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Governance and Corporate Valuation

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There has been so much airplay on corporate governance that sometimes its purpose is lost. Far too many people, for example, think of it as simply risk management, or "control, control and more control".

Far from it. Corporate governance rules, regulations and practices serve a greater purpose, and that is to engender trust in the capital markets so that funds can be fruitfully allocated to seed innovations and economic growth.

THE GOVERNANCE PREMIUM

In a functioning capital market, companies with good internal governance structures generally enjoy premium valuations. That premium comes from perceived lower risks, better operating performance as a result of higher efficiencies and effectiveness, and reduced agency problems.

This is backed by numerous empirical studies. For example, Ammanna, Oeschb, and Schmid (2010) studied more than 6,600 firm-year observations from 22 developed countries over the period from 2003 to 2007. Based on a set of 64 individual governance attributes, they found a strong and positive relation between firm-level corporate governance and firm valuation.

Luo Lei, in her study of UK firms (2006), concluded that it is the change in governance rather than the governance level that determines performance. Governance-improving firms are found to have higher future market firm value. In addition, a trading strategy based on changes in corporate governance yields an average return of about 8.6 per cent per year.

She noted: “As my results reveal that a governance-improving firm is associated with a lower cost of capital and higher valuation, large investors may be able to achieve a higher valuation for their assets by removing certain governance deficiencies, such as absence from board meetings, opacity of top executives’ remuneration, etc.”

So from a company’s perspective, good corporate governance can be seen as a value-enhancing effort. And the board, whose primary objective and responsibility is to sustainably enhance a company’s value to all its stakeholders, should embrace best practices in corporate governance with that end goal in mind.

ROUTINE VERSUS STRATEGIC

From my experience, boardroom matters can be categorised into two types: routine and one-off issues.

Routine matters for the board include the quarterly financial performance report and various aspects of risks and internal controls. These internal control practices, when properly implemented, will protect the value of the firm by preventing "leakages".

One-off issues include matters of succession, new businesses and investment decisions. These are often strategic issues and are challenging to directors. For example, there is nothing standard about an investment decision. Every proposal is different. They are often difficult and costly.

This is where a well-diversified board – with various skills, experience and independent perspectives – can be most effective. In fact, the need for diversified boards, how boards conduct themselves, and key officers' succession – are themselves corporate governance issues.

It therefore behooves a good board to focus sufficient time on the strategic investment decisions of the company.

Based on experience, my view is that a good board has three characteristics:

- It is collectively conscious of the risk-reward quotient in making a decision, or for that matter, in not taking a decision.
- It is aware of the capacity of the company to undertake any project.
- It comprises diversely skilled board members who all speak their minds.

Most executive directors and owners of companies are entrepreneurial by nature and optimistic by inclination. Every project "can make money". This is often the independent directors' dilemma. There is no one answer on how to approach this. A good board will have to carefully consider – discuss, debate, agree, reject, counter propose, persuade, vote – all options and their associated risks. A board must be prepared to engage in robust debate.

Some companies have tremendous hidden value in them and a good board should, within its means and capabilities, find ways to unlock these values. This, I concede, is easier said than done.

Several years back, I had the good fortune of working as an executive director of Sincere Watch where there were continuing discussions about the ways and means to enhance the company's valuation. What started as simple discussions during board meetings eventually led to a very successful exercise in enhancing the company's valuation. The lesson here is that nothing happens if you start nothing.

Good corporate governance is therefore not just about regulatory compliance or control. It is more than that. A fellow director once said that a company's assets can be compared to a block of ice. You think you can guard it by sitting on it. But one day, you realise that your precious assets have shrunk and melted away. And all this while you thought you were doing a great job guarding it by sitting on it! ■