International corporate governance and firm value

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Corporate valuations around the world

- Valuations differ widely across countries, in spite of financial market globalization
- E.g., average Tobin's *q* in 2006 ranges from 1.16 in Malaysia & South Korea to 2.24 in Denmark
  - Substantial variation within countries as well
- Why?
  - Corporate governance
  - Growth opportunities; trade & / or investment barriers; industry composition; taxes; accounting rules, etc.

Corporate governance

- Agency conflict
  - Insiders vs. outside investors
  - Insiders can divert corporate resources for their own benefit
- Corporate governance
  - Deals with ways in which suppliers of finance to corporations assure themselves of getting a return on their investments
- Country & firm-level mechanisms, e.g.,
  - Laws & the institutions that enforcement them
  - Financial reporting & disclosure
  - Board composition
  - Ownership structure & executive compensation, etc

Main research question

- Does corporate governance affect firm value?
  - Better governance limits expropriation by insiders
  - Increases firms' ability to finance growth opportunities
  - Focus is on the international literature
- Related questions
  - Why do some countries provide better legal protection for investors?
  - Why do some firms adopt better governance?
  - Which governance mechanisms matter?

International corporate governance

- In 2000 & 2003, the JFE & JFQA published special issues on “International corporate governance”
  - Single-country → non-US data, often follows US-based research
  - Cross-country → usually based on LLSV “Law & finance” paradigm
- Cross-country studies can exploit differences in
  - The nature of the agency problem
  - Laws, institutions, rules
  - Economic outcomes
  - Firms that are “domestic” vs. those that “cross” borders

Outline of talk

- Governance & firm value: evidence evidence
  - Country-level governance measures
  - Firm-level: governance indices
  - Firm-level: cross-listings
- In each case, discuss
  - The basic idea
  - The key results
  - Questions & limitations
- Conclusions

Country-level investor protection

- Are firm values higher in countries that protect investors better?
- Motivated by a series of papers by LLSV
  - Importance of laws that protect investors’ rights
  - Provide country-level measures
- Empirical approach: cross-sectional regressions
  - q = a + b×Investor protection + controls

Country-level investor protection

- LLSV (2002, JF)
  - Key result: Valuations are higher in common law countries & in countries with higher scores on the anti-director rights index
- Chua, Eun, & Lai (2007, JBF)
  - Key result: Valuations are higher in countries with common law origin, better shareholder rights, enforcement, disclosure, less corruption, & enforced insider trading laws

Country-level investor protection

- Questions & limitations
  - Corporate law? Securities law? Disclosure? Rules on the books vs. enforcement?
  - Different authors use different measures → changing samples
  - Measurement error, comparability, & relevance of investor protection proxies?
  - Small sample sizes
  - Many cross-country differences → omitted variables problem
  - Ignores within-country variation in valuations & governance

Firm-level governance

- Do firms with better governance have higher values?
- Firms can adopt governance mechanisms over & above the protection granted by the state, e.g.,
  - Better disclosure; independent, reputable auditor
  - More independent board members; non-classified board
  - Transparent ownership structure
  - Eliminate dual class shares
  - “Opt in” to another country’s regulatory regime, etc.
- Different measures of firm-level governance

Firm-level governance: indices

- Governance indices
  - CLSA, S&P, ISS (CGQ rankings)
  - Advantages / disadvantages of each index
- Empirical approach: cross-sectional regressions
  - q = a + b×Firm governance + controls

Firm-level governance: indices

- Klapper & Love (2004, JCF) & Durnev & Kim (2005, JF)
  - Focus mainly on CLSA data
- Key results
  - Positive relation b/w *q* & firm-level governance
  - Positive relation b/w *q* & country-governance
  - Better firm-level governance is valued more highly in low governance countries

Firm-level governance: indices

- Questions & limitations
  - Firm / country coverage & sample composition
  - Endogeneity problems
  - Governance is “sticky”
  - Isolating firm governance?
  - Which elements of firm / country governance matter?
- Three recent studies use the ISS CGQ data
  - Chhaochharia & Laeven (2007)
  - Bruno & Claessens (2007)
  - Aggarwal, Erel, Stulz, & Williamson, (2008, RFS forth)

Firm-level governance: cross-listing

- Large literature that studies why firms cross-list
  - Many theories offered → recent focus is on commitment to better governance & disclosure
  - Focuses mainly on cross-listings in the US

- Compared to governance indices?
  - Larger samples across & within countries
  - Time series data
  - Potential costs & benefits unrelated to governance
  - Governance measure may be less precise

Firm-level governance: cross-listing

- Doidge, Karolyi, & Stulz (2004, JFE)
  - Prior literature focuses on event studies
  - Regression: q = a + **b´Cross-listing dummies** + controls

- Key results
  - Foreign firms listed in the US are worth more → the "cross-listing premium"
  - Premium is higher for firms from countries with weak investor protection
  - Premium is higher for firms with more growth opportunities

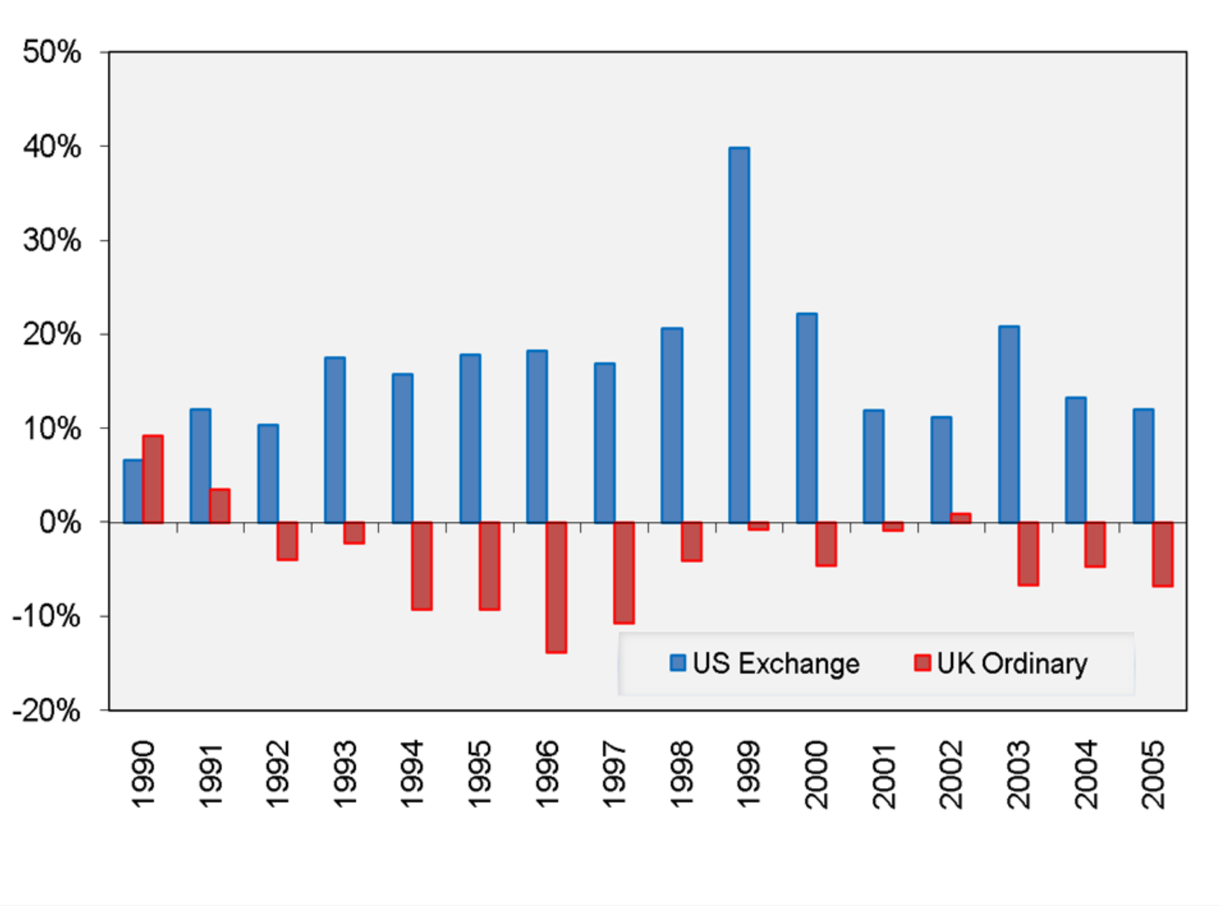
Firm-level governance: cross-listing

- Questions & limitations
  - Enforcement?
  - Specific monitoring mechanisms – formal vs. informal?
  - Other explanations for the premium?
  - Cross-sectional data for 1997 only
  - Endogeneity
  - Premium is temporary
  - Focuses on the US only → listings in other markets?
  - SOX?

Firm-level governance: cross-listing

- Doidge, Karolyi, & Stulz (2008, JFE forthcoming)

- **US listings**
  - Premium each year
  - Average is 17%
- **UK listings**
  - No significant premium in any year



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Firm-level governance: cross-listing

"Is a US Listing Worth the Effort? --- Premiums Paid for Shares In Foreign Firms Are Reduced Since Crackdown, Study Finds" - WSJ, Nov 2006

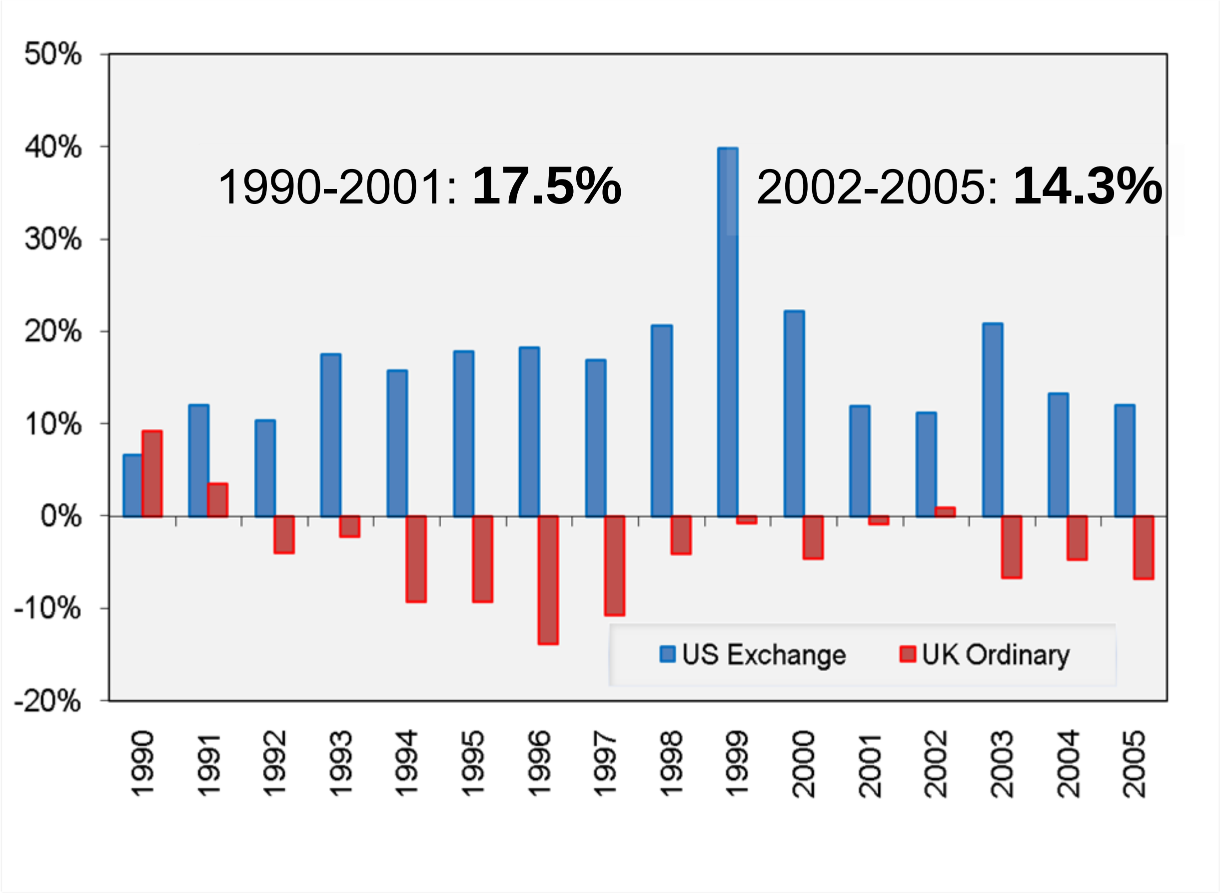
- Have the additional requirements imposed by SOX lowered the "governance benefit" of a US listing?

Firm-level governance: cross-listing

- Is the premium lower after SOX?

- Pre/post difference
  - Not significant
  - Tiny if 1999 is excluded

- More sophisticated statistical tests
  - Same conclusion



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Conclusions

- Clear evidence of association between governance & value
    - Variation in valuations across countries & firms is sensible
- Skeptic can still argue that the relation is not casual
- Which aspects of governance matter? Unclear
    - Which firm & country governance mechanisms matter?
    - Overall importance of country vs. firm governance
    - Generalizable results? Different mechanisms may be more/less important in different countries → back to single country studies?