms' competitive position was planned to be obtained from questionnaires. The response rate was rather low (43 firms responded), therefore the competition measures were not analysed. Finally, the corporate disclosure index was based on information that the companies provide in their web-pages. This measure (*WebDisclosure*) is a proxy for firm's voluntary disclosure, and it has attracted quite positive remarks from the audiences where it has been presented. The *WebDisclosure* index as of mid-2004 was created for 370 companies in the region, and it is included in the electronic dataset attached to this documentation. The analysis of the relationship between the voluntary disclosure and firm performance is presented in the paper "*What do firms disclose and why? Enforcing corporate governance and transparency in Central and Eastern Europe*".

The first part of the project intended to explore the link between firm performance, ownership structure and the success in overcoming the negative effects of Russian crisis in the CEE. This part has been completed fully (see the paper "*Do Good Governance Provisions Shelter Investors from Contagion? Evidence from the Russian Crisis*").

The second part of the project attempted to examine the evolution of ownership in the listed companies of the CEE countries from 1997 to 2002. The historical ownership data caused considerable problems. We were able to track the ownership change only in 120 non-financial companies in the region. The collected data are included in the electronic data set. There has been no change in the identity of the largest owner in one half of the sample companies. The other half has experienced either one or multiple changes in the identity of the largest owner. The summary of ownership changes by country are presented in Table 1.

Table 1. Number of different patterns of ownership changes by country

	Czech Republic	Estonia	Hungary	Lithuania	Latvia	Poland	Slovakia	Slovenia	Total
No change in identity and controlling stake	13	4	3	11	2	7	1	3	44
No change in identity; change in controlling stake downwards	.	.	1	2	.	3	1	.	7
No change in identity; change in controlling stake upwards	3	2	2	.	.	2	.	1	10
One change	15	3	1	17	3	6	2	.	47
Multiple changes	5	2	.	5	.	.	.	.	12
Total	36	11	7	35	5	18	4	4	120

If we differentiate between the domestic and foreign owners, we observe that 93 companies had domestic owners in 1997, and 27 had foreign owners. The foreign ownership tends to increase over years. At the end of 2002, 78 companies had domestic owners and 42 had foreign owners. The numbers of changes in domestic and foreign ownership are given in Table 2.

Table 2. Number of changes in domestic and foreign owned companies, 1997-2002

Type of change		Number of companies	Fraction of total
No change:	61		
Domestic		44	37%
Foreign		17	14%
Change:	59		
Domestic to domestic		29	24%
Domestic to foreign		20	17%
Foreign to foreign		5	4%
Foreign to domestic		5	4%
Total	120		100%

From preliminary analysis, we observe that changes, and in particular multiple changes, tend to occur in smaller, more financially constrained (with high leverage and low cash balances), and less productive companies. The median values of different financial measures (averaged over 1996-2002) by different change categories are shown in Table 3. Deeper and statistically meaningful analysis, however, requires further investigation and extension of the sample. The work on this study will continue and we will update you as soon as this effort results in a presentable paper.

Table 3. Average financial ratios over 1996-2002 (medians by category)

Type of change category	Size (log of sales in thsd USD)	Loans/ Assets	Sales (thsd USD) per employee	Total assets (thsd USD) per employee	Profit margin	Sales growth	Cash balance/ Assets	Market-to-book value of equity	Sales per employee growth
No change	11.52	0.11	61	82	0.040	0.060	0.040	0.62	0.120
No change in identity; change in stake	11.57	0.06	72	95	0.015	0.095	0.030	1.10	0.140
One change	11.10	0.12	77	64	0.010	0.080	0.060	0.79	0.150
Multiple changes	10.53	0.27	30	19	0.015	0.085	0.020	0.94	0.125
Total	11.13	0.14	66	69	0.020	0.080	0.040	0.73	0.130

Non-technical summary for *Do Good Governance Provisions Shelter Investors from Contagion? Evidence from the Russian Crisis (by Anete Pajuste)*

This paper studies how the Russian crisis of 1998 affected listed firms in the Central and Eastern European countries. The data cover 417 companies that were listed before the Russian crisis, and include financial, industry, ownership, and stock market information.

Stock performance varied substantially across firms and countries during and after the Russian crisis. The data show that firms:

- producing in industries that compete with major imports from Russia (*product competitiveness* effect),
- producing in industries with major exports to Russia (*income effect*),
- with greater liquidity (*forced portfolio recomposition* effect),
- that are highly levered (*credit crunch* effect),
- without a foreign blockholder, and
- operating in countries with a poor record of investor protection,

had significantly lower stock returns one year after the crisis. There is also a strong short-term *forced portfolio recomposition* effect: firms with presumably higher institutional investor presence, i.e., bigger and more liquid firms, exhibited sharp short-term decreases in stock prices.

The study finds that both firm and country level characteristics do matter in overcoming a crisis; however, firm-specific characteristics play a bigger role for firms operating in countries with weak legal investor protection. There is a clear advantage of a “good” country label. During the crisis, both exposed and non-exposed firms operating in countries with better investor protection tended to perform at least as good as, or better than, all firms in countries with weaker investor protection.

Key words: crisis; contagion; transition economies; corporate governance

Non-technical summary for *What do firms disclose and why? Enforcing corporate governance and transparency in Central and Eastern Europe (by Erik Berglöf and Anete Pajuste)*

While specific corporate governance rules often are controversial, most observers agree on the need to disclose who owns and controls a firm and what governance arrangements are in place. This study explores the transparency rules in individual countries and the nature of information released by companies, with particular attention to the enforcement of disclosure requirements in different countries. Using a sample of 370 companies listed on the Central and Eastern European stock exchanges, a *WebDisclosure* index is constructed based on the availability of information on the company's website. To evaluate enforcement of disclosure rules, 128 annual reports are analyzed in terms of information on remuneration and shareholdings by management and the board, as well as related party transactions. *ARDisclosure* index is designed to reflect the deviations from the legal disclosure requirements in a particular country. The study shows that the level of disclosure varies substantially across firms, and there is strong country effect on what companies disclose:

- ARDisclosure index is lowest in Lithuania and Poland, and highest in the Czech Republic and Estonia;
- What is disclosed depends on the legal framework and corporate practice in a given country, and it does not correlate with a firm's financial performance;
- Financial performance is strongly related with how easily information is available to the public (so called, *voluntary disclosure*), such that information is more available in larger firms, firms with lower leverage, higher market-to-book ratios, and more concentrated ownership.

Despite existing regulation, non-disclosure of the most basic elements of corporate governance arrangements is wide-spread. How could different forms of enforcement (private ordering, private enforcement and public enforcement) improve the situation? In the countries with weak court system marred by corruption, it is easier to go to court (and win) with a case that is either "black" or "white", i.e., where breach of law can be easily established. One contention is that in "grey" cases, where it may require considerable resources to prove that a particular regulation has been violated, wealth rather than right will prevail. Therefore, one way to improve enforcement is to make the rules less ambiguous. The paper proposes that this could be the key role of the regulator - to set clear standards and blueprints ("bright-line rules") on what has to be disclosed and how. Once this is done, private enforcement of public laws and regulation becomes easier.

Key words: corporate governance; ownership concentration; transition economics; disclosure; enforcement

Financial records (in US dollars)

	Approved budget	Changes (within 20% of total budget)	Adjusted budget	Payments made	Payments due
Principal researcher: Julia Alasheyeva	4000		**4000**	1333	2667
Principal researcher: Anete Pajuste	4000		**4000**	4000	0
Data gathering and processing (annual reports and questionnaires)	3000	+2748	**5748**		
Data gathering & processing (government approved scholarships)				2778	0
Data gathering & processing (external contracting)				426	2544
Trips for data gathering (*Datastream* and country info)	3000	-1731	**1269**	1269	0
Associates rates for country information (5 associates)	1000	-1000	**0**	0	0
Communications (telephone, fax)	500		**500**	0	500
English editing fees	250	-17	**233**	0	233
Overhead	1575		**1575**	1050	525
Total	**17325**		**17325**	10856	6469