Corporate Governance from the Bondholder's Perspective: Measurement and Analytical Considerations

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Agenda

> What is corporate governance?

> How does governance affect credit risk?
  > Empirical research
  > Fitch’s own work

> Fitch’s methodology for evaluating corporate governance
  > Bondholder perspective
  > Leveraging data
  > Contextual review

> Conclusions

> Appendix: Key Governance Principles to Evaluate for Bondholders
What is corporate governance?
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> Corporate governance addresses the classic “agency problem” inherent in managing a corporation by:

> Resolving tensions where the interests of management (the agents) and outside investors (the principals) are not aligned

> Instituting mechanisms for providers of capital/funding to monitor the behavior of corporate insiders

> Governance practices are critical to how the firm manages assets and controls risk

> Strong practices help to promote culture of risk transparency and more efficient resource allocation

> Weak or deficient practices can result in misuse of financial resources or impairment of the company’s credibility
Governance failures can destroy value for all investors…

<table>
<thead>
<tr>
<th>Company</th>
<th>Nature of governance failure</th>
<th>Event (bankruptcy, restatement, stock price, etc.)</th>
<th>Date of event (Month, Year)</th>
<th>Loss in share value around time of event*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adelphia Comm.</td>
<td>Executive fraud</td>
<td>Bankruptcy</td>
<td>June 2002</td>
<td>96.5%</td>
</tr>
<tr>
<td>Enron</td>
<td>Accounting</td>
<td>Bankruptcy</td>
<td>Dec 2001</td>
<td>99.2%</td>
</tr>
<tr>
<td>Global Crossing</td>
<td>Accounting</td>
<td>Bankruptcy</td>
<td>Jan 2002</td>
<td>99.4%</td>
</tr>
<tr>
<td>Tyco</td>
<td>Executive fraud</td>
<td>Share Losses</td>
<td>Early 2002</td>
<td>61.7%</td>
</tr>
<tr>
<td>Worldcom</td>
<td>Accounting</td>
<td>Bankruptcy</td>
<td>July 2002</td>
<td>99.7%</td>
</tr>
<tr>
<td>Xerox</td>
<td>Accounting</td>
<td>Restatement</td>
<td>May 2001</td>
<td>61.9%</td>
</tr>
<tr>
<td>HealthSouth</td>
<td>Accounting</td>
<td>De-listed</td>
<td>Mar 2003</td>
<td>95.9%</td>
</tr>
<tr>
<td>Tenet Health</td>
<td>Medicare fraud</td>
<td>Share Losses</td>
<td>Oct 2002</td>
<td>29.3%</td>
</tr>
<tr>
<td>Ahold</td>
<td>Accounting</td>
<td>Share Losses</td>
<td>Feb 2003</td>
<td>74.3%</td>
</tr>
<tr>
<td>Parmalat</td>
<td>Executive Fraud</td>
<td>Bankruptcy</td>
<td>Dec 2003</td>
<td>95.2%</td>
</tr>
</tbody>
</table>

*Share losses measured from highest share price prior to public knowledge of event to the lowest share price reached thereafter
How does corporate governance affect credit risk?
How does governance affect credit risk?

> Recent “high profile” meltdowns illustrate that corporate governance can matter to bond investors

> But, a key question we asked is: **Is there a systematic way to determine how much it matters?**

> Is there a quantitative link between corporate governance and credit quality?

> If so, what implications might this have for the credit rating process?

> In tackling these questions, Fitch looked to a variety of resources

> Empirical research (both academic and our own)

> Our ratings experience and knowledge of credit risk
How does governance affect credit risk?

> Growing body of empirical research on corporate governance and firm performance…though most of focus has been on equity-holder impact

> Not surprisingly, there is evidence of a positive link between good corporate governance and equity performance

> “Corporate Governance and Equity Prices” (Gompers, et al, 2003)
  > Firms with stronger shareholder protection (based on 24 different indicators) outperformed those with weak protection by 8.5% per year

> “Governance Mechanisms and Equity Prices” (Cremers & Nair, 2003)
  > Looked at role played by different governance mechanisms
  > Showed that interplay between practices is important
How does governance affect credit risk?

> Some (but more limited) research showing that quality of corporate governance matters to bondholders as well

> “The effect of corporate governance on bond ratings and yields” (Bhojraj & Sengupta, 2003)

> Firms with more outside directors tend to have stronger bond ratings / lower yields
Fitch research: corporate governance affects credit quality (i.e., higher CGQ scores associated with better credit ratings)

Regression Analysis: CGQ Scores and Fitch/S&P/Moody's Credit Ratings

* RATINGS AVERAGE is the average issuer rating (Fitch, Moody's, and S&P) scaled in inverse relation to the rating. For example, a rating of AAA is coded as "1" and a rating of "B" is coded as a "15".
How does governance affect credit risk?

> **So, what practical lessons can we draw from these findings?**

> Empirical work shows that corporate governance can and does affect economic value…but doesn’t really tell us much about **how** to reflect governance within the credit ratings process

> **Complicating the measurement is:**

> Subjective nature of corporate governance

> Governance failures can follow unique patterns

> Complex inter-relationship of different elements of corporate governance (Board quality, management compensation, etc)

> Another complicating factor is the asymmetric impact of governance on bondholders

> Particularly strong governance practices will generally help to promote timely repayment, but “upside” is limited

> Fundamental corporate governance weaknesses can potentially cripple a borrower’s financial position

> Because of these complications, there is no formula that can measure an issuer’s governance quality and translate it into a credit rating outcome

> Leveraging data and empirical work is useful…but Fitch believes that case-by-case “contextual” review is also critical
Fitch’s methodology for evaluating corporate governance
Fitch’s methodology takes bondholder view

In April 2004, Fitch published a criteria report on corporate governance ("Evaluating Corporate Governance: The Bondholders’ Perspective")

Fitch’s criteria provide a bondholder’s view on corporate governance

- Much of public debate has focused on the role of corporate governance in protecting equity-holders
- Generally, there is broad alignment between the two…however, Fitch believes that important divergences can occur
- Namely, the potential for equity-holders to drive management to take decisions that serve their own interests at the expense of bondholders
  - Riskier investments
  - Mergers and acquisitions (particularly those that increase debt levels)
  - Increase in dividends
  - Increase in leverage (including share repurchases)
Fitch’s methodology for evaluating corporate governance

> Corporate governance had traditionally been an implicit factor in our credit ratings process

> Fitch’s new methodology provides an explicit, more systematic framework for assessing governance quality:

> Leverage data and information, where available

> Performing contextual reviews of each company to reflect qualitative attributes and divergences with equity-holder perspective (where appropriate)

> Incorporating the governance analysis into Fitch’s credit rating process
Leveraging governance data

> Leveraging data in a systematic manner is one tool for assessing the quality of governance practices
> Statistical comparisons and other indicators of governance quality can help to “flag” companies with the weakest practices
> One source of data Fitch is using is Institutional Shareholder Services’ (ISS) Corporate Governance Quotient (CGQ)

> However, governance can be an elusive concept to quantify and measure
> Some academic research questioning validity and reliability of governance rating models (recent Wharton study by Larcker, Richardson, Tuna)
> Other research (Brown & Caylor) suggests governance ratings are in fact correlated with firm performance

> Important to recognize that governance scores are not an automatic feed into bond ratings…but can serve as a useful platform for further analysis
“Contextual” reviews

> Beyond the data, Fitch performs more individualized, case-by-case “contextual review” of governance practices of each company:

> Review governance practices that require more qualitative analysis and cannot be readily measured in a data set (including the interplay of different practices)

> Focus on key governance principles for bondholders (see appendix for more detail):

> Board quality (independence and effectiveness)
> Review of related party transactions
> Reasonableness of management compensation
> Integrity of audit process
> Executive and director stock ownership
> Shareholder rights / takeover defenses

> Companies that might not fit neatly into the “traditional” governance paradigm:

> Majority-owned and family-owned companies;
> Complex holding company structures; and
> Banks and financial institutions
Ratings impact of corporate governance

> Ultimate objective of governance assessment is to determine when and how the quality of a company’s practices affect its credit risk

> Corporate governance is part of Fitch’s “credit committee” discussion

  > Review findings from data analysis and contextual review

> In terms of rating impact…

  > Companies with *exceptionally weak* or deficient governance practices may face a downgrade or negative ratings action;

  > Note, however, that governance concerns might already be embedded for lower-rated companies

  > On the other hand, companies with *exceptionally strong* governance might warrant special mention but will likely not receive an upgrade as a result
Some interesting analytical points...

> To give a “flavor” of Fitch’s analytical approach, some examples of interest are how we look at…

> Takeover defenses, which highlight potential divergences between the bondholder and equity-holder perspective

> Majority-controlled companies can pose unique analytical challenges for bondholders
Understanding takeover defenses

> In Fitch’s view, the impact of takeover defenses sometimes can cut differently in the bondholder context

> Academic literature almost always shows that takeover defenses are an undesirable governance practice in the equity context

>   Removes the discipline that takeover markets exert on management performance and behavior

> However, takeover defenses can in some instances help to protect bondholder interests

>   For example, bondholders can be harmed from a takeover if the acquirer increases leverage materially

>   Indeed, NYU (Cremers, Nair, Wei, 2004) and University of Wisconsin (2004) studies demonstrate that bondholders expect to receive a higher yield if takeover defenses are not in place ►► particularly if there is a large blockholder

>   NYU study also shows that covenants can help to mitigate some of the differences between bond and equity investors

> In our methodology, we look carefully at how takeover defenses are used by a particular company and the inter-relationship of several factors

>   For example, look at block-holders, covenants, leverage, track record of equity-holders and management, mechanisms to protect minority shareholders, etc.
Evaluating majority-owned companies

> Since Fitch covers companies worldwide, we look carefully at differences in governance structures across markets

> Majority-controlled companies pose unique analytical challenges in the bondholder context, given that:

  > Ownership is concentrated in the hands of a tight circle of individuals, who often hold key managerial roles as well

  > Other stakeholders might not have sufficient power to challenge or check majority owner decisions

  > Bondholders (in the absence of covenants) can thus be more exposed to shareholder self-interest

> Interesting to look at different levels of majority ownership across countries…
Share Ownership Differs Across Markets

Percentage of Listed Companies Under Majority Control

Source: country chapters in Barca and Becht (2001)
Evaluating Majority-owned Companies

> Fitch believes that bondholders need to understand the relationship between the majority owners and the company

> Who are the owners? What are the **legal and commercial relationships** between the company and other businesses the owners are involved with?

> How are the owners/managers compensated? Are they salaried? What are the company’s dividend policies? Does the owner rely on dividends for personal income or to fund other businesses?

> Not all block-holders are necessarily bad for bondholders…

> …but important to understand the history of the owners and look at mechanisms that might help to protect other stakeholders
Conclusions

> Corporate governance matters to bondholders
  > Recent market experience of governance failures
  > Empirical research (academic and Fitch’s own)
> Data can be a helpful tool…but no single formula or model can replace the analytical process
> Reflecting governance within credit analysis ultimately requires:
  > Strong knowledge of the company,
  > Careful consideration of a range of factors (both measurable and not),
  > Analyst judgment, and
  > Well-informed discussion
> High quality disclosure is essential and signals to the market that governance is taken seriously
Contact Information

Fitch’s governance criteria report is available free of charge on Fitch’s website (www.fitchratings.com):

► Evaluating Corporate Governance: The Bondholders’ Perspective (April 12, 2004)

Questions or thoughts, please contact:

► Kim Olson (e-mail: kim.olson@fitchratings.com)
Appendix: Key Governance Principles to Evaluate for Bondholders
Key Governance Principles to Evaluate for Bondholders

Board quality is a fundamental part of governance evaluation

> An active and independent Board is crucial to monitoring company strategy and management performance

> But, inherently challenging to assess Board quality…since public and analysts are not privy to what goes on “behind closed doors”

> Important to explore issues that can help shed light on the Board’s activities

> How assertive is the Board in evaluating management decisions?

> What key questions did the Board pose to management during its last few meetings, particularly in relation to any negative events?

> How are Board members selected? How broad is the pool of candidates? What is the CEO’s role in the nomination process?
Key Governance Principles to Evaluate for Bondholders

> **Related party transactions** can potentially be misused by executives and majority shareholders to divert corporate wealth for personal enrichment

  > Can pose direct financial costs by dissipating resources

  > More broadly, can provide a “window” onto the board’s effectiveness and independence (or lack thereof)

> Important for bond investors to get a clearer sense of the **nature, purpose** and **economics** of these transactions

  > Quality of **disclosure** is critical ►► however practices vary greatly across companies

  > Onus is on company to communicate the attributes of any related party dealings

> Fitch looks carefully at ways to detect potentially abusive transactions based on public disclosures
Key Governance Principles to Evaluate for Bondholders

- Management compensation should be within reasonable bounds and aligned with the company’s long-term performance
  - Peer/comparison benchmarking can be helpful
  - Evaluate company’s compensation policies
- Empirical relationship between compensation and performance is an important area for further research
- Better disclosure of compensation policies is critical to this effort
The use of equity ownership (including options) as an incentive mechanism for management can cut a few different ways for bondholders:

> On one hand, equity ownership can provide a direct financial motivation to promote the market value of the company

> All else equal, will benefit bondholder

> On the other hand, substantial equity exposure to the company could create incentives for propping up the company’s short-term returns and stock price

> If done at the expense of long-term fundamentals, could harm bondholders