FINANCIAL POLICY AND CORPORATE GOVERNANCE OF RUSSIAN COMPANIES

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The extensive empirical evidence shows that country's financial development is crucial to achieve sustainable economic growth as it facilitates firms' access to external finance, which is especially important for young entrepreneurial firms with little cash and short history. Starting from the scratch in late 1994, the Russian stock market has currently reached the total market capitalization of almost $600 bln and has become one of the largest emerging markets in the world. Yet, the level of Russia's financial development lags behind the advanced market economies. Most Russian firms are non-traded and prefer to finance their investment from internal funds rather than from securities issues or bank loans (see Guriev et al. (2003)).

Why do many firms or entrepreneurs fail to raise external finance even when they have profitable investment opportunities? Which ways of financing are chosen by those who manage to turn to the market and why? How do Russian entrepreneurs finance their start-up companies and what determines how successful their ventures are? Finally, does the market for corporate control help to achieve more efficient redistribution of assets and impose discipline on firms' managers? The answers to these questions in Russia are likely to substantially differ from the developed countries because of the specifics of the post-privatization institutional and ownership structure. The relatively short history, small number of listed firms, and high concentration of the market have hindered formal analysis of the above questions. Hence, there is a large room for research in the area.

The goal of this project is to tackle the above questions both empirically and theoretically. Empirical analysis will employ standard financial econometrics methods that have been applied to the developed and emerging markets (see Campbell et al. (1997), Bekaert and Harvey (2003), Bhagat and Jefferis (2005) and many others). The data employed in the analysis include market-wide variables such as risk-free rates, oil prices, and exchange rates as well as company-specific credit and corporate governance ratings, ownership structures, accounting variables, stock prices and dividends coming from different sources, such as http://www.cbr.ru, http://www.rbc.ru, http://www.rts.ru, http://www.finam.ru, as well from the enterprise survey conducted by CEFIR and IET (Institute for the Economy in Transition).

Theoretical models are very important to understand empirical findings and to analyze economic effects of various rules and regulations. Even though there has been extensive research in the area in the developed countries, little has been done to analyze the above issues in a weak institutional environment, like Russia's. Thus, the models developed in this project should necessarily take into account the weaknesses of Russia's institutions. The models would employ game-theoretic tools, especially the ones used by the literature on financial contracts. An excellent book that summarizes the most important research in theoretical corporate finance is Tirole (2006).

Suggested topics for student papers

Corporate governance, ownership structure and performance of Russian firms. Corporate governance is a set of mechanisms that ensure optimal coordination of different company stakeholders' interests. The primary function of these mechanisms is to ensure that outside investors receive adequate return to their investment (i.e. protected from expropriation by insiders) and, therefore, are more willing to provide finance to a firm in the first place (Shleifer and Vishny (1997)).[1] It is well-documented that corporate governance is an important determinant of firm performance. For example, Gompers et al. (2003) find that U.S. companies with stronger shareholder right protection have higher stock returns and higher market-to-book ratios than their peers. Interestingly, the relationship between corporate governance and firms' valuations and investment are significantly stronger in countries with weak legal protection of investors, like Russia (see e.g. Durnev and Kim (2005)). This implies that companies' corporate governance practices become very important when courts and regulators do not safeguard shareholder interests,. Indeed, Black, Love and Rachinsky (2005) find that market valuations of Russian companies are strongly and positively correlated with their corporate governance ratings. There is, however, large variance in the quality of corporate governance among Russian firms. In addition, even the champions of corporate governance do not reach the level of corporate governance practiced by their western counterparts. Why do some firms choose to bond themselves to good governance and some do not? What restrains firms from adopting the norms of good governance?

The goal of the project would be to study the determinants of corporate governance in Russian firms, as well as the link between corporate governance, ownership, investment and performance. There is a room for both empirical and theoretical work. A theoretical model should endogenize the choice of the mechanisms of corporate governance and the ownership structure as functions of the firm's characteristics (like growth opportunities, need for external finance, initial ownership structure, asset size and structure, managerial talent) and of country-level shareholder protection.

An interesting separate issue to study is the impact of a company's reputation on its market valuation. Does systematic good treatment of minority shareholders raise the firm's market value? How short is the market memory? Does reputation substitute for or complement other mechanisms of corporate governance?

Hostile takeovers in Russia. This topic is related to the previous one. There has been a lot of anecdotal evidence about hostile takeovers in Russia. A lax legal system, where control over a company is highly valuable, is a fertile ground for hostile takeovers. Takeovers are hampered by high ownership concentration in Russian firms (which can itself be a response to takeover threats), but are facilitated by weak legal enforcement and corrupt courts, which allows "raiders" to use "grey" and "black" schemes when acquiring firms.

Though media often portrays corporate raiders as merciless aggressors ruthlessly destroying healthy companies, their true effect is unclear. Since privatization many Russian enterprises had been managed by inefficient owners, and raiders may have actually served the goal of transferring ownership to more efficient hands. In addition, the prospects of a hostile takeover may force controlling shareholders of firms to practice better corporate governance in order to discourage or impede a takeover (Guriev et al (2004)). On the other hand, as anecdotal evidence suggests,

[1] Examples of mechanisms that protect investors include complying with international accounting standards, placing independent directors on the company's board, setting constraints on managerial discretion in the corporate charter, empowering shareholders with more voting rights, etc.

takeover threat may lead to lowering a firm's transparency and asset diversion by the controlling owner.

The goal of the project would be to analyze the following questions. What are characteristics of firms that become takeover targets? What means do incumbent owners use to respond to a takeover threat, depending on the ownership structure and firm characteristics? What happens to a firm after a successful takeover, depending on the characteristics of the firm and the raider? What is the link between raiders' characteristics, the methods they use and types of firms they attack?

A theoretical model would be a great complement to an empirical study. Such model should necessarily take into account weaknesses of legal environment in Russia (like e.g. Bebchuk (1999)). It would help to analyze whether legal rules, encouraging or impeding takeovers would be socially beneficial.[2]

The IPOs of Russian companies. During the last decade, several Russian companies made initial public offerings (IPOs) of their shares and the IPO wave is currently growing fast. However, some of the companies (e.g., Vympelcom and Wimm-Bill-Dann) chose to make an IPO abroad, while others (such as RBC and Irkut) did it in Russia. Moreover, it seems that more and more firms prefer listing abroad rather than at home.

Which factors motivated these choices? What explained the magnitude of the underpricing (the difference between the offering price and subsequent secondary market price) at the IPO? What are the consequences of the IPO for these companies; do they develop more rapidly afterwards? This study will try to answer these research questions, accounting for the specifics of Russia and relating the findings to the vast literature on IPOs in the developed countries (see Ritter and Welch, 2002, for an excellent survey on IPOs). The project could also help to answer the question: should there be mandatory restrictions on listing abroad in order to spur the development of the domestic stock market (such restrictions are currently argued for by the Federal Financial Markets Service)?

Choice of the capital structure by Russian companies. The goal of this project will be to study the dynamic choice of capital structure by Russian companies. The typical choices faced by the companies (see Megginson (2001) for a survey) are between debt and equity, common and preferred equity, short-term and long-term debt, local-currency and foreign-currency denominated debt, bank credits and open market bond issues, etc. The stress will be on how changes in the capital structure (e.g., new bond issues and dividends) are related to developments in the local and international financial markets, in particular, changes in interest rates and taxation.

Another important, primarily theoretical, issue is to relate the choice of capital structure by Russian firms to Russia's legal environment, in particular to legal protection of shareholders and creditors. While most of the "law and finance" literature has focused on the effect of legal protection on ownership concentration, size of firms, dividends and valuations (La Porta et al. (2000)), its effect on the capital structure of firms has been barely studied.

Private equity and venture capital investment in Russia. It is commonly recognized that the growth of Russian economy largely depends on its natural resources sector. However, to achieve sustainable growth in the long run it is necessary to develop other sectors of the economy, especially those where innovations can spur technological progress. Entrepreneurial activity is crucial for achieving this goal. However, a start-up company without a performance history and

[2] An example of a rule, impeding takeovers, is a recently introduced in Russia mandatory bid rule, according to which an acquirer of a 30% stake in a firm must bid for all other shares of the company at a fair price.

funds and with high uncertainty about the success of its potential project will find it extremely difficult to raise finance on the market. Here is where private equity funds (including venture capital funds) come with help. This type of funds is designed specially to finance high risk projects with large information asymmetries, like most start-ups.[3] By employing very detailed contingent contracts (which allocate substantial control rights to funds under certain circumstances) close monitoring and advice, these funds limit entrepreneurial opportunism, reduce information asymmetries and help to follow the right strategies. The main return to private equity investors comes from successful exits from their portfolio firms: if in several years a project has proved to be successful and has grown sufficiently large, private equity investors sell their stake at either an IPO, to the management or to a strategic investor.

Though the private equity industry is very young in Russia, it is developing rapidly and has already a number of successful exits (e.g. RBC, Delta Credit, CTC media). Using the data of the Russian Private Equity and Venture Capital Association (RVCA), as well as other sources, the project could examine the determinants of private equity finance (which projects get financed), as well as links between projects' characteristics and types and duration of contracts, the ways of exit. It would also be interesting to compare performance of projects financed by different types of funds, as well as of private equity backed firms with those who did not rely on private equity capital.

Another interesting topic is a comparison of Russia with other emerging markets. What are the distinct features of Russian private equity industry? How successful is it in comparison with other transition and developing countries? Can governmental policies catalyze the development of the industry?[4]

On the theoretical side, private equity contracts are best described in the framework of the incomplete financial contracts (Aghion and Bolton (1992), Berglöf (1994)). Russia's institutional environment, however, is likely to bring county specifics into these contracts. As Lerner and Schoar (2005) show, institutions matter a great deal for structuring and exiting private equity investment. It is thus, important to theoretically rationalize specificities of Russian private equity industry in order to understand its needs and the direction for necessary legal reforms and possible government participation.

An excellent reference for studying the basics of the private equity and venture capital industry is Gompers and Lerner (2004).

Comparative valuation of common and preferred stocks of Russian companies. The main objective of this project will be to explore the comparative dynamics of common and preferred stocks of a given company. The main difference between the two classes of stocks is that preferred stocks have limited voting rights and more stable dividend income, which by law may not be lower than dividend income for common stocks. However, in Russia preferred stocks are often traded with a large discount to common stocks. Goetzmann et al. (2002) and Muravyev (2004) investigated a number of potential explanations, such as difference in liquidity, premium for voting rights, and premium for potential expropriation, which however could hardly account for the whole picture. The current project will extend this analysis and study the up-to-date changes in the preferred-to-common stock discounts.

[3] In the US, such giants as Intel, Microsoft, Apple Computers and many other smaller hi-tech firms were initially financed by venture capital funds.
[4] There is evidence that they indeed can. The most successful example is Israel. The US, Singapore and Taiwan also had successful programs.

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