McKinsey & Company

Investor Opinion Survey

June 2000

McKinsey & Company Investor Opinion Survey on Corporate Governance

Increased shareholder activism in the U.S. and elsewhere stems from the conviction that better corporate governance will deliver higher shareholder returns. Yet repeated attempts by academics to show an irrefutable link between the two have failed, such is the complexity of the relationship.

With this in mind, McKinsey & Company conducted a series of surveys to discover how shareholders perceive and, importantly, value corporate governance in both developed and emerging markets. Undertaken in co-operation with the World Bank and the *Institutional Investor's* regional institutes, the surveys gathered responses about investment intentions from over 200 institutional investors, who together manage approximately US$3.25 trillion in assets. Forty percent of the respondents were based in the U.S.

Among the key findings from the surveys detailed in this pamphlet are the following:

- Three-quarters of investors say board practices are at least as important to them as financial performance when they are evaluating companies for investment. In Latin America, almost half the respondents consider board practices to be more important than financial performance.
- Over 80 percent of investors say they would pay more for the shares of a well-governed company than for those of a poorly governed company with comparable financial performance. (For the purpose of the surveys, a well-governed company is defined as having a majority of outside directors on the board with no management ties; holding formal evaluations of directors; and being responsive to investor requests for information on governance issues. In addition, directors hold significant stockholdings in the company, and a large proportion of directors' pay is in the form of stock options.)
- The actual premium investors say they would be willing to pay for a well-governed company differs by country. For example, investors say they would pay 18 percent more for the shares of a well-governed UK company than for the shares of a company with similar financial performance but poorer governance practices. They would be willing to pay a 22 percent premium for a well-governed Italian company, and a 27 percent premium for one in Venezuela or Indonesia.

Interpreting the results

The fact that so many investors say board governance is as important as financial performance points to the poor quality of financial reporting in many countries. The priority of investors the world over is that their investments grow. Yet in Asia and Latin America, where financial reporting is both limited and often of poor quality, investors prefer not to put their trust in figures alone. They believe their investments will be better protected by well-governed companies that respect shareholder rights. In Europe and the U.S., where accounting standards are higher, the relative importance of corporate governance is lower.

The size of the premium that institutional investors say they are willing to pay for good governance seems to reflect the extent to which they believe there is room for improvement.

For example, the lower premiums for UK and US companies suggest that investors feel these companies have already addressed many fundamental governance issues. They can improve by fine-tuning current practices, and identifying innovative ways to raise governance standards still further.

The premiums in continental Europe suggest that, in addition to improved corporate governance at board level, there is a need for more effective disclosure of information to shareholders concerning governance practices and financial issues.

In Asia and Latin America, still higher premiums reflect the need for more fundamental disclosure of information, and stronger shareholder rights. In Latin America, for instance, local investors say better disclosure is the main concern, while foreign investors see shareholder rights as the priority. For them, the value of more information is undermined if they cannot influence board or management decisions.

Meeting the Corporate Governance Challenge

Although it remains difficult to measure the impact on market prices of the premiums investors say they are willing to pay for well-governed companies, the amounts they are prepared to pay leave little doubt that good governance does feed through. Precise measurement apart, the fact that a majority of investors say they already take corporate governance into account when making investment decisions is a powerful argument in favour of corporate governance reform.

Companies and policy makers should take heed. If companies could capture but a small proportion of the governance premium that is apparently available, they would create significant shareholder value. Moreover, those companies that fail to reform will find themselves at a competitive disadvantage when it comes to attracting capital to finance growth. High governance standards will prove essential to attracting and retaining investors in globalized capital markets, while failure to reform is likely to hinder those companies with global ambitions.

Companies should therefore improve their board practices and board and management incentives. The surveys make clear where investors' priorities lie in these areas. In addition, companies should promote better relationships with all their shareholders.

Policy makers wishing to attract more foreign investors should also play their part, as companies alone cannot produce the magnitude of change that is necessary, particularly in emerging markets. At the regulatory level, the corporate governance framework should encourage governance reforms or, at the very least, not hinder them.

Improved disclosure of information and stronger shareholder rights appear to be the most appropriate target areas for policy makers, who must also take into account what may well be different priorities of both domestic and foreign investors.

However, it would be wrong to conclude from the survey that good corporate governance is a simple issue. An effective board of directors is a combination of the right people, the right structure, and the right procedures. Determining what is appropriate for each individual company is the real challenge. Likewise, policy changes are likely to impact countries differently depending on existing cultural and economic practices. Each company and country needs to consider its own circumstances before deciding the best way to improve corporate governance.

Paul Coombes

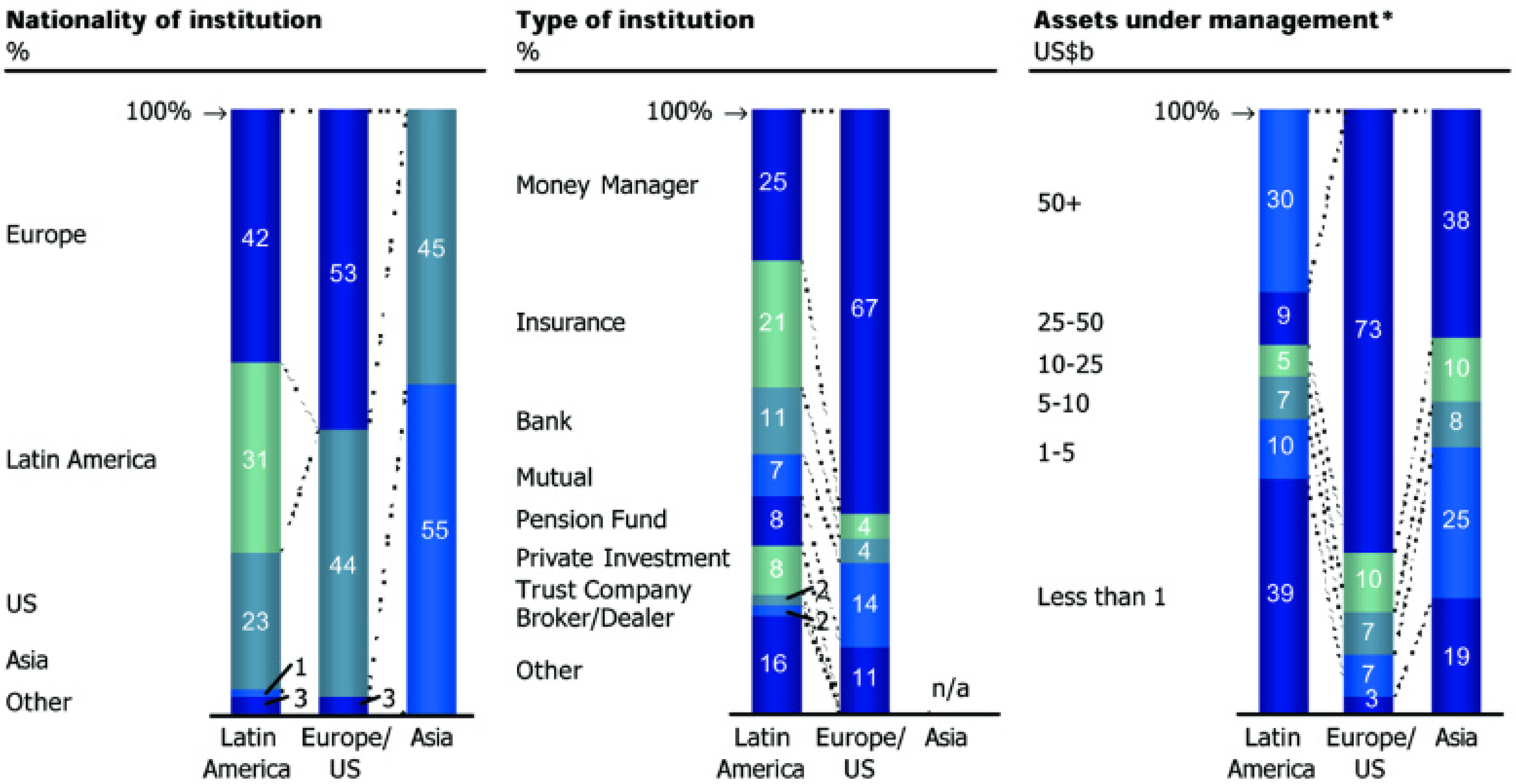
Paul Coombes
Director, London Office

Investor Opinion Survey

- Latin America
  - Undertaken March/April 2000 in cooperation with The World Bank Group
  - 90 respondents with an estimated US$1,650b+ assets under management
  - 70% of respondents had invested in Latin America
- Europe/US
  - Undertaken October/November 1999 in cooperation with the *Institutional Investor's* U.S. Institute and European Institute
  - 42 respondents with an estimated US$550b+ assets under management
  - 95% of respondents had invested in Europe and the U.S.
- Asia
  - Undertaken September/October 1999 in cooperation with the *Institutional Investor's* Asia Pacific Institute
  - 84 respondents with an estimated US$1,050b+ assets under management
  - 82% of respondents had invested in Asia

* All postal surveys. Latin America survey also web-based. Some questions did not appear on all surveys. Percentages given exclude non-responses

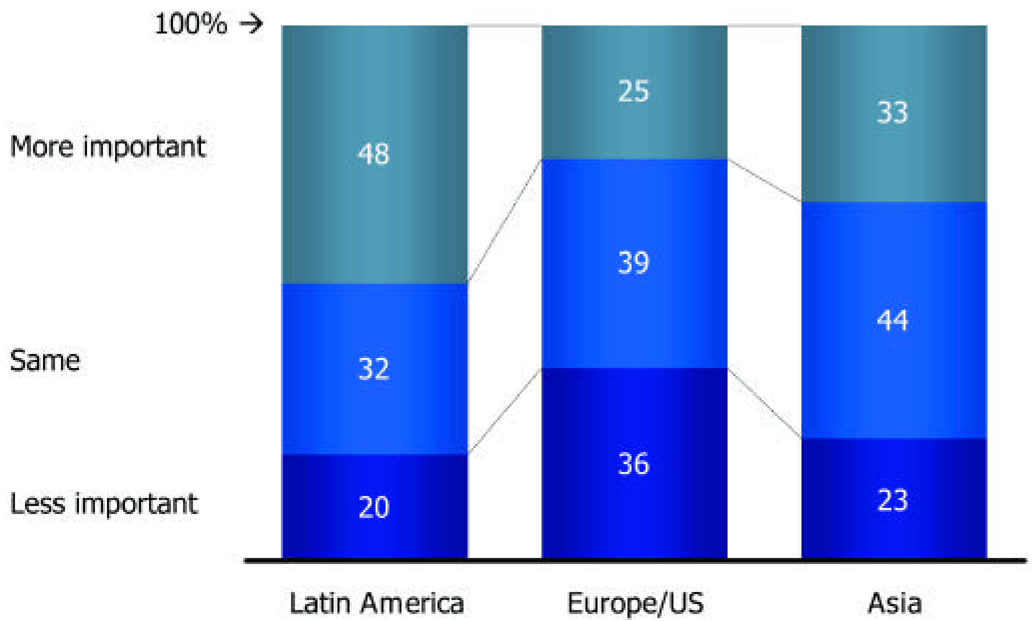
Respondents' profiles



* For Europe/US and Asia surveys, highest category was US$25b+

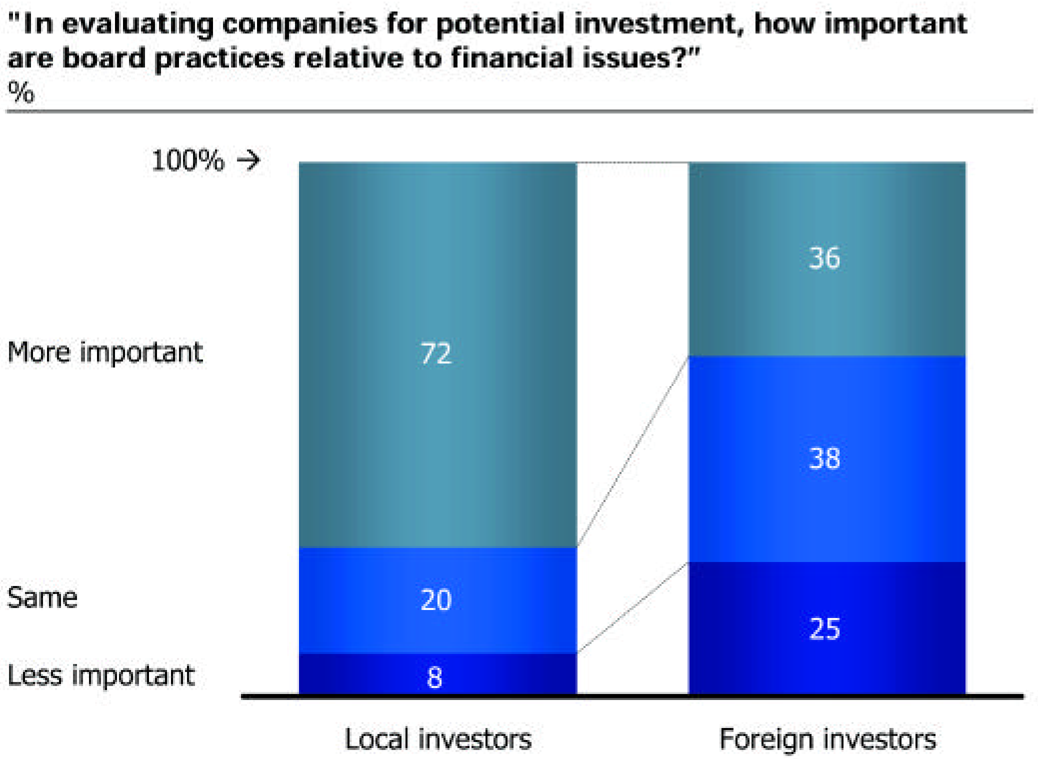
Board practices are important in selecting companies in which to invest . . .

"In evaluating companies for potential investment, how important are board practices relative to financial issues?"
%



Governance factors appear to be at least, if not more, important than financial issues in stock selection

. . . but as seen in Latin America, views differ by origin of investor



Local investors in Latin America consider governance more important than financials in stock selection

Are investors willing to pay more for a company with good board governance practices?

"Suppose you are considering investing in two well-known companies. Both have performed well in the past, but are currently going through difficult times. However, their board governance practices differ."

Company A – 'Poor' governance

- Minority of outside directors
- Outside directors have financial ties with management
- Directors own little or no stock
- Directors compensated only with cash
- No formal director evaluation process
- Very unresponsive to investor requests for information on governance issues

Company B – 'Good' governance

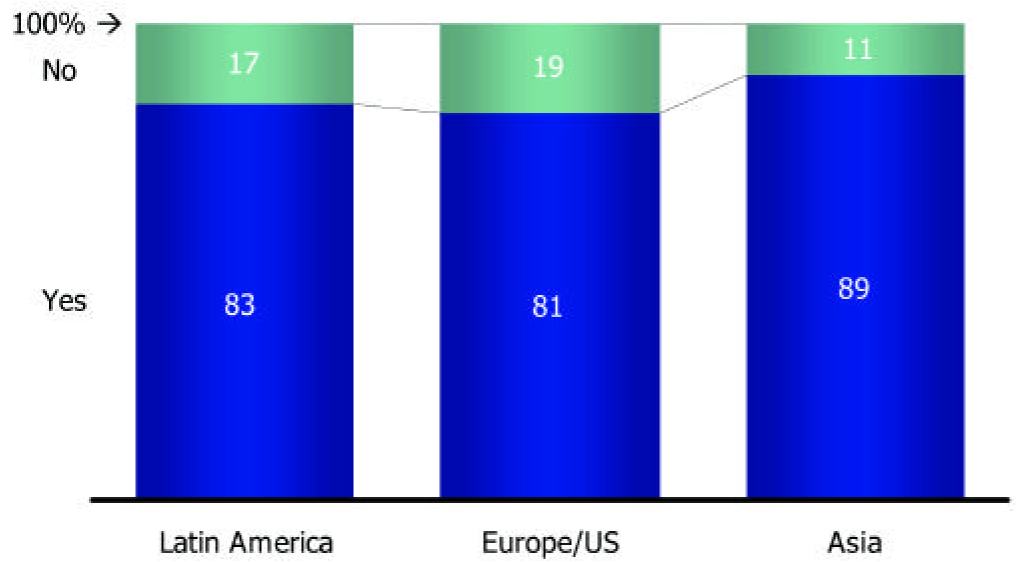
- Majority of outside directors
- Outside directors are truly independent, no management ties
- Directors have significant stockholdings
- Large proportion of director pay is stock/options
- Formal director evaluation in place
- Very responsive to investor requests for information on governance issues

Question:

- Would you be willing to pay more for company B's stock than company A's?
- If yes, what percentage premium do you estimate you would be willing to pay for B's stock?

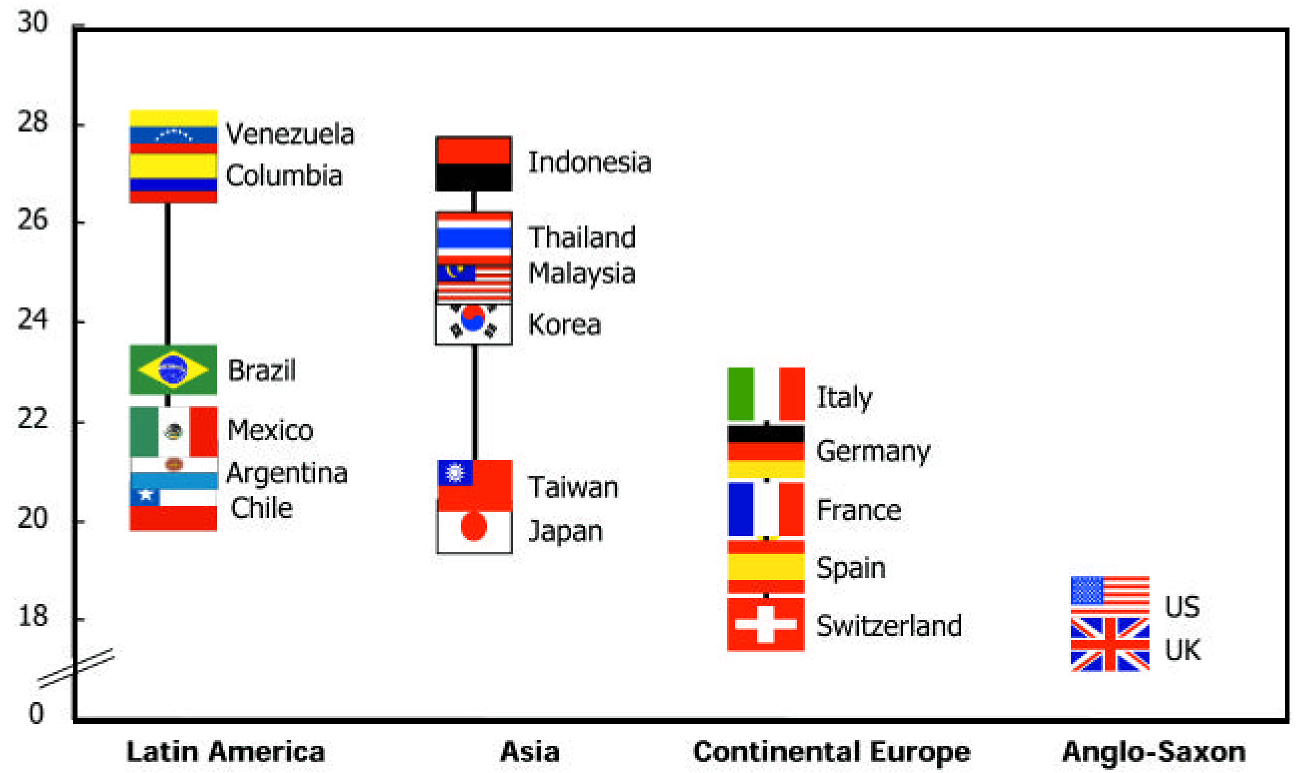
A clear majority say yes

%



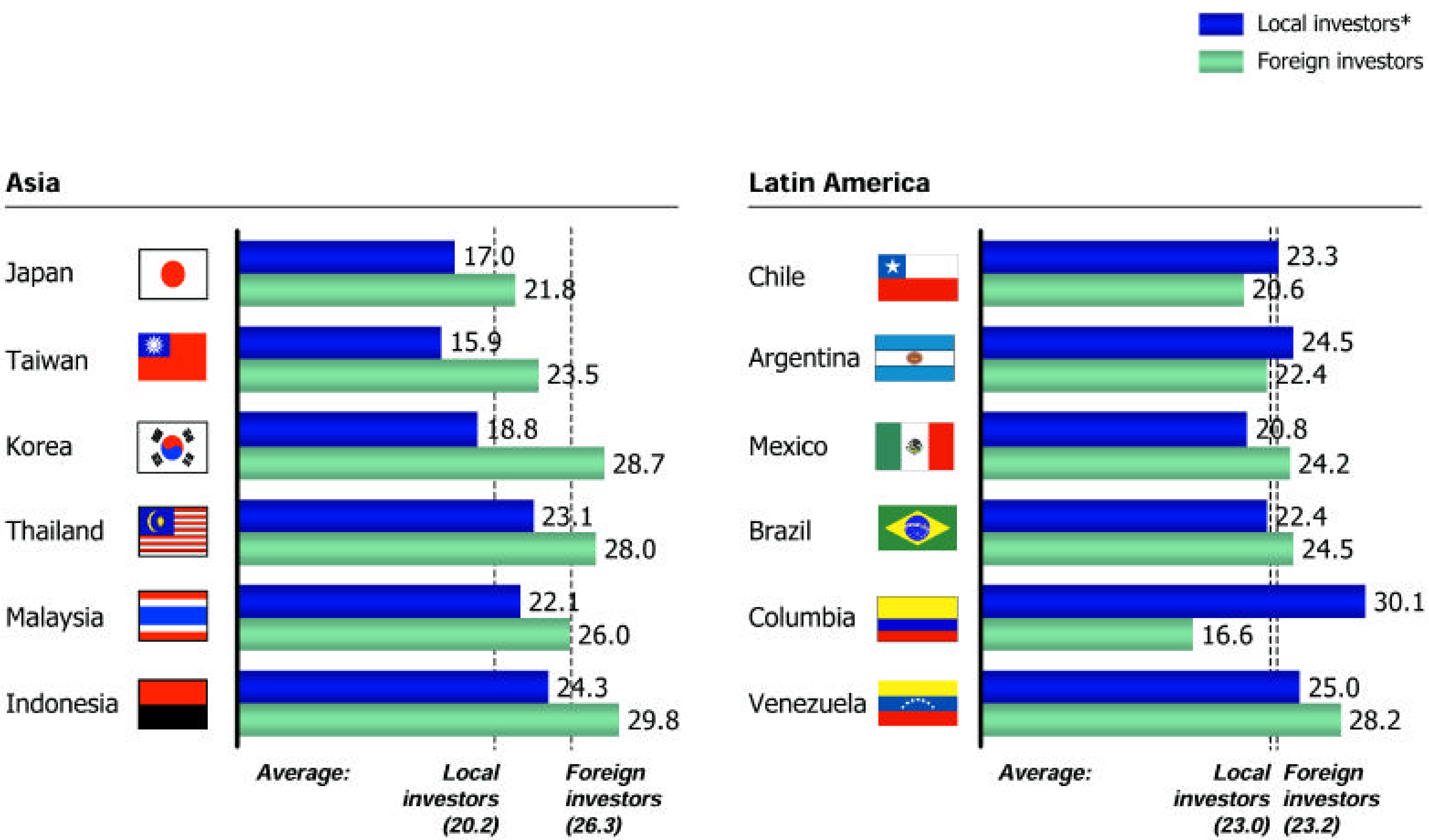
The average premium investors would be willing to pay differs by country . . .

Average %



. . . and differs between local and foreign investors

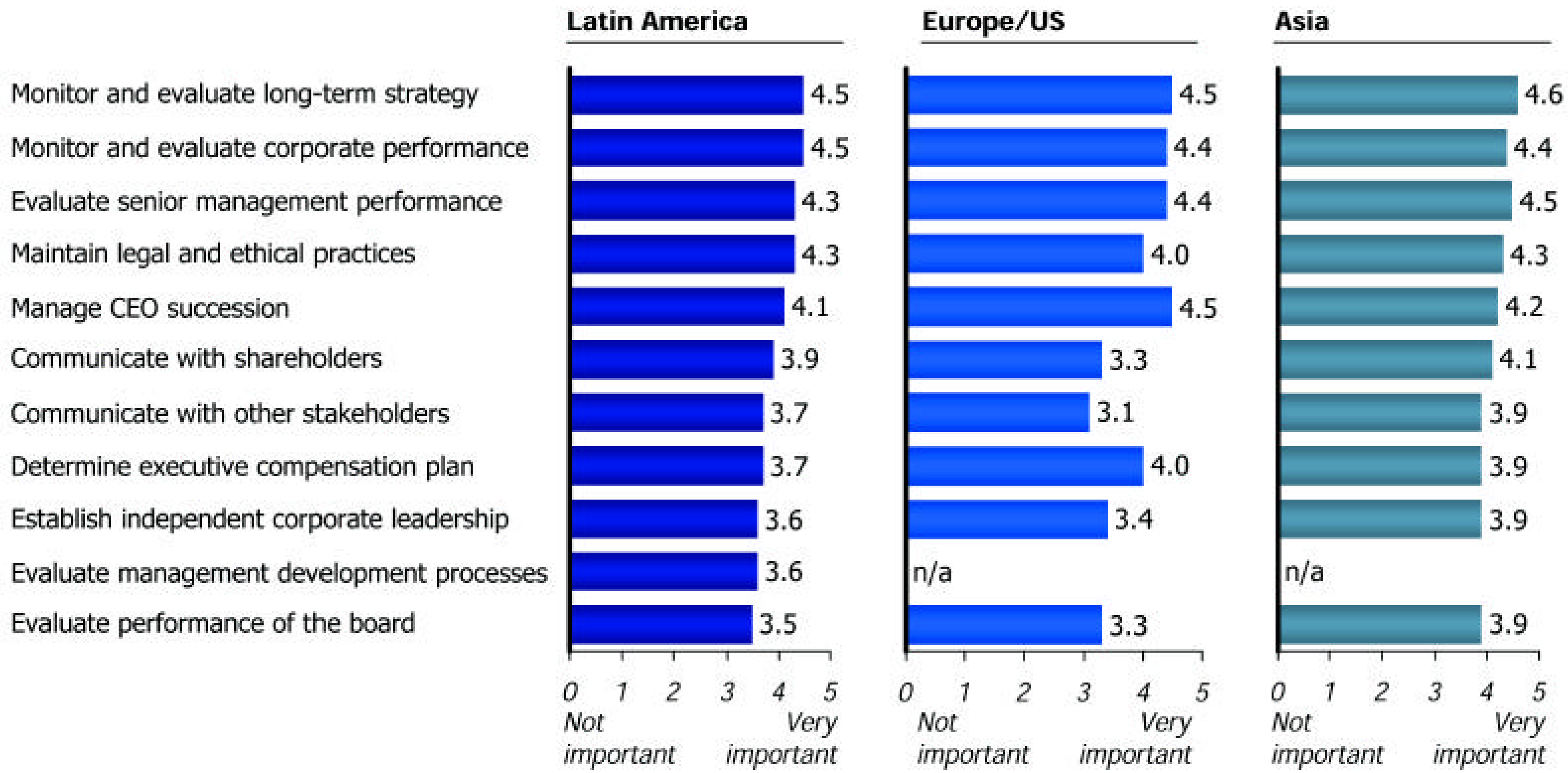
Average %



* Defined as those based in the local region

Investors agree on the important board tasks* . . .

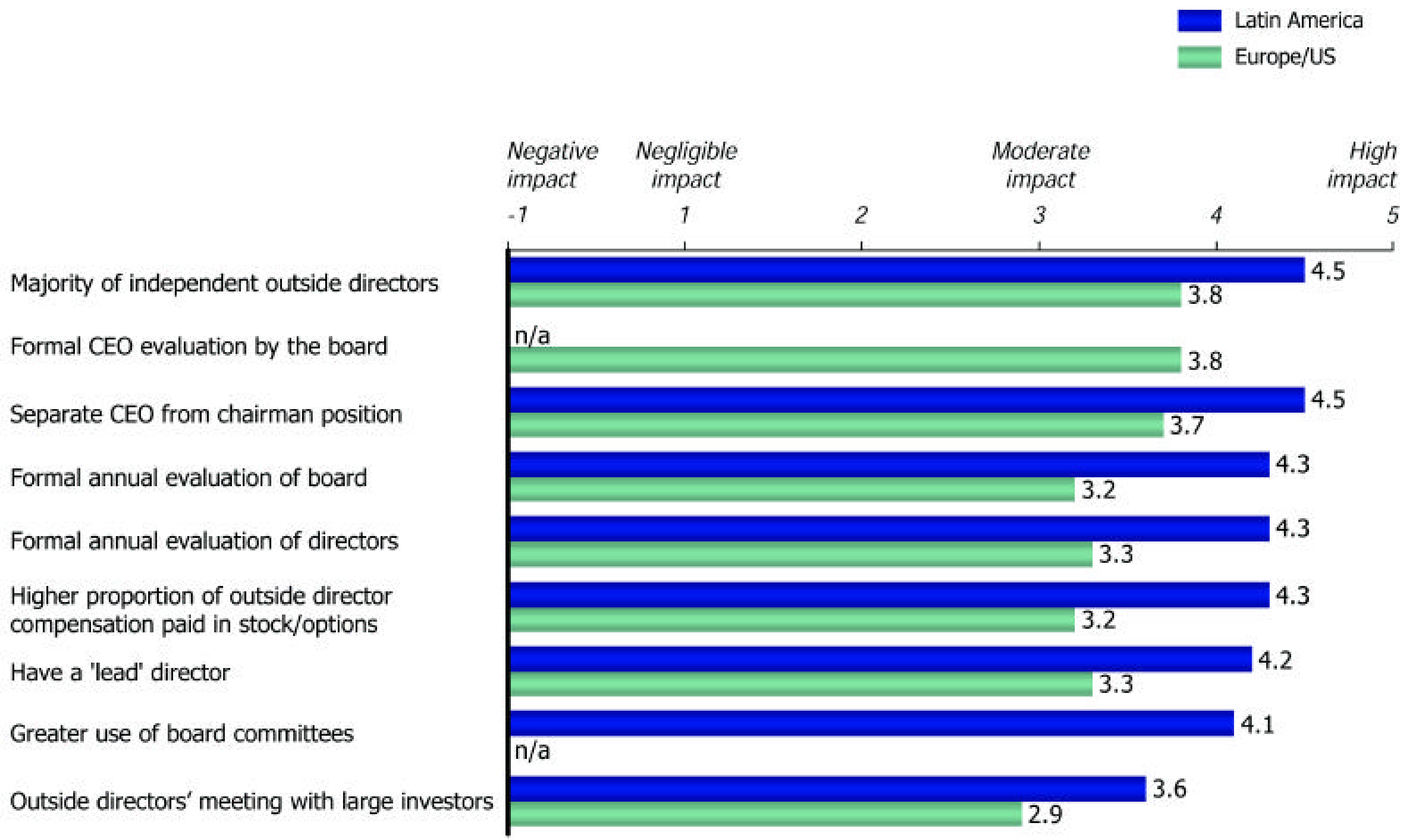
Average response



* The list of board tasks was predefined. Investors were asked to rank their importance

. . . and on how to improve board performance*

A'

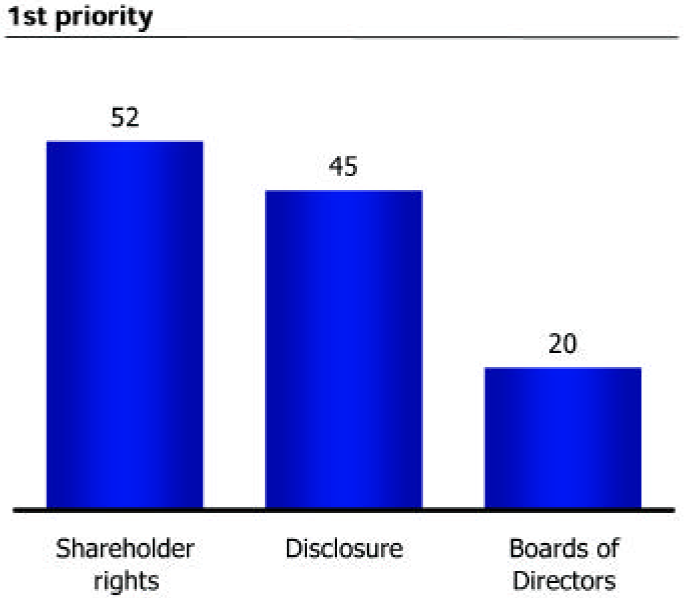


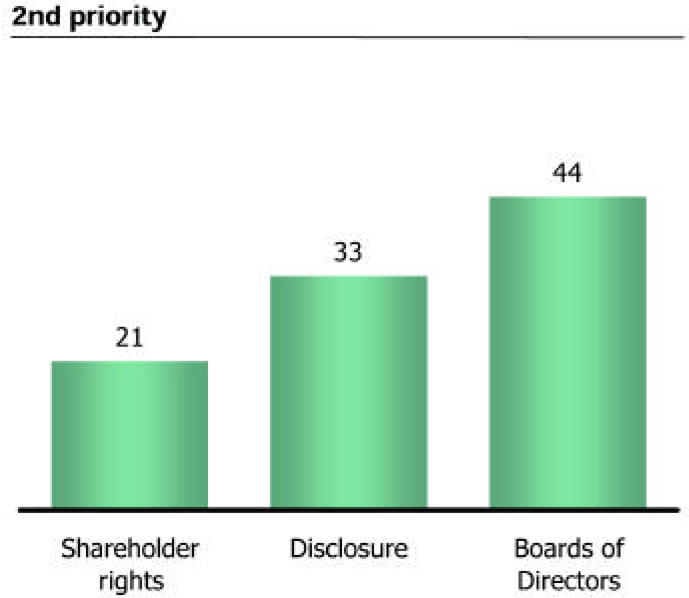
* The list of practices was predefined. Investors were asked to rate their impact on board performance

Shareholder rights rank as the most important corporate governance issue in Latin America

Question: for Latin America, please rank the following corporate governance issues

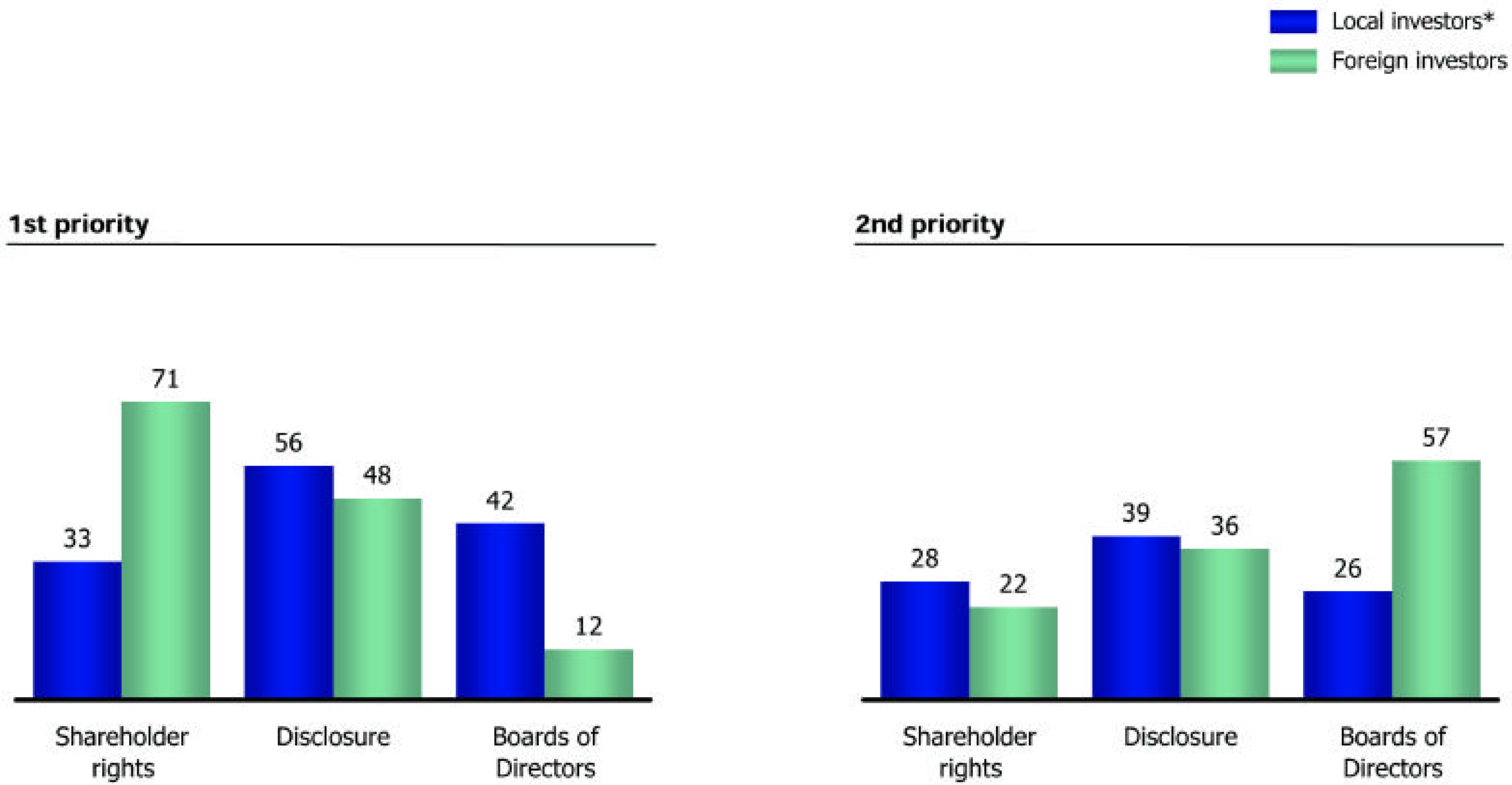
%





But priorities for local and foreign investors differ

%



* Defined as those based in the local region

Investors' willingness to pay a premium for a well-governed company by country

%

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Abu Dhabi
Amsterdam
Antwerp
Atlanta
Bangkok
Barcelona
Beijing
Berlin
Bogota
Boston
Brussels
Budapest
Buenos Aires
Caracas
Charlotte
Chicago
Cleveland
Cologne
Copenhagen
Dallas
Delhi
Detroit
Dubai
Dublin
Düsseldorf
Frankfurt
Geneva
Gothenburg
Hamburg
Helsinki
Hong Kong
Houston
Istanbul
Jakarta
Johannesburg
Kuala Lumpur
Lisbon
London
Los Angeles
Madrid
Manila
Melbourne
Mexico
Miami
Milan
Minneapolis
Monterrey
Montreal
Moscow
Mumbai
Munich
New Jersey
New York
New Zealand
Orange County
Osaka
Oslo
Pacific Northwest
Paris
Pittsburgh
Prague
Rio de Janeiro
Rome
San Francisco
Santiago
São Paulo
Seoul
Shanghai
Silicon Valley
Singapore
Stamford
Stockholm
Stuttgart
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