

Corporate Governance Myths in Brazil: An Analysis of Common Statements Made by Market Practitioners

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Abstract

Corporate governance has become a hot topic in Brazil in the past few years, with several events and lectures about the subject taking place nowadays. At these venues, it's possible to identify some common statements about this topic made by market practitioners which have seemed to become uncontested truths. However, many of these beliefs succumb to a more theoretically and empirically structured analysis. They can be considered Brazilian "corporate governance myths". This essay qualitatively analyses seven main Myths: 1) Bovespa's Corporate Governance Index (IGC) as a proof of the value of good governance; 2) the higher expected stock returns from companies with better governance; 3) the importance of the tag along, a mandatory bid rule in case of control transfers; 4) the entrepreneur who must be in control; 5) the need for a poison pill; 6) the prospectus as an evidence of transparency; and 7) the sustainability as the new corporate objective-function. The goal is to deconstruct such statements by showing that theoretical and empirical evidence on these issues do not seem to support such common views. As a result, this work may help to bridge the gap between current worldwide research on corporate governance and market practitioners, both in Brazil and in countries where similar statements have been made in corporate governance market events.

Key-words: Corporate Governance, Myths, Essay, Best Practices, Corporate Objective-Function.

JEL classification: G30, G32.

INTRODUCTION

In 2004, the well known finance academic Aswath Damodaran released a book entitled “Investment Fables: Exposing the Myths of “Can’t Miss” investment strategies”. In that, the author sought to deconstruct six investment strategies exhorted by practitioners as with “guaranteed returns”, but which showed themselves rarely successful after a methodologically correct and objective analysis. Similarly, market practitioners in Brazil have been exhorting some views on corporate governance that have seemed to become uncontested truths, although they mostly do not hold up to a more structured analysis. They are our corporate governance myths. I have collected these common views after attending several corporate governance events in Brazil designed for executives, in which I usually shared roundtables with market practitioners. As a result, this essay analyses seven main Brazilian “Corporate Governance Myths”: 1) Bovespa’s Corporate Governance Index (IGC) as a proof of the value of good governance; 2) the higher expected stock returns from companies with better governance; 3) the importance of the tag along, a mandatory bid rule in case of control transfers; 4) the entrepreneur who must be in control; 5) the need for a poison pill; 6) the prospectus as an evidence of transparency; and 7) the sustainability as the new corporate objective-function. The aim is to deconstruct such statements and help to bridge the gap between current research on corporate governance and the common view by market practitioners.

1. THE MYTH OF IGC AS PROOF OF THE VALUE OF GOVERNANCE

IGC (Índice de Governança Corporativa – Bovespa’s Corporate Governance Index) is an index created by Bovespa that takes into account all firms listed at the three Bovespa’s special listing segments¹. It is usual to see people initiating their presentations by stating that corporate governance creates value. As evidence, they show the return of IGC stocks versus

Ibovespa². As IGC provided a higher nominal return since its inception in 2001, then you have a “proof” that governance creates value. This statement is based on two rarely noted but fundamental assumptions: that IGC is a good proxy for companies with higher governance standards, and that IGC portfolio has the same risk as Ibovespa index. Both are highly questionable. Firstly, only 41.2% of IGC’s current weight is comprised of New Market companies (the higher corporate governance listing segment), whereas 54.2% of its weight is Level 1 companies (the lower special listing segment).

Therefore, we should ask ourselves if Level 1 companies really have higher governance quality, to only then affirm that IGC is a correct proxy for companies with higher standards thereof. It does not seem to be truth, since the requirements for listing at Level 1 only deal with additional disclosure practices, not dealing with delicate and more important governance aspects, such as those involving board of directors and minority shareholder rights.

It is also important to note that, by April 2004, the percentage of Level 2 and New Market companies in IGC portfolio was pretty low, representing less than 5% of the index’s weight. Finally, the sum of the weights accounted for by Vale³ and by the three largest domestic banks still represents about 36.7% of IGC. In early 2004 they represented 61.4%. Therefore, a new question arises: does a high IGC return mean that good governance creates value, or does it mean that mining and local finance markets did well throughout that period?

Regarding the second question, it’s the first lesson of any investment analysis course: one cannot simply compare nominal returns of assets with different risks. In fact, the correct thing to do would be to analyze the risk adjusted returns for assets with different risks. For instance, suppose a comparison of the returns of New Market companies, usually smaller and younger, with the group of Ibovespa companies, older and with more stable cash flows. Are we talking about two groups with the same overall risk? If not, which seems clear, then we should have to adjust the effective returns to the expected returns in order to draw any

conclusion. This could be made by traditional ratios, such as Treynor (1965) or Jensen's (1968) alpha, for instance. As evidence of the potential difference on the overall risks of the two groups, a quick research on Economatica® database shows that the beta of IGC, a traditional measure of systematic risk, has oscillated from 0.67 in 2001 to 1.04 in 2008. This ought to be incorporated in the analysis, in order to allow a correct comparison between the two indexes. In short, IGC is a helpful index, but its direct comparison with Ibovespa, and the subsequent proof of the real gains coming from good governance are not that simple.

2. THE MYTH OF GREATER EXPECTED RETURNS FROM STOCKS OF COMPANIES WITH BETTER GOVERNANCE

The vast majority of practitioners take it for granted that companies with better governance standards should systematically achieve better stock returns for their shareholders. Unfortunately such a simplistic approach goes against logic and theory. First of all, from the point of view of the investor, corporate governance basically represents a risk factor, a chance of loss or expropriation of the invested capital. This risk factor is reduced as companies adopt better governance practices, since there is then a smaller chance of unpleasant surprises due to better internal controls, more active and independent boards, greater transparency, etc. Technically speaking, these companies are able to reduce their agency costs and their informational asymmetry.

Since one of the basic principles in finance is that risk and expected returns should walk side by side, why should we wait for a greater return from such companies? Furthermore, since the expected stock return is used as a measure of the cost of equity capital, this would mean a higher cost of capital for companies with better governance practices, something simply illogical. So, as already pointed in several studies such as Drobetz, Schillhofer and Zimmermann (2003), better governance should lead to lower expected stocks returns and,

therefore, to a larger relative value for such companies, due to greater investor confidence. What happens – and what probably confuses market practitioners – is that governance improvements should lead to a reduction in the perceived risk, translating into a discrete positive effect in share prices and, therefore, greater returns during the improvement period. In other words, it is the improvement in corporate governance practices that should lead to better returns, by reducing the level of business risks. So, a curious fact happens: when we look back, we often observe a superior return from the stocks of companies which, currently, have better governance practices. Such returns are the result of the improvements obtained in the period. However, when we look forward, we shouldn't necessarily expect greater returns again. In fact, it's pretty reasonable that they would diminish, due to the lower risk / cost of capital.

Finally, there is another complicating factor for this analysis: it is probable that improvements in a governance model lead not only to risk reduction, but also to better business decisions by top management, as a result of better decision processes. As a consequence, such companies with better governance would tend to increase the frequency of positive surprises in the future (such as announcing good investment decisions, good leadership succession processes, adequate executive's compensation packages, etc.) which could lead to greater returns on such occasions.

How to solve such a complex matter? Again, we must look at the risk adjusted returns of companies with superior levels of governance, instead of nominal returns. In sum, companies with better governance practices should show greater risk adjusted returns over time, which, occasionally (and counter-intuitively), would be fully compatible with smaller nominal returns than those registered by other companies.

3. THE MYTH OF THE TAG ALONG

Many stock analysts and market agents in Brazil frequently point out the voluntary granting of tag along rights (a mandatory bid rule providing minority shareholders the right to sell their shares in the same conditions of controlling shareholders in case of control transfers) as the main corporate governance practice that a firm can adopt and even as a synonym of good governance. Such granting is undoubtedly a good governance practice. However, puzzlingly, other countries also characterized by concentrated ownership structures and family-owned businesses (such as those from Continental Europe, Southeast Asia, or Canada) hardly discuss this issue, not considering it a priority on governance discussions. Why, then, do we put so much weight on the voluntary granting of tag along rights? Is it something so positive?

Firstly, tag along is a potential right that may never be exercised if control is not transferred. So, it is possible for a company to have bad governance practices throughout its life, investing in poor projects or expropriating investors resources (by related party transactions, excessive compensation, etc.), whereas it simultaneously concedes the so valued right to their investors. The important thing is to understand that that the need for tag along rights derives from the control premium paid only for controlling shareholders' stocks in case of control transfers. However, should the controlling stocks really be worth so much more than the others if, at the end, all shareholders were paid exclusively from dividends?

Two studies, by Nenova (2003) and Dyck and Zingales (2004), addressed this question, achieving a similar overall conclusion: the premium for ordinary stocks varies significantly across countries, being higher in countries with poor investor protection and with higher probability of controllers obtaining certain benefits not shared with other stockholders (the so-called private benefits of control). In both studies, Brazil was placed among the three countries with the highest control premium, indicating that local controlling shareholders

seem to reap many more benefits than those of other countries. For instance, in Dyck and Zingales (2004) study, the control premium in Brazil was about +65%, the higher among 39 countries analyzed, against 1%, 1%, and 6%, in Canada, Norway, and Sweden, respectively (countries also characterized by concentrated ownership structures and family control). In Nenova (2003) study, Brazil shared the second highest control premium (25%) with Italy and South Korea, just behind Mexico (50%)⁴. In short, tag along is so valued in Brazil because, in its absence, the control premium would be extremely high, much higher than in most other countries. Thus, we arrive at a conclusion opposite to the local common sense: despite a good governance practice per se, the more relevant the voluntary granting of tag along right is for a certain company, probably the poorer the perception of its governance practices will be. Therefore, as companies improve their corporate governance, controllers will have less and less ways to reap extra benefits, thus reducing the relevance of tag along rights.

4. THE MYTH OF THE ENTEPRENEUR WHO MUST BE IN CONTROL

Unquestionably, talented entrepreneurs/managers are key to the success of most businesses. Based on this assumption, many investment bankers and corporate representatives during the 2004-2007 IPO wave in Brazil have argued that it was essential to keep them as controlling shareholders of the business after the IPO, based on their enormous “expertise and importance” to the company. On behalf of such special capabilities, they suggest that any mechanism is valid in order to keep the control of the company in the hands of such people: issuance of nonvoting stocks, listing in foreign jurisdictions that allow multiple voting rights among shareholders of the same class (such as Bermudas, Bahamas, and Luxemburg, among others), etc. These are the so-called control enhancing mechanisms, common worldwide devices in order increase insiders/controllers political powers. As a justification for such devices, they argue that keeping the entrepreneur as controlling shareholder will

assure his or her permanence at the company and, consequently, a better result for all shareholders.

Unfortunately, this is a fragile argument after careful analysis. Firstly, corporate governance basically means two things: the separation between ownership and control, and the implementation of mechanisms designed to make that all decisions are always made in the best interest of all shareholders. Then, if the entrepreneur is really truly essential to the business's success, any controlling shareholder or controlling group would be interested in keeping him or her at the head of the management team, since he/she will be fundamental for maximizing long term firm value. As an example, take the case of Apple, founded by its current CEO, Steve Jobs. Few people notice, however, that Steve jobs currently holds a paltry 0.63% of the company's stocks. Even so, in recent years, no relevant shareholder has formally considered to replace him, given the common view of the importance of his expertise for the company's success. So, it is not crucial for Steve Jobs to eternally remain as controlling shareholder in order to maintain his leadership of the company's management team. Hence, such a governance myth seems to stem more from some controllers' desire to arbitrarily and permanently define their businesses' headings on their own than from a systematic value creation for all shareholders.

5. THE MYTH OF THE NEED FOR A POISON PILL

Brazil went under an IPO wave from 2004 to 2007, with about 110 companies going public during that period. Although most of them listed at Bovespa's higher premium listing segments Level 2 and Novo Mercado, a common governance practice could be noted: about 90% included in their by-laws provisions in order to prevent or hinder hostile takeover attempts. These mechanisms, known as Brazilians poison pills, usually take the following general rule: if a shareholder decide to acquire a percentage of stocks above a specified

threshold (generally about 15%), then it would be obliged to make a public offer to buy all shares outstanding, at an inflated price (generally, the highest among three options, involving a premium over current prices, a premium over an Ebitda multiple, and the economic value provided by an outside party). Worldwide, the adoption of poison pills is generally seen as a bad corporate governance practice. However, many Brazilian companies with dispersed ownership structures (and their investment banks and lawyers) try to justify their poison pills, arguing that they constitute a good practice by acting as mechanisms to avoid a sudden concentration of stocks, which could hypothetically harm shareholders through a reduction of shares liquidity or the entry of an “undesirable” controller.

In order to evaluate such statements, nothing could be more helpful than observe the Anglo-Saxon markets, where companies with dispersed ownership have been present for a long time. In that countries the overall economic result of such device has not been proved favorable to shareholders, after being extensively studied in the three last decades. One of these papers, a well-known research by Bebchuk, Cohen and Ferrel (2005), shows a clear negative correlation between the use of poison pills and stock returns in the United States from 1990 to 2003, in line with dozen other similar results. Besides the academic results, shareholders, particularly American institutional investors, have clearly pointed their discontent with such anti-takeover devices. Bebchuk et al. (2005), for instance, show that about 20% of all shareholder proposals in the U.S. markets during their sample period were related to attempts of limiting or eliminate poison pills, and that these proposals are receiving increasing support in the last years. Finally, after extensive research, I have not found any example in these dispersed markets of companies “waken up with an unknown and undesirable controlling shareholder”, as commonly argued by practitioners defending such device. This is probably due to the fact that, in a pulverized company, an attempt to rapidly purchase a very high ratio of stocks would have obvious consequences: a steep increase in

price and operational difficulty in acquiring a substantial percentage of stocks – leading the buyer to formulate a public offer in order to acquire a substantial share of stocks, at a price that would indicate his/her maximum limit. Besides, it is also important to consider that several studies throughout the past two decades, recently surveyed by Martynova and Renneboog (2007), have shown that an active market for corporate control is good for the restructuring of inefficient industries, fostering greater economic growth.

Finally, we have a peculiar case in Brazil: companies with defined controlling shareholders (with more than 50% of voting shares, therefore without any chance of suffering a hostile takeover) that have decided to include poison pill clauses in their by-laws. In this case, only two factors seem to motivate the adoption of such device: the maintenance of a mentality of “wholly owned firms”, instead of the mentality of public companies after the IPOs (allowing the controllers to “select” under their own criteria the future shareholders of their companies), and/or the perspective of diminishing their stock holdings in the future, keeping them as controllers shareholders with less than 50% of the voting shares (since other potential large shareholders would not be allowed to buy stocks above a certain threshold). In both cases, the motivations are not aligned with best corporate governance practices.

6. THE MYTH OF THE PROSPECTUS AS AN EVIDENCE OF TRANSPARENCY

When questioned about certain governance practices, such as, for example, the systematic hiring of services from companies that belong to relatives of the controlling shareholder, many company representatives try to justify such actions by saying that such information was already contained “in the prospectus”. In other words, it is argued that since the practice was written out on “page 385” of the prospectus⁵, it is transparent and, therefore, plainly compatible with good governance. Nothing could be farther from the truth.

Again, the final purpose of good governance is to have all decisions made with the goal of maximizing the business's long term value. So, with the example at hand, if the company pays an excessive amount for services from other companies belonging to the controlling shareholder, the fact of having made these transactions publicly available in a prospectus does not transform them into a good governance practice. Secondly, transparency is only one of the pillars of good governance. It must be followed by equity and accountability. As for equity, it is the obligation to treat all shareholders equally, which is obviously not the case in the situation above. As for accountability, there is the need for management to highlight to current and potential investors all material aspects of the business, facilitating (and not hindering) a correct understanding about the company in order to improve investment decision making. It is the distinction between volume of information and transparency.

7. THE MYTH OF SUSTAINABILITY AS THE NEW CORPORATE OBJECTIVE-FUNCTION

Undoubtedly, this is the most controversial myth. Nobody questions the importance of discussing the sustainability of the planet, bearing in mind the survival of future generations. However, here we have the question of business sustainability, a very widespread, and not to mention vague, concept. In the last few years, many have started to preach sustainability (or long-term survival) as the new objective of companies, even including corporate governance in a great subject called "sustainability". This vision is incorrect.

In the first place, there is no concrete evidence that a well produced documentary and a few books by consultants on the importance of the planet's climatic changes were enough to alter human nature, which seeks to maximize personal well-being. So, people continue creating companies or investing in securities with the basic purpose of reaping the greatest

possible returns (it is possible that there are exceptions, but we cannot work with behaviors outside the standards). As a result, companies' main role is still the same - to maximize cash flows over time - and managers' purpose is still to maximize their careers, which inevitably leads to conflicts of interest. Since a greater firm value tends to be reached when the time frame of these cash flows is longest, then we have the connecting point of sustainability and long-term cash flow growth.

Therefore, the theme of sustainability may be presented through two well known (and old) prisms: risk management and opportunities. As a tool for risk management, it reinforces the need for companies to make a more correct understanding of the environment, in order to avoid public embarrassment and legal action. Companies must carefully manage their goodwill risks, environmental liabilities, government corruption and labor issues due to slave or child labor, among other things. For opportunities, it is the idea that a "green strategy" can create value and become part of the company's competitive advantage (naturally moving towards the traditional corporate objective function, erroneously called "financial"). This may occur in three main ways: i) reducing waste and the operational costs of the business (e.g. reducing energy consumption and using recyclable bags at supermarkets); ii) exploiting a market niche with a demand for products with an environmentally correct label; and iii) exploiting niche investors more willing to buy shares in companies with the sustainability label, as has been shown by the increase in socially responsible investment funds. In January 2008, the magazine *The Economist* summarized the sustainability theme in a tough, though (fortunately or unfortunately) correct manner: "this survey concludes that, done badly, it is often just a fig leaf and can be positively harmful. Done well, though, it is not some separate activity that companies do on the side: it is just good business".

CONCLUSION

In sum, the myths described in this essay are the result of the non-observance of basic concepts such as: measuring risk adjusted returns, evaluating the private benefits of control, understanding the separation between ownership and management, understanding the distinction between volume of information and transparency, relation between incurred risk and expected return, and companies' objective function. Such concepts should be strengthened in business schools and market entities, aiming at reducing the dissemination of these and other corporate governance myths in Brazil and in other countries.

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¹ In 2001, Bovespa (São Paulo Stock Exchange) launched its Corporate Governance Special Listing Segments, usually known as “Novo Mercado” or New Market. To list on these premium trading segments, the companies must voluntarily adopt specific disclosure and corporate governance practices beyond what is mandated by Brazilian corporate law. The adoption of such stricter corporate governance practices is guaranteed by a private contract between Bovespa and the companies. There are three levels of premium listings segments. Level 1 (L1), which requires additional disclosure practices; Level 2 (L2), which requires everything in L1 plus an assortment of corporate governance practices; and, the “Novo Mercado” (NM), which is equal to L2 with the additional requirement that the firm does not issue preferred (nonvoting) shares. Details can be found at Bovespa’s website: www.bovespa.com.br

² Ibovespa is the main Brazilian stock market’s index. It reflects the variation of Bovespa’s 60 most traded stocks and it has maintained the integrity of its historical series without any methodological change since its inception in 1968.

³ Vale do Rio Doce, one of the largest mining companies of the world and the second largest company in Brazil.

⁴ For comparison purposes, Canada and Sweden presented an average control premium of only 4%.

⁵ The prospectus in Brazil have been really large, reaching about 500-600 pages. Since no requirements for “plain English” rule is in place, it mainly consists of technical language, making it difficult to the average investor to understand its content.