

# Holding Horses: Bringing Governance up to Date in Emerging Markets

Teresa Barger, CEO Cartica Capital



During World War II, the US Army wanted to improve the efficiency of mobile artillery. An expert was brought in and began his work by observing a gunnery crew load, aim, prime and fire its guns. He was puzzled that three soldiers were working tirelessly while two did very little. Before firing the gun, the

two underworked soldiers stepped back, one to each side, and stood, watching the others work. When the expert interviewed the old colonel who had trained the team, he asked what the two soldiers were doing. The older man replied, "They are holding the horses." What horses? The ones that were used decades earlier when the Army hauled artillery by horses, not trucks. The colonel explained, "If you did not hold the horses steady when the gun fired, they would bolt."

I have observed countless companies make their way in emerging markets by twisting themselves into contortions designed to overcome obstacles in their local environments. In the last ten or fifteen years, however, the regulatory environments have improved remarkably, but many of these old "contortions" remain. These alternative practices, while often necessary for survival in a poorly-regulated macro environment, are impeding the ability of companies to professionalise and scale-up to compete with the regional and global companies that are now freely entering their markets. Many of these companies are still "holding the horses".

Unravelling the legacy structures developed over time is complex because these companies have created sets of relationships, vested interests, and customs that are often comfortable and may even be benefitting some stakeholders. Often an outside agent of change is needed to identify "horse holding" and then to overhaul the company's processes to match the current new challenges.

Typical contortions or self-defense measures we see as legacies in companies include:

**Two sets of books.** Lack of transparency. Faced with a corrupt government and tax collector, a rational company could well decide to keep a second set of books which understates taxable revenues, shipments received, or inventories held. After the governmental "tax" of corruption is removed or the tax rate lowered, the habit of keeping

two sets of books can be a hindrance to control over actual movements of inventories, sales of products, and the extending or receiving of credit. Though initially "adaptive" in the earlier environment, bad controls that remain in place become a threat to productivity and accountability.

**Irrational corporate structures.** In Russia, companies used to break up business lines into separately incorporated companies so that each would have a lower tax bill and would be less likely to attract a visit from a bribe-hungry tax collector. Now, with a lower 24% tax rate and better tax administration, this is not so necessary, but the businesses still continue to have separate lines of accountability. A similar effect was visible in India when tax preferences were given to smaller companies. Suddenly big industrial groups broke their divisions into dozens of companies employing no more than 100 people each. Not only does this impede realisation of synergies, but it also creates dozens of new Boards, new control systems, and new company cultures that make overall corporate control more difficult and inefficient.

**Intertwined Corporates.** When there is no effective third-party capital market, groups of companies may start borrowing from member companies, pledging shares and assets to each other, mutually extending suppliers' credit, and otherwise locking themselves into a web of complex financial relationships. As this trend intensifies, as we saw in Colombia, Korea and Turkey, complex interlocking of shareholdings can make it difficult to tease out the ownership, financial results, and shareholder rights of one specific business to be listed or sold to a strategic buyer.

**Related-party transactions (RPTs).** Often in emerging markets, where legal protections are not sufficient, RPTs are a reasonable defensive measure. It is possible that the only trucking company a food producer could trust was the company owned by the brother of the CEO. As legal frameworks improve and business becomes more market-driven, however, it might now make more sense to bid out the logistics and award the contract to the lowest bidder. But that CEO still has to have Sunday dinner with his brother! Often these affective ties make it hard to transition to better business practices even when minority shareholders are asking for assurances that controlling block shareholders are not using RPTs to reap undue benefit for themselves.

**Family employment.** A general mistrust of how the government or other public bodies will use a company's

information can be an incentive to keep key positions within the family or other trusted hands. As the disclosure of information to the public becomes less threatening, this dynamic can, and in some cases, should change."

Over the last fifteen years there has been a grand sweep of policy changes in the emerging markets which have made the old contortions needed to do business no longer as necessary. These vestigial practices, can in fact, impede strategic decision making, accountability and alignment of incentives throughout an organisation.

Since the Asia Crisis of 1997-98, the pace of policy reform in the emerging markets has been extraordinary. This is due to the hard work of national policymakers who have installed policy regimes that promote private business, lighten the regulatory load, change the tone on corruption, build regulatory enforcement capability, and enforce the rule of law. It is backed up by the work of development agencies like IFC, the World Bank, ADB, and others; the "Doing Business" reports and attendant Investment Climate Assessments; the blossoming of Institutes of Directors; McKinsey Global Institute work on productivity by sector and by country; corruption tracking by Transparency International; capital market development work by IOSCO; the expansion of first tier banks throughout the emerging markets. And the list goes on.

Specific improvements that change the landscape include:

- Improved macroeconomic management as evidenced by the parade of S&P upgrades on sovereign debt.
- Opening up to foreign competition. One sees both (a) better-run foreign companies entering into competition with local stalwarts and (b) aspirations of local stalwarts to become regional or international players.
- Progress on tax administration from "abysmal" to a range between "bad" and "pretty good".
- Lowering of corporate tax rates starting perhaps with Chile moving to 19% (then 17%) in the late 1980s
- Streamlined business registration, licensing, title registry, government procurement, and sometimes even customs procedures.

- More emphasis on property rights (the Hernando de Soto agenda) and on quicker dispute settlement (fast track courts eg, Ghana; arbitration mechanisms eg, Brazil and Pakistan)
- Either improvement in the level of corruption (Transparency International annual index shows general improvements) or a move away from regulation-related corruption to campaign-finance and "grand" corruption
- Development of capital markets open to all who qualify, openness to foreign investors and development of institutional investors with some level of accountability to beneficiaries

The increased foreign and local competition has provided an incentive to create Boards better able to set strategy and hold management accountable for performance. Boards and management groups must also develop better internal procedures, appropriate controls, and aligned incentives for workers from top to bottom. As foreign competitors (often listed companies with fully disclosed financials) begin taking away market share from local family companies, it should be imperative to find the best professional staff and expert independent Board members. But the old vestigial habits can stubbornly persist.

Concomitant capital market development has brought foreign shareholders into new emerging markets and they demand better accountability, disclosure and minority rights. New local pension funds and institutional investors are also getting the message that they are accountable to policy holders and beneficiaries. This puts more pressure on companies to exchange their established governance procedures – which may have worked in the old regimes – for ones that promote more accountability. Making these changes can be tough since not all stakeholders will "win", but they may determine the difference between eventual irrelevance and vibrant growth.

Companies that have made the transition and behave transparently and honestly toward minority shareholders have been rewarded by higher valuations in the market (Infosys, Good Morning Securities, Yukos before intervention, Bavaria, Argos, Natura, inter alia). Companies willing to break their old customs and give up holding the horses in favour of "modern corporate governance" are likely to be richly rewarded.