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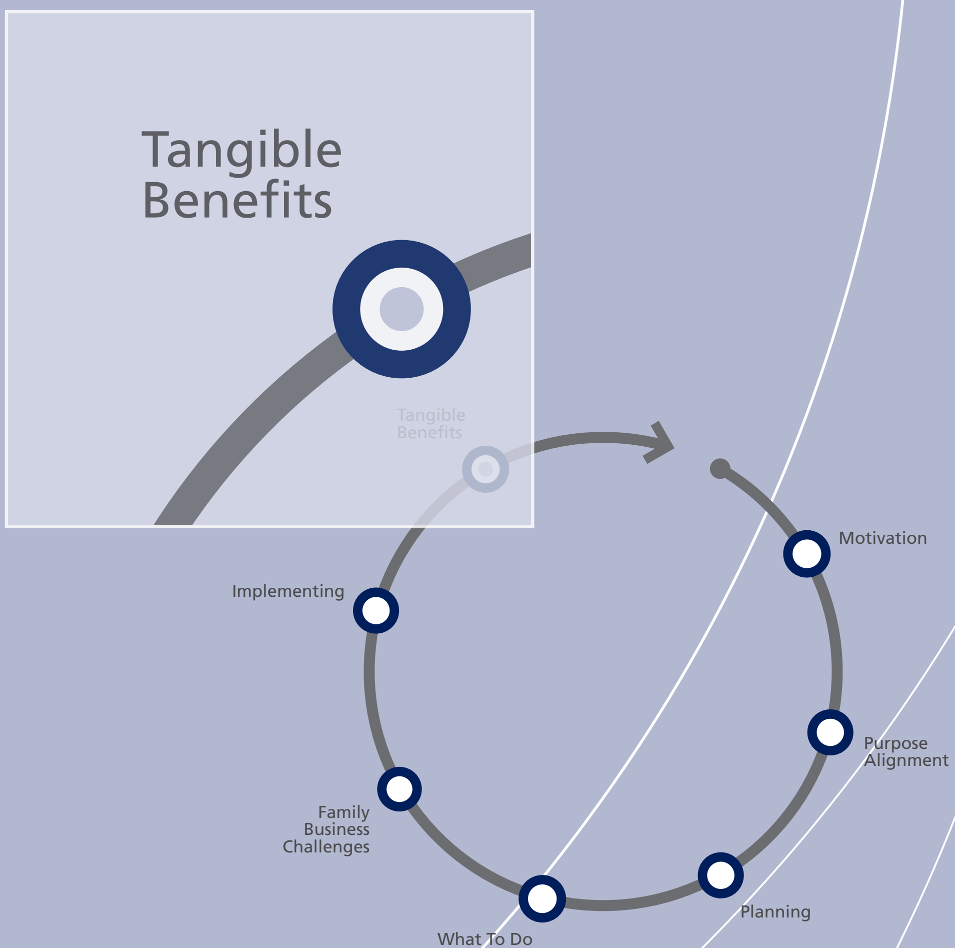
THE TANGIBLE BENEFITS OF GOOD GOVERNANCE



Chapter 7
The Tangible Benefits of Good Governance

KEY MESSAGES

Companies believe in the value of good corporate governance. The Companies Circle members, as leaders in corporate governance in Latin America, strongly believe that good governance contributed substantially to the success of their companies and is essential for good business prospects in the long term.

Empirical data support the companies' belief in the benefits of improving governance. Empirical analysis carried out for this chapter found that Companies Circle member-firms, which have invested more in corporate governance policies and practices, have produced substantially better operational and market results than their Latin American peers. This is reflected in higher levels of profitability, relative share prices and liquidity, and reduced cost of capital.

Good governance helps in good and bad economic times. The tangible positive results of good governance are clear when the economy and the market are growing. Good governance also helps companies to weather the severe consequences of an economic downturn with more equilibrium, as the results during the current global financial crisis show.

Efforts to measure company performance and the impact of corporate governance improvements on results have gained momentum since the issue first started attracting increased attention in the early 1990s.

The entire corporate governance discussion is based on the premise that adopting good governance practices has a positive influence on company performance. As noted in Chapter 1, several benefits result from good governance practices. Among them:

- Improved top level decision-making processes
- Better control environments
- Reduction in firms' cost of capital

For companies listed on a stock exchange, the most commonly discussed benefit of good governance is the effect on share value, liquidity and investor portfolio composition. Such benefits were the main motivating factors for Companies Circle members as they embarked on the path of governance policy and practice improvements.

This chapter lays out evidence from a quantitative analysis to identify tangible gains achieved by the group of Companies Circle members as a whole,[84] compared to the broader community of listed Latin American companies.

Tangible Benefits

[84] Not all Companies Circle members were used in all of the analyses. The Suzano Group is treated as two separate com-

Section 1 describes the overall approach taken in these analyses, followed by Sections 2 and 3, which detail the results with indicators of operational and market performance, including the cost of capital, during sustained periods of growth.

Section 4 compares the performance of Circle members to other Latin American firms, following the emergence of the 2008 global financial crisis, including their stock reaction. It addresses the impact of an economic downturn on firms with leading corporate governance practices.

The chapter concludes with first-hand testimony from leaders of Companies Circle firms on the value of their governance best practices journey.

1 Overall Approach to the Comparative Analysis

Academics and corporate governance experts have long tried to identify and empirically prove that there is a link between good corporate governance practices and the success of the firms. Several studies focused on examining how separate governance characteristics of a company affect its profitability, share price fluctuations, firm valuation, and other results.[85] With all this evidence, many academics and practitioners, international organizations and advocacy groups, investors and company leaders, including those of the Companies Circle, strongly believe that good governance leads to tangible benefits and affects the company's performance and results.

At the same time, it is not easy to fully and unequivocally quantify the relationship between good corporate governance practices and the firm's specific performance results. There are those who dispute the direct link between governance and performance claiming that there is no fully-accepted framework to determine the ways in which corporate governance structures and processes influence corporate performance. Among the issues: the complexities involved in defining and measuring corporate governance improvements and how to attribute success, since improved corporate governance may not be the only reason for better performance by a particular firm.

Despite these difficulties in measurement, it is important to emphasize that there is global acknowledgment of the benefits of good governance for firms—and for markets.

This said, the analysis undertaken here finds that Companies Circle members demonstrate better operational and market performance than their Latin American peers in recent years, as they have improved the quality of their corporate governance. The comparative evidence shows that a group of companies identified as Latin American leaders in corporate governance, with strong commitments to improving their governance as a key part of their business strategy, also have enjoyed strong financial and operational performance success across a number of indicators compared to the typical Latin American company.

The analysis takes a detailed look at a group of Companies Circle members that have invested more than average resources and attention to improving corporate governance struc-

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panies, Suzano Papel Celulose and Suzano Petroquímica, since the two firms were listed separately on the stock exchange, although they participated in the Circle as a single company and both entities belonged to the same controlling group. Suzano Petroquímica was excluded from the 2008 data, following its 2007 acquisition by Petrobras. The analysis does not include Atlas, which was listed in Costa Rica before its 2008 acquisition by Mabe of Mexico, since the Economatica® database does not cover companies listed on the Costa Rica stock market.

85 See Chapter 1 (page 14) for references to some of the studies that have found benefits of corporate governance improvements in terms of firm value.

tures and processes, as described in the previous six chapters of the guide, and whether they display better performance indicators than a broad group of their Latin American peers.

While the data do not necessarily prove causality between improved governance and performance, it nevertheless provides strong support for the 14 Companies Circle members' belief, based on their own analysis, that improving governance standards has led to better results and impressive benefits—financial and otherwise.[86]

1.1 Analysis Features Five Approaches

To demonstrate tangible, financial and economic gains from better governance practices, a pragmatic and quantitative analysis of Companies Circle members was conducted, making use of five different approaches.[87] The approaches are divided into two broad groups, looking at the impact of good governance on operational indicators and cost of capital.

GROUP 1: Operational indicators

- First approach: Comparison of traditional accounting indicators
- Second approach: Economic profit analysis

GROUP 2: Cost of capital

- Third approach: Comparison of traditional stock market indicators
- Fourth approach: Analysis of the impact of governance improvements announcements
- Fifth approach: Analysis of total stock returns

The rationale behind employing several approaches is clear—to confirm Companies Circle members' perceptions that they achieved better results after improving their corporate governance standards, across multiple methodologies. The diverse nature of the group—in nationality, size, industry, and ownership structure—reduces the possibility that performance improvements were due to a specific characteristic, such as industry, size, or location.[88]

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86 It is not the intention of this chapter to prove causality between Circle members' governance improvements and their impressive financial, share price and operational results. The analysis is not based on random sample selection, and it has not fully controlled for other factors that may also have contributed to Companies Circle members' performance. However, some of these factors are reviewed and taken into account later in this chapter in a review of the robustness of the results, such as differences in countries and sectors represented, size, and risk. Different time periods related to both market growth and market downturns are also examined to further test the applicability of the results.

87 The methodology behind each approach is presented in Appendix 5

88 Diversity is an interesting aspect of studying a group of companies such as the ones in the Circle. The intention of the multilateral institutions that support the Companies Circle initiative in seeking this diversity was to offer a set of experiences shaped by different contexts and conditions, thus permitting the Circle to serve as a reference for a larger number of Latin American companies. This condition is appropriate for an analysis of the relationship between good governance and results.

2 Impact of Corporate Governance on Operational Indicators

Many studies argue that better corporate governance practices translate into better access to both equity and debt financing, resulting in lower cost of capital.[89] However, since a better governance model can help companies make better business and strategic decisions, it is also reasonable to argue that better-governed firms will achieve better operational results as well, as described below. This potential benefit is important, since it is applicable to both listed and non-listed companies, whereas higher stock value applies only to listed companies.

2.1 Comparison of Traditional Accounting Indicators

In this first group of analyses, the results of a comparison of Companies Circle members against their Latin American peers are presented. Initially, the comparison is made using traditional accounting indicators. This analysis compares selected operational indicators of the Companies Circle members against the mean indicators of all Latin American listed firms. To prevent short-term distortions, the average indicator of each firm was calculated for three years (2005–2007).[90]

The idea here is to look at whether firms with better corporate governance standards, as represented by Companies Circle members consistently achieve better operational results than the average firm in the market. Six usual and relevant indicators were chosen:

- Two measures of profitability:
    - ROE—Return on Equity (net income / book value of equity)
    - EBITDA[91] margin (EBITDA / operational revenues)
- One measure of dividends' distribution: Payout Index (dividends per share / earnings per share)
- Two measures of business solvency in the short term:
    - Current ratio (current assets / current liabilities)
    - Solvency ratio (EBIT[92] / Interest Expense)
- One measure of financial leverage:
    - Debt ratio (current + long term financial debt / total assets)

After collecting data for all Companies Circle members and for 1,078 Latin American listed companies, the results are presented in Chart 1 below:[93]

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89 See Chapter 1 (page 14) for references to some of the studies that have found benefits of corporate governance improvements in terms of capital costs as well as firm value.

90 A relatively recent time period was chosen for this analysis, corresponding to the period during which the Companies Circle was established and many corporate governance improvements were undertaken by Circle members. However, other time periods were chosen for other analyses later in this chapter to consider how performance may have varied over a longer period of time

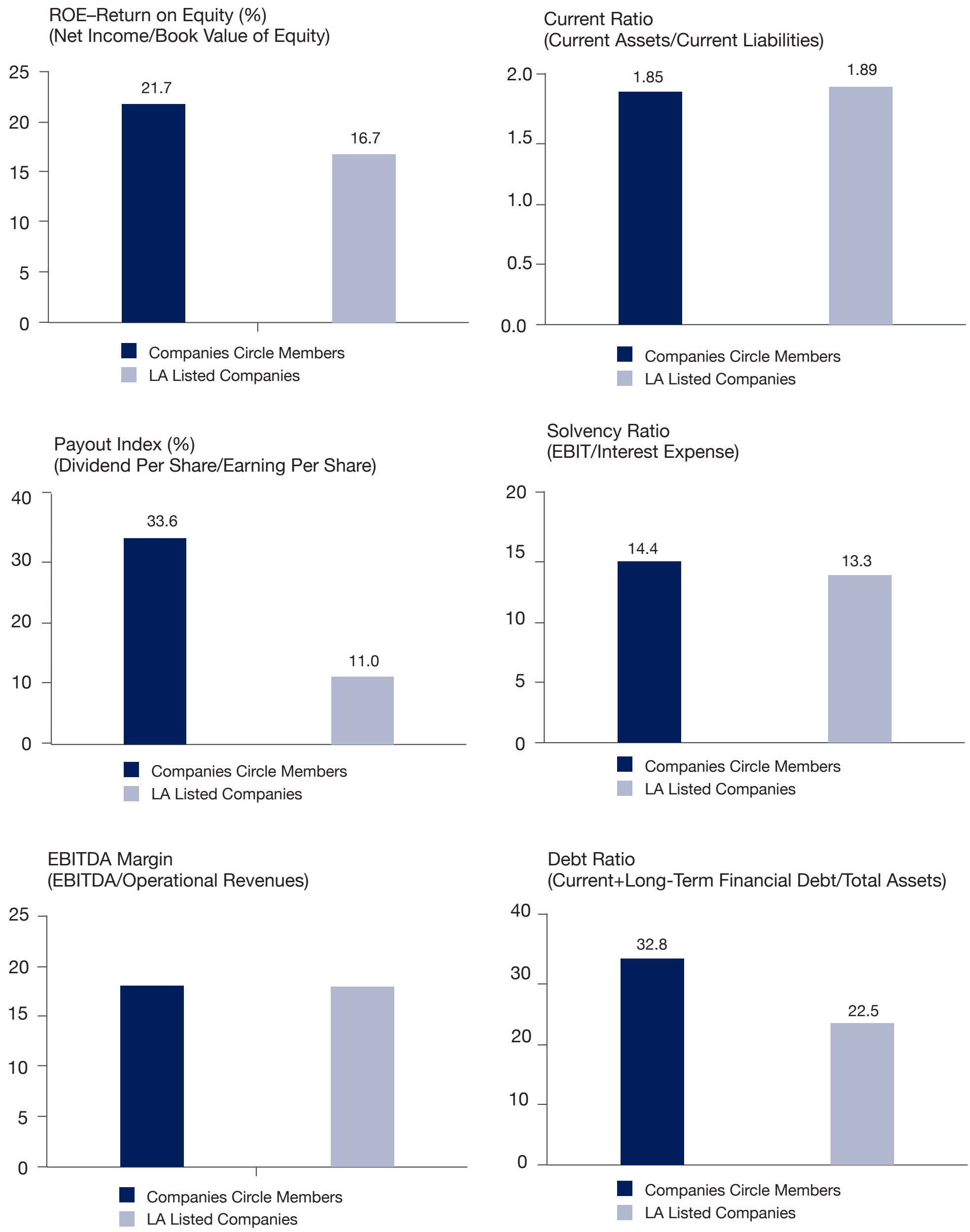
91 EBITDA is the Earnings Before Interest, Tax, Depreciation and Amortization. It is a commonly used way of measuring the profitability of a company. Some analysts also use it as a proxy measure for the cash-flow generated by a firm.

92 EBIT is the Earnings Before Interest and Taxes. It is a commonly used measure of the earning power of a company from ongoing operations.

93 The peer group consists of all Latin American companies with stocks traded from 2005 to 2007. The data was collected from Economatica®, an electronic database focused on Latin American companies. Further details on the methodology are contained in Appendix 5.

Chart 1 Comparison of Selected Operational Indicators

Companies Circle members compared to 1,078 Latin American listed firms, using mean results from both groups for the period of 2005–2007.



In line with the hypothesis that good governance pays off, Chart 1 shows that the group of Companies Circle members produced better operational results in terms of profitability, as noted by ROE, than their Latin American peers. Specifically, they displayed an average ROE of 21.7 percent in the three years from 2005 to 2007, against an average ROE of 16.7 percent by the broad group of Latin American firms in the same period.

Two additional results stand out:[94]

- Companies Circle members paid more dividends in relative terms, as shown by the payout index chart. They distributed about 34 percent of profits per share, compared to only 11 percent by all Latin American companies. Although it is not clear that higher dividend payouts are necessarily better for investors, since higher dividend returns are sometimes linked to preferred shares with restricted shareholder rights, many investors prefer larger cash flows from dividends. This, in turn, may increase the company shares' appeal in attracting additional investors.
- Companies Circle members are financially leveraged higher than the group of Latin American companies, as shown by their debt ratio of 32.8 percent, compared to 22.5 percent with the broad comparison group. Likewise, the dividend payout index results, this also may be seen as a positive indicator: Latin American companies historically have been poorly leveraged especially in the long term, due to lack of access to long-term credit at reasonable costs. Thus, one could argue that higher long-term debt ratios indicate that these companies are better able to access long-term debt markets or bank financing at reasonable costs. Still, firms with more leverage might incur higher solvency risks, especially in moments of great credit market distress, since they depend on the ability to issue new debt or generate constant cash flows to repay the debt service.[95]

2.2 The Second Approach: Economic Profit Analysis Reveals Positive Results

Since the adoption of better corporate governance practices can improve the top level decision-making processes and reduce the cost of capital, there is a good probability that better-governed companies can create more shareholder value through better operational results. Bottom line: long-term investors want to know how much economic value their investee companies are creating or destroying.

A specially-designed measure of the economic profit of all firms from 1995 to 2008[96] identifies the economic value created or destroyed by Companies Circle members and their Latin American peers over a longer period of time. The analysis compares the evolution of the annual economic profit—a simplified version of EVA®[97]—of Companies Circle members against mean indicators for Latin American listed firms from 1995 to 2008. Since Companies Circle members substantially improved their corporate governance practices during the period, it is possible to see whether firms also increased their wealth creation during the period in which they improved their corporate governance practices.[98] The results are presented in Chart 2 below.

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[94] For the three other indicators, on the EBITDA margin and short-term solvency (current and solvency ratios), only a slightly higher but statistically insignificant difference for Companies Circle members compared to their Latin American peers was observed, which does not allow for a clear-cut conclusion that this group displayed better results on these indicators.

[95] This result may be due to better access to bond markets and/or to banks by Companies Circle members, rather than more financial difficulties.

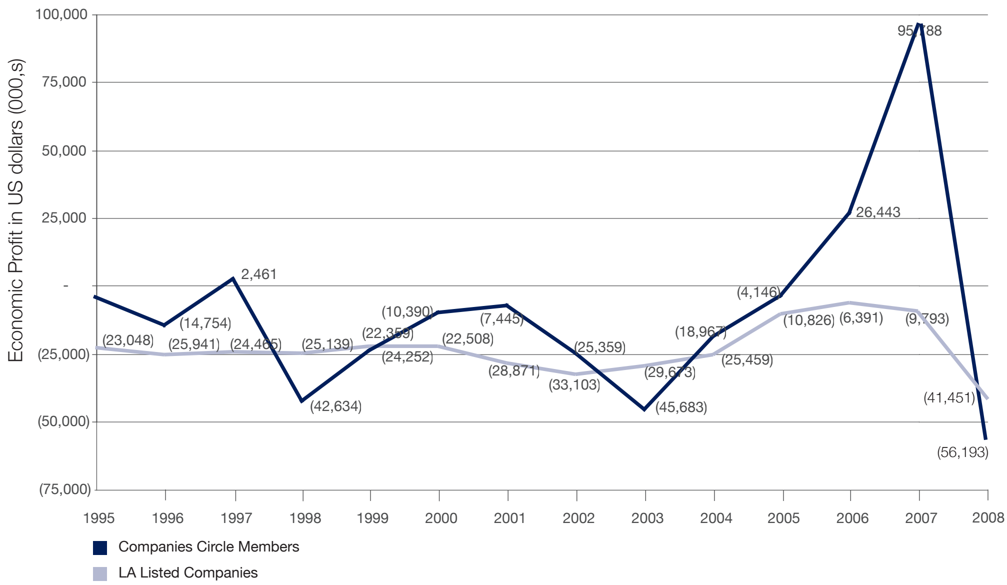
[96] This period was chosen for two main reasons: during this period the corporate governance improvements of Companies Circle members took place and reduced inflation allowed more realistic analyses, especially for the Brazilian data.

[97] See Glossary for a more complete definition of EVA®, the Economic Value Added.

[98] It should be noted that the indicator of economic profit has an advantage over traditional accounting ratios (used in the first approach) by taking into account both the opportunity cost of capital and the amount allocated in a firm by investors.

Chart 2 Economic Profits, 1998–2007

Evolution of the yearly economic profit (a simplified version of EVA®) of Companies Circle members against 1,078 Latin American listed firms, using mean results from both groups for the period of 1995–2008.



Cost of capital can influence results. Chart 2 shows that firms from the region—including Companies Circle members—presented an overall negative result on value-creation during the ten year period from 1995 to 2004. This likely was caused by the higher cost of capital in Latin America. However, the reduction of the cost of capital in subsequent years because of the region's relative financial stability seems to have contributed to a changed picture. A look at the period between 2006–2007 reveals that Companies Circle members appear better prepared, with an aggregate value-creation of approximately US$ 122 million in 2006–2007, compared to overall value destruction of approximately US$ 16 million for the group representing all Latin American companies during the same period. The 2008 global financial crisis seems to have impacted all companies from the region, with an average economic value destruction of around US$ 41 million to the group with Latin American companies, against an average value destruction of US$ 56 million for Circle members.

The apparent higher economic profit volatility for the Companies Circle group, with larger extremes for both positive and negative results, may be the result of two factors: the exclusion of outliers (extreme values) from the group of all Latin American firms, and the fact that Companies Circle members are a significantly smaller group.

Overall, the second analysis shows that Companies Circle members destroyed less value when macroeconomic conditions in Latin America were more turbulent until 2004, created more value when the region became a more stable economic and business environment during the boom period of 2005 to 2007, and suffered an economic value destruction of the same magnitude of their Latin American peers after the emergence of the global financial crisis in 2008.

3 Impact of Corporate Governance on Cost of Capital

In this second broad group of analyses, the focus is on the crucial component of the competitiveness of any firm: the cost of capital. The access to a lower cost of capital immediately generates two benefits: an increase in the market value of the company—and on the shareholders' wealth position—and an increase in the number of viable projects to be carried out by firms, since the company's required rate of return is diminished.

3.1 Comparison of Traditional Stock Market Indicators

This section presents a comparison between Companies Circle members and all Latin American firms, using traditional stock market indicators—the third analytical approach used. Here, select market indicators from the 14 Companies Circle members are compared to mean indicators from all Latin American listed firms. Similar to the first approach presented in Section 2, the average indicator of each firm is calculated for three years, 2005–2007, to prevent short-term distortions.

The idea here is to see whether firms with better corporate governance standards, as represented by Companies Circle members, display better stock market indicators than the average Latin American firm in the market. Six commonly used and relevant market indicators were chosen:

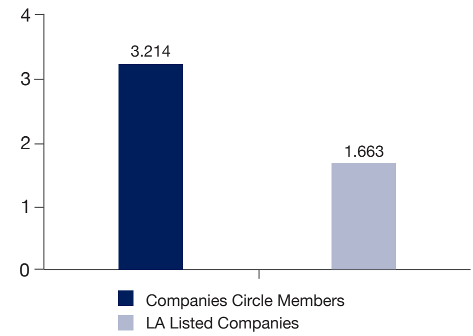
- One measure of absolute value:
  - Market capitalization (number of outstanding shares x share price)
- Two measures of relative value:
  - PE ratio (share price / projected earnings per share)
  - PBV (share price / book value of shares)
- Two measures of stock liquidity:
  - Daily volume of shares traded
  - Liquidity index (calculated by the respective stock exchange)
- One measure of stock return solely due to dividends received in the year:
  - Dividend yield (dividend per share during the year / share price in the beginning of the period)

The results are presented in Chart 3.

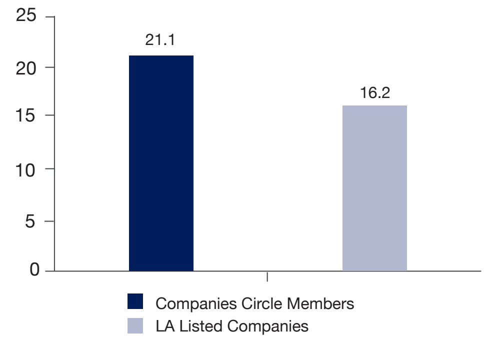
Chart 3 Comparison of Selected Market Indicators

Comparison of selected market indicators of Companies Circle members and 1,078 Latin American listed firms, using mean results from both groups for the period of 2005–2007. Numbers reference the three-year average for each group.

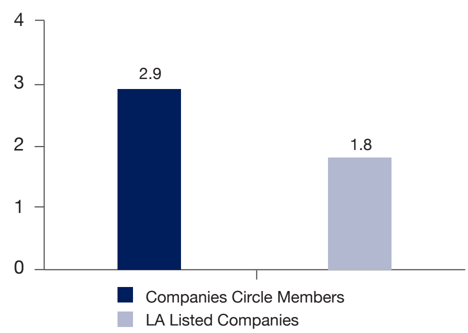
Market Capitalization in US$ Billion Dollars
(Number of Outstanding Shares x Share Prices)



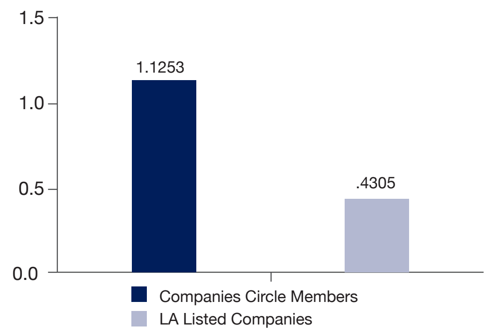
PE Ratio
(Share Price/Projected Earnings per Share)



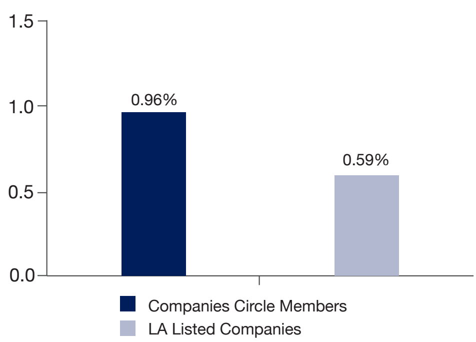
PBV
(Share Price/Book Value of Shares)



Daily Volume of Shares Traded in US$ Million Dollars



Liquidity Ratio
(calculated by Economatica® comparing each stock with its respective stock exchange)



Dividend Yield
(dividend per share during the year/share price in the beginninig of the period)

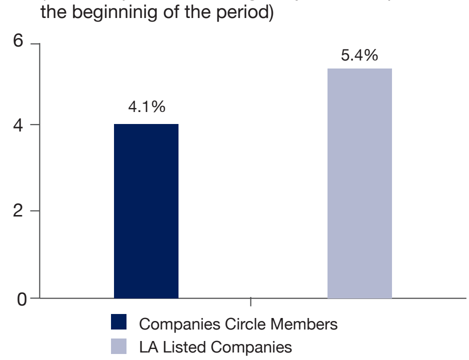


Chart 3 results underscore the value of good governance: the group of Companies Circle members produced substantially better market indicators than the group of all Latin American listed firms in terms of relative value and stock liquidity. Two results stand out:

On average, Companies Circle firms trade at higher stock multiples than Latin American companies, indicating a better "value perception" by investors. On average, their stocks are traded at 21 times earnings per share, compared to approximately 16 times for other Latin American companies. In addition, their shares are worth about 2.9 times the book value, compared to 1.8 times for their Latin American peers. The results clearly show that investors value Circle member stocks more than the stocks of average firms.

The Companies Circle members also have higher liquidity for their shares, another fundamental that investors consider. Their share liquidity ratio is about double the ratio for their Latin American peers.

Interpretation of dividend yield results. The final indicator on dividend yields requires more analysis: The stocks of Companies Circle members present a lower return, solely due to dividends paid in the period as a percentage of the share price.

It is important to note that, since the total return on a share also depends on the share's appreciation (the price increase), and keeping in mind that Circle members' share prices were rising at faster than average rates during this period, the overall return to investors may still have been higher for Circle members. In addition, some companies offer higher dividend returns for non-voting shares as compensation for the weaker shareholder rights that are attached to them. So higher dividends in some cases may be inversely correlated to some aspects of governance quality.

3.2 Analyzing the Impact of Governance Improvement Announcements

When firms announce that they have or will improve their corporate governance standards—cross-listing on stock exchanges with stricter requirements, hiring independent directors and professional (non-family) managers, undertaking large-scale corporate governance improvement measures and the like—it is reasonable to expect that their businesses will run better in the long run. The result: an immediate and positive stock price reaction after the announcement of the good news.

This fourth approach, analyzing the impact of good governance looks at the effect of unexpected announcements of corporate governance practices' improvements on stock prices. When firms announce that they have or will improve their corporate governance standards (such as cross-listing on stock exchanges with stricter requirements, hiring independent and external (non-family) directors, and undertaking large scale corporate governance improvement measures). It is an event study analysis, using relevant of corporate governance improvements announcements from Companies Circle firms.

The idea here is to see whether firms achieved substantial positive returns during the period around the announcement of corporate governance improvements, called an "event window."[99] This is probably the strongest measure of confidence in the real impact of corporate governance on firm value.

For this analysis, 12 separate announcements of changes that qualify as substantial corporate governance improvements were collected and reviewed for impact. Chart 4 displays the aggregate results. For additional information on the individual releases, including actual wording of announcements, dates and companies issuing the releases, see Appendix 5.

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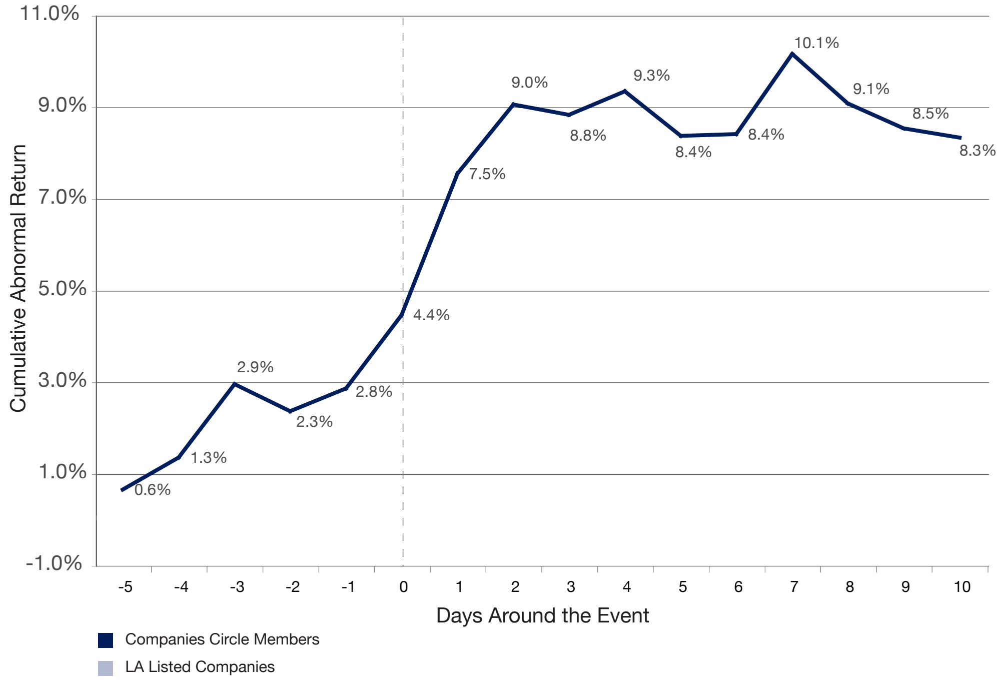
99 The event study methodology elaborated by Campbell et al (1997) was applied. This methodology is well known and accepted in the academic field.

Chart 4 Cumulative Average Abnormal Return

Event study analyzing the impact of 12 unexpected announcements of corporate governance practices' improvements on stock prices of Companies Circle members.



Positive market reaction. A look at Chart 4 reveals that the market reaction after the announcement of corporate governance improvements is extremely positive: on average, Companies Circle members experience an abnormal[100] positive return of about 8 percent after the announcement of such news in the media. This clearly demonstrates that the market welcomes and values improvements in corporate governance practices—with an immediate willingness to pay a higher price for shares.

For Your Consideration

Companies Circle firms added approximately 8 percent to their market value by communicating improvements in their corporate governance structures and processes to the market.

3.3 The Bottom Line: Analyzing Total Stock Returns

This final approach covers the bottom line for stock market investors: total stock returns. Specifically, it investigates whether Companies Circle members produce a higher return on their shares in the long term than two different benchmarks: all listed Latin American companies and

100 The term "abnormal" means the share appreciation during the period discounted by the marker return and the expected stock return in the same days.

the group of Latin American companies with ADRs issued in the US market.

From the investors' point of view, it is important to determine whether investments in a portfolio of firms with better governance practices would have produced higher returns in the long term than investments in different portfolios. The hypothesis is that firms with better corporate governance practices will be a better investment option for shareholders, yielding higher annual stock returns. To explore this hypothesis, two charts, analyzing the evolution of compound annual returns of a hypothetical Companies Circle portfolio—equally weighted among the firms—were created against the two benchmarks specified above. The results are presented in Charts 5a and 5b.

Striking results. The results presented in Charts 5a and 5b are striking: an individual investing US$ 1 in a portfolio with shares of all Companies Circles members on December 31, 1997 would have reaped exceptionally higher returns eleven years later, even after the emergence of the current global financial crisis in 2008, compared with an investment in any other portfolio.

Specifically, US$ 1 invested in the hypothetical "Companies Circle Portfolio" would have resulted in US$ 15.45 at the end of 2008—an accumulated return of 1,445 percent. Compare this return the US$ 3.41 earned in a portfolio with all Latin American companies, and US$ 2.32 in a portfolio composed of Latin American ADR issuers.[101]

For Your Consideration

Overall, investors buying Companies Circle member stocks on December 31, 1997, on December 31, 2008 would have an equity position worth:

- Five times more than a similar investment in all Latin American companies
- Six times more than a similar investment in Latin American companies with ADRs in US markets

The slower growth in share values of ADR issuers, a group of companies that is required to follow stricter disclosure and governance requirements than the average listed Latin American company, may be explained by the fact that Latin American ADR issuers are among the largest and longest established Latin American companies. In many cases, they were required to adopt stricter practices prior to cross-listing their stocks, so they may have earned improvement-related gains early on, leaving less room for additional gains during the period under analysis.

By contrast, Companies Circle members improved their corporate governance standards during the period under analysis, including many improvements that go beyond the corporate governance-related requirements of ADR issuers. This may be a reason for their superior stock returns compared to ADR issuers. Another possibility is that ADR issuers were companies with a lower ex-ante expected return, since they were viewed as less risky companies. If this were the case, then a lower total absolute return would not necessarily mean a lower risk-adjusted return. This possibility is examined later in this chapter.

[101] Since some Companies Circle members presented extreme (both high and low) stock returns in specific years, two additional tests were made: one excluding Companies Circle stocks with highest and lowest returns in each year, and another excluding Companies Circle members with highest and lowest compound returns during the whole period. In both cases, the portfolio with Circle members still provided substantially superior stock returns. Finally, an analysis from 2002–2008 was done, excluding the period from 1998–2001 when several extreme stock returns from both Circle members and their Latin American peers were identified. Again, the results remained essentially the same

Chart 5a Compound Annual Returns, 1998–2008

Compound annual stock returns of Companies Circle members compared to an equally-weighted portfolio of 1,073 Latin American listed companies from 1998 to 2008.

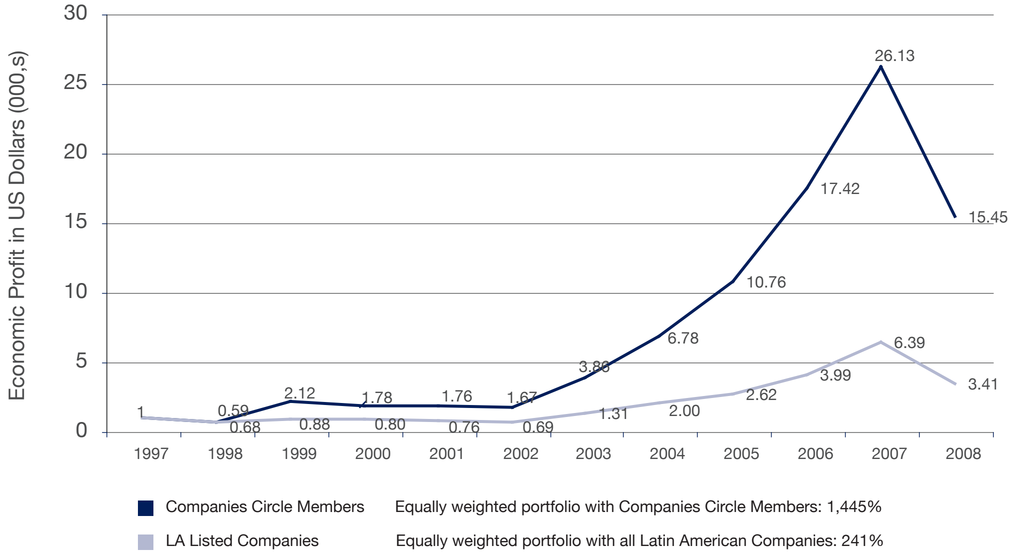
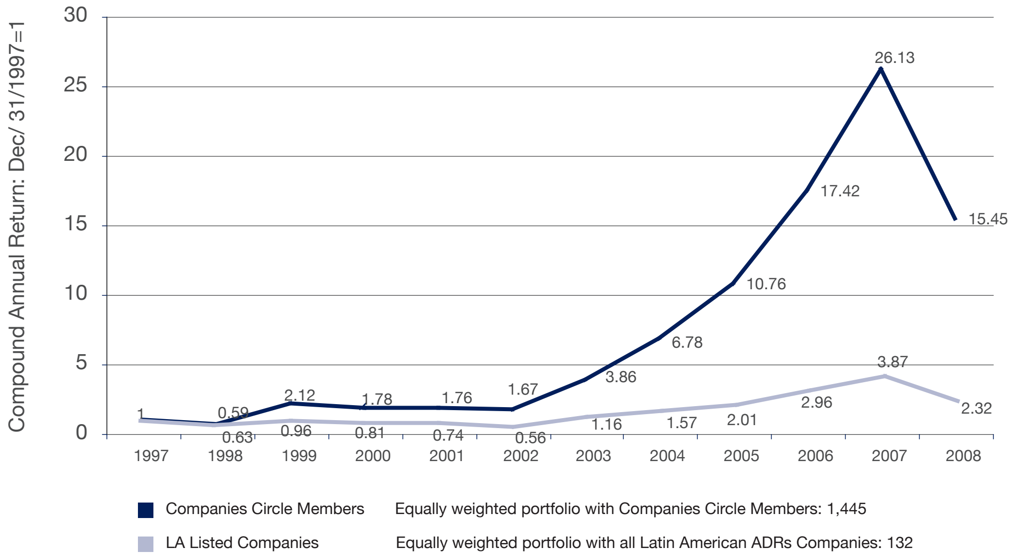


Chart 5b Compound Annual Return: 1998–2008 Companies Circle Members vs. Latin American ADRs Companies

Compound annual stock returns of Companies Circle members compared to an equally-weighted portfolio of all 113 Latin American Companies with ADRs from 1997 to 2008.



3.4 How Robust Are the Results?

As noted in the first section of this chapter, some may question the robustness and applicability of the results—are Companies Circle members sufficiently representative of Latin American companies? Are they comparable to the broader set of Latin American listed companies?

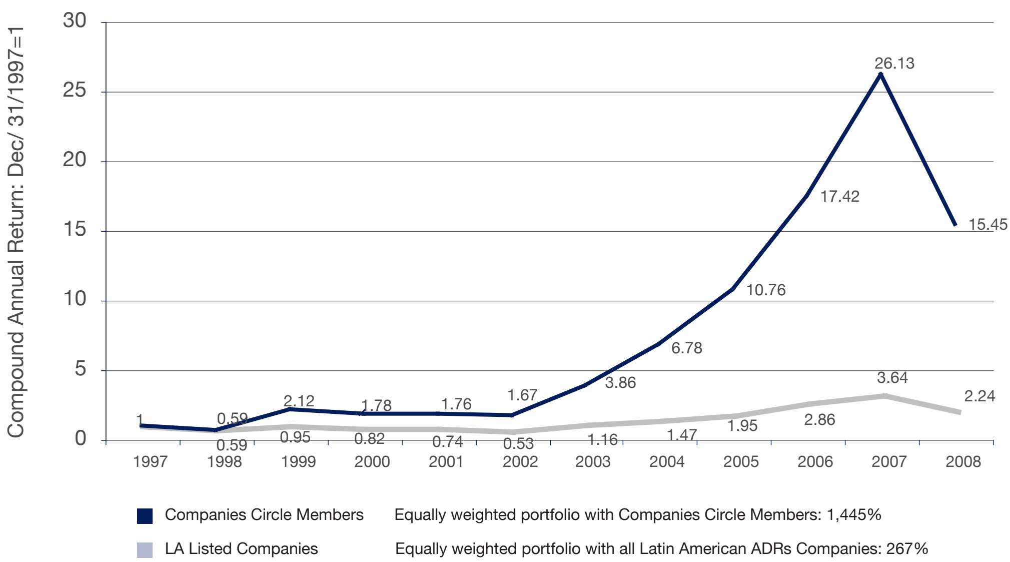
For example, with eight of the Circle's fourteen members based in Brazil, there are other factors, such as economic trends and risks unique to a particular sector and this particular country that can contribute to returns and operational results. To account for such factors an additional review of the robustness of the results was undertaken. The review considered two potential points of bias:

- The weighting of the countries in the different portfolios
- Failure to consider the different risks associated with the portfolios

Accounting for country weighting. In the robustness analysis, a country represented in the Companies Circle portfolio was assigned the same weight in the portfolio of all Latin American companies for each year. For instance, in 2005, Brazilian companies represented 64.3 percent of the total number of Circle members with data available. The same 64.3 percent weight was assigned to Brazilian companies in both comparison portfolios for the 2005 data analysis. Chart 5c shows the comparative results following these adjustments.

Chart 5c Compound Annual Return: 1998–2008 Country-Weighted Analysis of Companies Circle Members vs. All Latin American Companies

Compound annual stock returns of Companies Circle members compared to an equivalent country-weighted portfolio with 1,073 Latin American listed companies from 1998 to 2008



Based on the data provided in Chart 5c, it is clear that the superior results of the Companies Circle member portfolio remain unchanged after adjusting the broad portfolio with all Latin American companies for equal country weight. The results against ADR issuers reveal a similar outcome. This leads to the conclusion that, the higher returns from the Companies Circle portfolio are not caused by variations in country weighting.

Adjusting for risk. The other potential bias deals with the potential for different risks in each portfolio. For investors, evaluating the investment's return based on the risks they are taking is crucial. To do so, the financial literature has developed the so-called "risk-adjusted" measures of stock returns, which are performance measures that allow the comparison between volatile stocks and steadier, lower-risk ones. Three risk-adjusted measures stand out in the literature and are widely used by market practitioners.[102]

The results of this analysis indicate that the portfolio of Companies Circle members displayed higher overall mean risk-adjusted measures of return than the portfolio with their Latin American peers in the period 1998–2008. The results against the portfolio with ADR issuers were qualitatively the same. Again, this reinforces the view that the Companies Circle member portfolio has delivered superior returns over the eleven-year period under analysis than the competing portfolios.

A look at the Jensen's Alpha, a measure of the "extra" return that an investor would have earned by investing in a given asset or portfolio, provides an interesting perspective on this. The mean value of 17.1 percent for the Circle portfolio indicates that it has provided an annual "extra" return of about 17 percent, after discounting the expected "fair" return that an investor should have gained from running the risks of investing in such portfolio. By contrast, for the broad portfolio with all Latin American companies, this "extra" return averages close to zero, meaning an effective return similar to the expected and fair return.

4 Benefits of Good Governance During the Recent Financial Crisis

Good corporate governance practices are just as relevant to differentiating companies; performance during market downturns as they are in boom periods. To evaluate this proposition, this section reviews the performance of Companies Circle members against Latin American peers during the emergence of the current financial crisis in 2008.

4.1 Comparing Operational and Market Indicators

Testing the benefits of good governance during the downturn begins by comparing the operational results of Circle members with their Latin American peers at the end of 2008. Similar to the comparisons made in the first and third approaches, shown in Charts 1 and 3, the focus is on whether the results for the years 2005–2007 years are able to hold up consistently during a more turbulent period.

In Charts 6a and 6b, six operational and market indicators are analyzed, revealing stronger performance, and increased immunity to the market shocks. Chart 6a shows the results for five selected operational indicators.[103]

102 The three ratios used are the Sharpe Ratio, the Treynor Ratio and Jensen's Alpha.

103 It was not possible to calculate the payout index for the 2008 year, since companies have not released their dividends per share until late April, 2009.

Chart 6a Comparison of Companies Circle Portfolio Market Performance to Latin American Company Performance, 2008

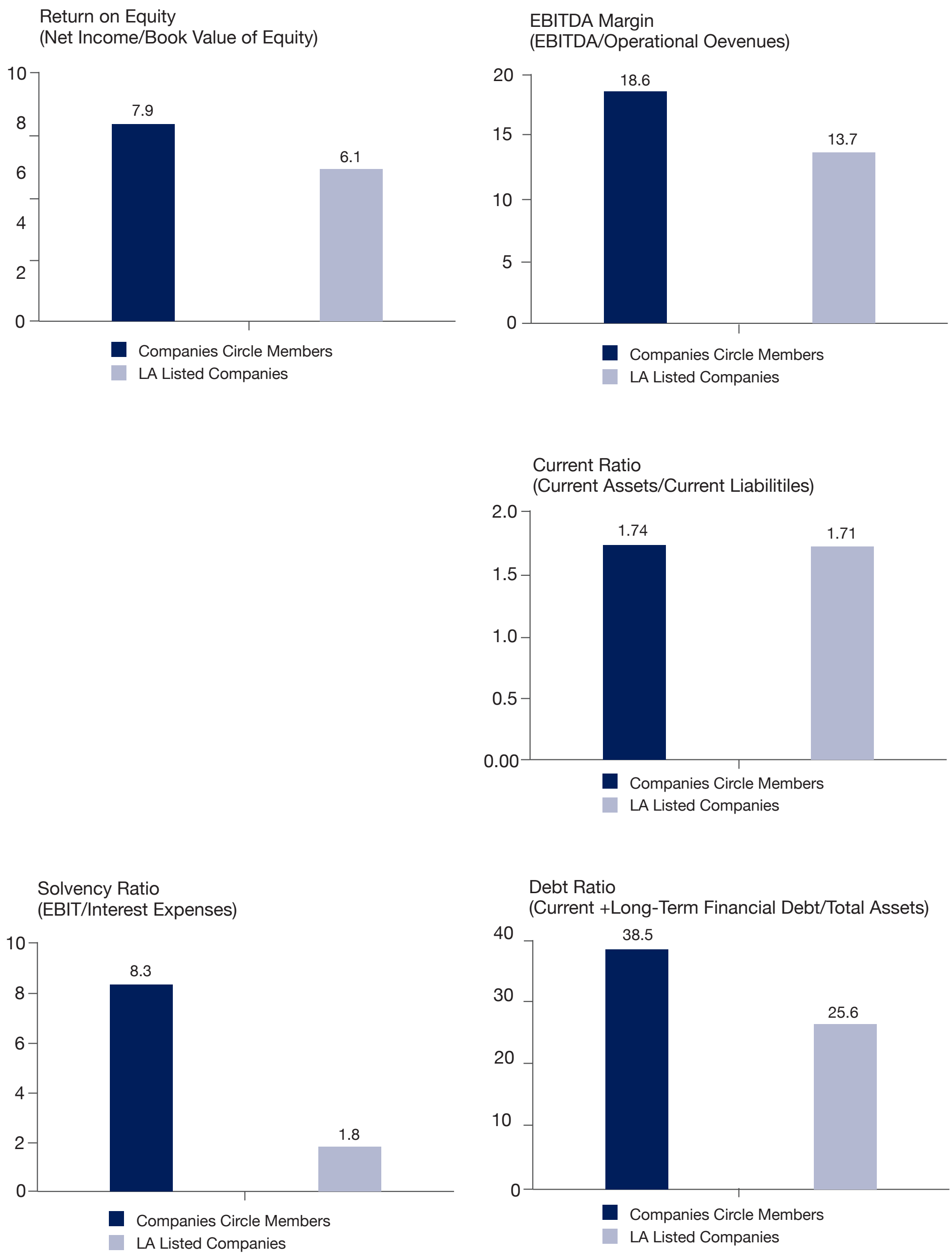
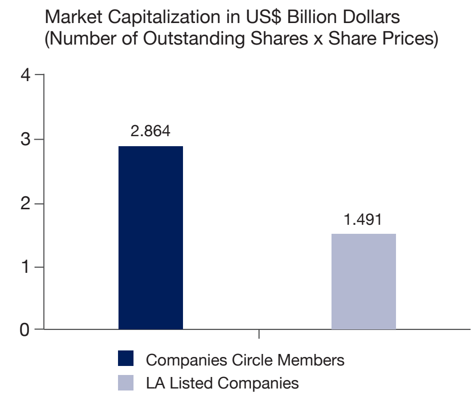
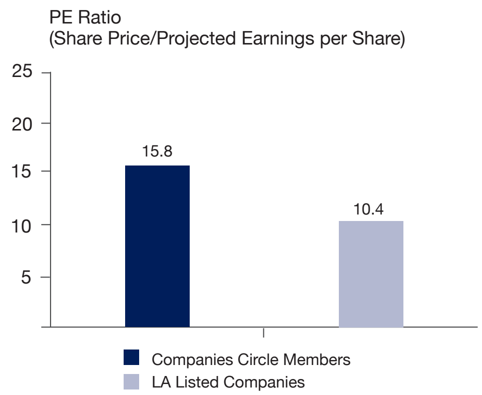
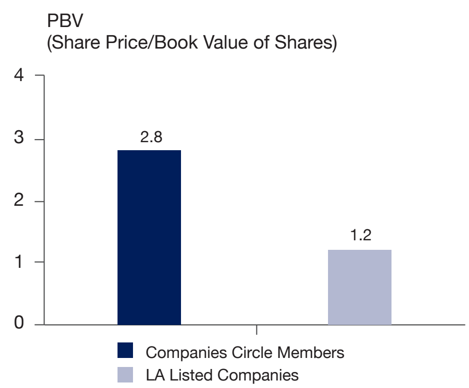


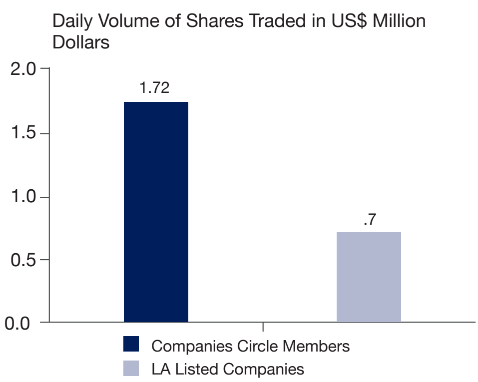
Chart 6b Comparison of Companies Circle Portfolio Operational Performance to Latin American Company Performance, 2008

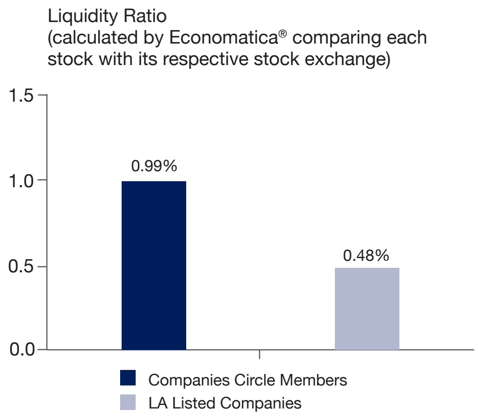
Comparison of selected market indicators for Companies Circle members and for 1,073 Latin American listed firms, using mean results from both groups at the end of 2008.

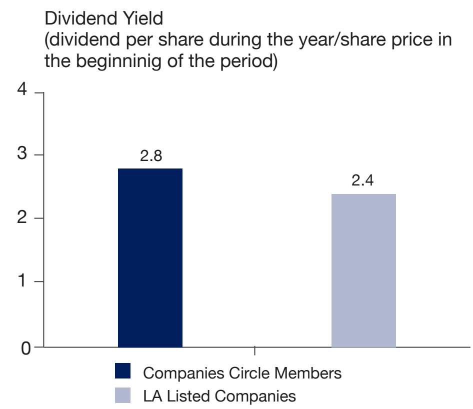












The information in Chart 6a highlights the fact that despite the emergence of the global financial crisis in the second half of 2008, the overall picture of the indicators in favor of Circle members remained the same as in Chart 1 for the 2005–2007 years. Again, Circle members displayed a higher return on equity than their Latin American counterparts (7.9 percent compared to 5.1 percent). They also have displayed a superior EBITDA margin (18.6 percent compared to 13.7 percent) and a better solvency ratio (8.3 versus 1.8)—of particular importance during turbulent times like 2008. Similar to the Chart 1 results, both groups have displayed about the same current ratio and Circle members demonstrate a higher debt ratio.

Chart 6b reinforces the view that the global financial crisis did not alter substantially the overall picture—the indicators continue to favor of Circle members. In addition, the Circle group expanded its lead for price/earnings ratios and share price/book value ratios compared to Chart 3 results for 2005–2007. Such results indicate that investors perceive that Circle companies offer better value than the broad comparison group in a time of market distress. The dividend yield comparison is interesting as well: Companies Circle members demonstrated a significantly smaller reduction in dividend yield than the broader group.

4.2 Analyzing the Stock Market Reaction of Circle Members in 2008

A number of researchers have investigated the link between sustaining better stock performance during a downturn and good governance practices. The vast majority have confirmed this link, that good governance practices are a determining factor in explaining better stock behavior during financial crises.[104]

This research also compares the performance of Circle members with the performance of all Latin American companies after an external economic shock. The analysis reviews the performance of Circle members' stocks against two broad benchmarks:

- Portfolio of all listed Latin American companies
- Country-weighted portfolio of all Latin American companies

These portfolios are constructed similar to the portfolios built for Chart 5c.[105] In Chart 6c the results from the three portfolios are shown during four different time windows: third quarter 2008, fourth quarter 2008, second half of 2008, and all of 2008.

Chart 6c shows that the portfolio of Circle member stocks suffered slightly less than the broad portfolios with all Latin American companies. For example, the portfolio with Circle member shares lost 41.3 percent of its value in US dollars through 2008, compared to a loss of 49.3 percent for the country-weighted portfolio of all Latin American companies.[106]

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104 BAEK, J-S; KANG, J-K; PARK, K. S. (2004), Corporate Governance and Firm Value: Evidence from the Korean Financial Crisis. Journal of Financial Economics, 71, pp. 265–313.

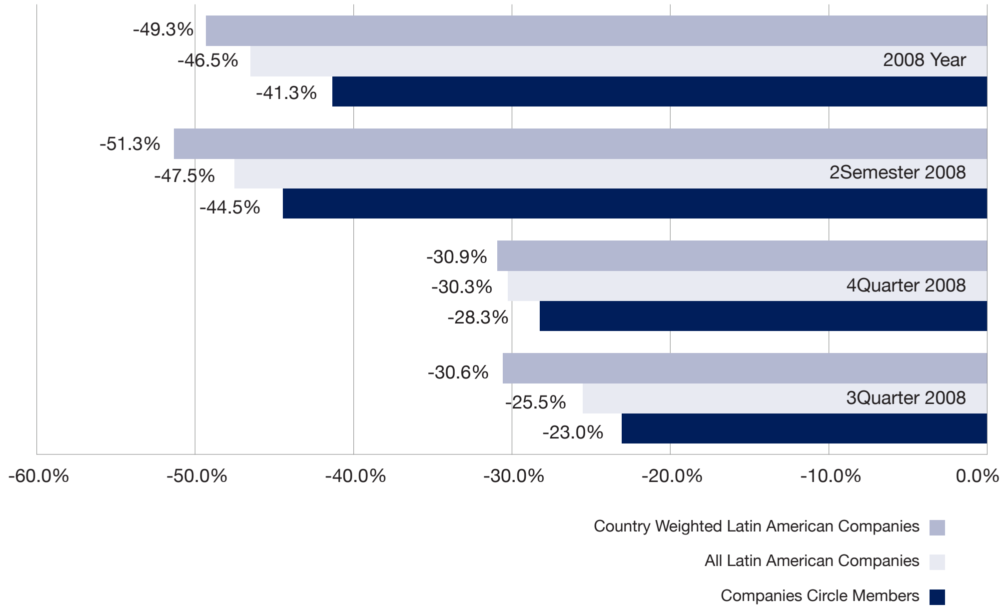
CLAESSENS, S,; DJANKOV, S.; KLAPPER, L. F. (1999, revised 2004), Resolution of Corporate Distress: Evidence from East Asia's Financial Crisis (June 1999). *World Bank Policy Research Working paper No. 2133. Available at SSRN: http://ssrn.com/abstract=168530.*

MITTON, T. (2002), A cross-firm analysis of the impact of corporate governance on the East Asian financial crisis. *Journal of Financial Economics*, pp. 64, 2, 215–241.

105 The analysis of the equally country-weighted portfolio is particularly important, since exchange rates fluctuated differently among Latin American companies and, since all results are presented in US dollars, the stocks of some Latin American companies may have struggled less in US dollar terms. For instance, the Chilean peso has struggled less than the Brazilian real, which tends to favor Chilean companies when evaluating their US dollar return. Since there is not yet a Circle member from Chile, this country is not represented in the country-weighted portfolio, avoiding the potential bias from different exchange rate reactions to the 2008 financial crisis.

106 However, since all portfolios display a high standard deviation of returns, these results were not statistically significant and do not allow for a clear-cut conclusion based exclusively on this analysis.

Chart 6c Stock Price Reaction to the Emergence of 2008 Global Financial Crisis
Stock market reaction after the emergence 2008 global financial crisis: comparison of stock returns against equally-weighed and country-weighted portfolios of 1,073 Latin American companies.



A second analysis redefined the comparison group and the time window, to provide a more accurate comparison.

- A matching control group consisting of 13 companies,[107] relatively similar to Circle members was created. For each Circle member, a peer company from the same country and industry was chosen. Firms were selected for their market capitalization and operational profitability similarities to the Circle member firms.[108] See Appendix 5 for the list of firms in this matching control group.
- The time window called "critical period" was redefined to cover the period from September 1, 2008, shortly before the collapse of Lehman Brothers and the announcement of problems with U.S. mortgage lenders Fannie Mae and Freddie Mac, to December 1, 2008, when National Bureau of Economic Research officially announced that the US was in recession.

The rationale here is that a comparison between a more equivalent peer group and within a more precise time window can distinguish more clearly the reactions to these external events. Chart 6d provides the mean and median results of both groups during this critical period. For comparison purposes, it also displays the mean and median returns of the official stock market indexes from the countries in which the firms are listed.[109]

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107 This portfolio of the Circle companies does not include Atlas (see Footnote 1) and Suzano Petroquímica since it was acquired in August 2007 by Petrobras (the Brazilian national oil company).

108 Due to restrictions on the number of listed firms in some countries, it was not always possible to find a comparable listed company from the same industry of a Circle member. In such cases, similarly sized companies, from similar industry environments were selected.

109 The stock market indexes used are: IBOVESPA in Brazil, IGVBL in Peru, IGBC in Colombia, and IPyC in Mexico. The results are weighted based on the number of companies from each country comprising the portfolio of Circle members.

Chart 6d Stock Price Reaction to the Emergence of Current Global Financial Crisis: Analysis of Critical Period, September 1, 2008–December 1, 2008

Stock market reaction after the emergence 2008 global financial crisis: comparison of stock returns against selected matched control group and average official stock market indexes from September 1 to December 1, 2008.

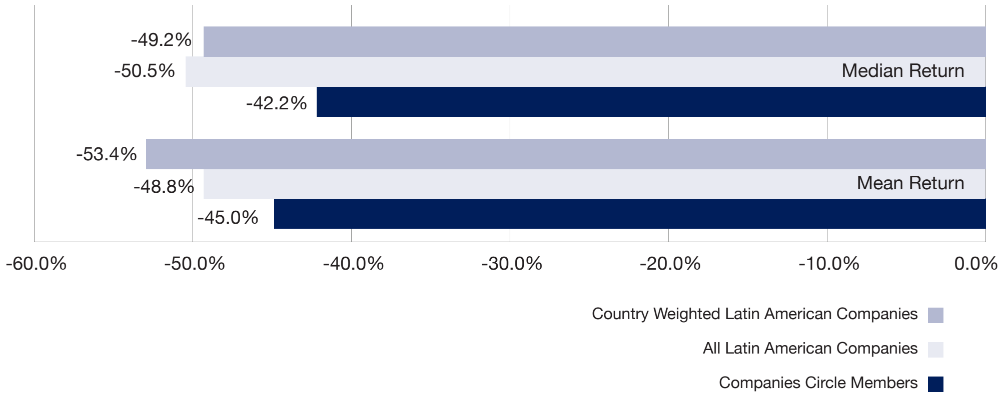

Chart 6d shows that the portfolio of Circle members declined slightly less than the matching control group and the average returns of the official stock market indexes. For instance, the median return for the Circle member portfolio was -42.2 percent during the period studied, compared to median drop of -50.5 percent from the matched control group portfolio.[110]

4.3 Corporate Attributes Affecting Better Stock Performance During an Economic Shock

The third analysis replicates the more complex methodology employed by previous academic research, particularly the study carried out by Baek, Kang and Park (2004) on the East Asian financial crisis of the 1990s. It uses a multiple statistical regression to evaluate the corporate attributes that may be associated with relatively better stock performance during an economic shock,[111] such as firms' size, profitability and debt ratio. In this analysis two variables related to corporate governance were included:

- Membership in the Companies Circle group
- The issuance of Level II or III ADRs[112]

Why look at these variables?

If there are positive and statistically significant results, this would be a clear sign that being part of the Circle group and/or cross-listing in a stricter market are factors that mitigate stock market deterioration during a period of sharp market distress, after filtering for other specific corporate attributes.

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110 Since all portfolios display a high standard deviation of returns, these results were not statistically significant and do not allow for a clear-cut conclusion based exclusively on this analysis.

111 The authors argue that the advantage of focusing on the crisis period is that it allows the unambiguous examination of the effect of corporate governance on firm value. The use of a given set of measures for corporate governance immediately before an external shock to explain changes in firm value can avoid any spurious causality caused by the endogeneity problem.

112 Issuers of Level II and III ADRs are subject to the requirements of Sarbanes-Oxley Act, thus subject to stricter disclosure and internal control rules.

This analysis provides clear—and quite interesting—results.[113] In all model specifications and time windows employed, being a member of the Companies Circle group is associated with better stock performance, after filtering for other possible explanatory factors. The results are statistically significant, reinforcing the connection even more. The results remain consistent with the inclusion of the ADR variable, which also had a positive influence on stock price reaction.

Companies Circle members' stocks declined less than the stock of other firms in the region during this recent period of dramatic market stress.

5 Companies Circle Members Acknowledge Gains

While numbers and results provide bottom-line support for the benefits of better governance, Companies Circle members say that their efforts have produced a combination of hard, numbers-based gains, and soft, harder-to-quantify gains. Some of these benefits are detailed in Chapter 1. Here, members provide further insight on the advantages.

- An institutionalization process, with less dependence on specific people to run the business
- Higher investor community confidence
- Better access to credit terms, including long-term capital from development banks
- More recognition from stakeholders, including national and international institutions
- Greater confidence in carrying out mergers and acquisitions because of increased standards of transparency
- Substantial improvement of business processes, including internal controls and supervision of the decision-making process

Circle members point to significant, qualitative results from their corporate governance journeys.

Homex

For **Homex**, the early stages of the company's life included the same struggles that most family businesses face when starting a business. Today, the leader of this company, now Mexico's largest and most diversified homebuilder with operations in 33 cities and 21 states, points to specific gains from adopting better corporate governance practices. Here is how Eustaquio de Nicolás, Homex's Chairman of the Board, puts it:

> *"Ten years ago we began our institutionalization process. Our efforts and good governance practices have brought us numerous benefits internally at Homex and to our operations, and it has also helped us gain the investment community's confidence, along with that of our share-*

113 Appendix 5 has the complete results, including the methodological details on the data and variables construction.

holders and suppliers, and the recognition of several national and international institutions."[114]

—Eustaquio de Nicolás, *Homex, Chairman of the Board*

Suzano

For the **Suzano Group**, corporate governance improvements have been elevated to a strategic level, and the efforts have paid off, with an impressive display of share appreciation.

"…The story of Suzano Group since 2003 is impressive in terms of value creation. It is obviously impossible to link it exclusively to corporate governance, but one can unquestionably say that it has been an essential element of the strategy.

Suzano Papel e Celulose shares traded by the end of 2007 at the level of R$ 29.00, compared to roughly R$ 4.24 in early 2003, reaching more than 580 percent appreciation, with a daily trading liquidity more than 100 times bigger. It financed a long-term expansion plan which doubled its pulp production capacity and has placed it as a relevant world player in the industry.

Suzano Petroquimica followed a similar path and evolved from an irrelevant holding position to a leadership position in its business segment, through a series of acquisitions, divestment of assets and a consistent capital markets plan. As a direct result of its recognized standards of corporate governance, market position and relevance of its assets, the company was sold to Petrobras in late 2007 for an equity value of R$ 2.7 billion. This translates into a share appreciation of about 600 percent

[114] DIRECTORSHIP (October 10, 2007), *http://www.directorship.com/homex-joins-governance-group.*

when compared to the value of the stock—R$ 1.53—in the beginning of 2002. Minority shareholders were protected with tag-along rights.

The implementation of the sale was extremely simplified and accelerated due to transparency and well known practices of the company. Due diligence was only performed after announcement. These issues have a hidden value which can only be correctly perceived as part of the overall successful transaction."

— **João Pinheiro Nogueira Batista,** former co-CEO, Suzano Petroquímica.

Last words. Companies Circle members' experience has taught them that the companies most successful in facing complex business challenges are the ones that have adopted a constant learning attitude, pursuing shareholder value creation, and taking into account the perspectives of all stakeholders.

The Companies Circle members invite you to embark on the governance journey. They hope that this book will serve as your travel guide as your company moves forward toward better corporate governance practices.