

## РОЗДІЛ 5

### Наукові повідомлення

#### Corporate Governance as a Factor of Investment Attractiveness of Ukraine

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The increasing importance of corporate governance is a global trend due to the crisis events and obvious corporate needs of external financing. The paper explores the problems of the corporate governance system in Ukraine, which could act as the barriers for the investments, and potential ways to overcome them. The most important characteristics of corporate governance for the investors' decision-making are discussed. The paper also analyses the compliance of the Ukrainian practices of corporate governance mechanisms with the global ones, which increase investors' confidence and desire to pay a premium for the better-governed companies. The importance of a proper Ukrainian corporate governance system as the key aspect for the potential investors' decisions is explained.

*Keywords:* corporate governance, investment attractiveness, investment decisions, disclosure, board of directors, ownership.

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*JEL codes:* G34, M14, O16

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**Introduction.** Corporate governance has become an increasingly important issue in recent years as a core not only for company's performance, but for developing the economy as a whole. Moreover, recent corporate governance scandals and financial crises have emphasized the importance of good governance. The issue is becoming even more complicated, taking into account the dependence of the companies on additional financing and thus competition for investors. The investors are attracted to markets that provide the investment opportunities they are looking for, and perceive good corporate governance in the company as an important indicator, for which they are ready even to pay a premium [11]. The quality of corporate governance is globally considered by the investors in their investment decisions, however for emerging and transition markets this factor becomes even more crucial.

The Emerging Markets Investor Survey [8] revealed that investors don't want to invest in emerging market corporations with poor governance. They also believe that better governance at a firm-level can make up for country weakness in this area with the emphasis on governance reforms as one of the determinants of the attractiveness of the destination for investment [8].

Ukraine, being an emerging market, is still perceived as a country with a great potential. However, the investment climate of it is far from favourable. With an increased uncertainty in

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the Ukrainian business environment the investors have opted to reduce their exposure to it. At the same time, Ukraine's access to financing is already limited by investor concerns over the sustainability of its macro framework and the poor investment climate. Hence, the improvements in the Ukrainian corporate governance system could be considered as an effective action to attract investors to the Ukrainian market and improve their confidence of this destination.

**The aim** of the paper is to identify the gaps in the compliance of the Ukrainian corporate governance with the best global practices, which can be used to influence the attractiveness of the companies for the investors; and to suggest possible ways for the improvements in the field.

**Literature review.** There is an essential mass of literature, studying corporate governance system quality as the driver for investors within the specific host country. For example, Bøhren, Cooper and Priestley [7] found out that for the US manufacturing firms increased governance quality is associated with higher levels of investment, greater responsiveness of investment to investment opportunities, better firm performance and higher marginal product of capital. The good governance remains an important national asset – as the investors have a variety of national markets to choose from, the quality of corporate governance can enhance the attractiveness of one country's financial markets relative to another's and at the same time the attractiveness of one company's stock relative to another's within the same market [20]. The results reported by Fazio and Chiara Talamo [10] also validate the hypothesis that corporate governance and institutional quality are important attractors of investment attraction, especially when it comes to the FDI. Kim [13] also finds strong positive relationships between corporate governance or transparency level of hosting countries and FDI inward performance within hosting countries, which is again consistent with corporate governance explanations as the reason for FDI. Demircuc-Kunt and Levine show that corporate governance encourages investment and stock market development, which is associated with improved macroeconomic growth. Khemani and Chad argue that, in the case where “competition is intense and global in scope, more firms realize that corporate governance makes good business sense. Investors seek out firms that run the business efficiently, treat shareholders equitably and comply with high standards of disclosure, even when they are not mandatory.” Thus, in general firms with better corporate governance would have better reputation and efficient access to finance, lowering their cost of capital and enhancing their ability to compete [5]. Even though the existing literature provides essential findings on the connections between corporate governance quality and investment attraction, such transition countries as Ukraine, where the issue of external financing attraction is of the highest urgency, lack research in this regard.

**Results.** The examination of the Ukraine's business climate perceived by investors, conducted by the European Business Association (EBA), reveals that the investment climate remains unfavourable. The international business emphasizes the impossibilities of honest and fair activities in Ukraine and thinks of exiting the market. The dynamics of results of the Investment Attractiveness Index, reported by the EBA is presented in the Figure 1.

As can be seen from the Figure 1, the investors have assessed the business climate of Ukraine at 2,12 out of 5, which is the lowest level starting from the launch of the research in 2008 [1]. With this negative trend of money flow to the Ukrainian economy, a special attention is to be given to the potential drivers of the investments, with the corporate governance being one of the most crucial.

According to the 2002 Global Investor Opinion Survey released by McKinsey & Company [3] and the Emerging Markets Investor Survey by IFC [8] the corporate governance system as a factor of investment attractiveness can cover the following aspects:

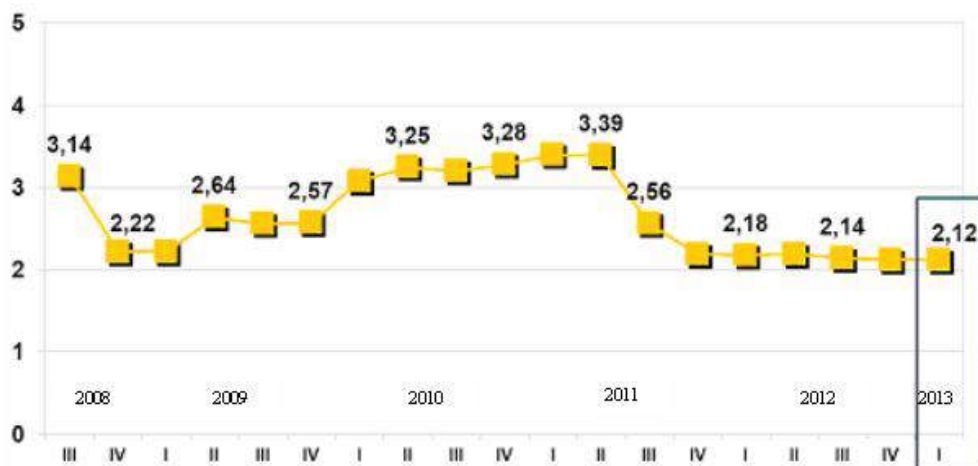


Fig. 1. Investment Attractiveness Index by EBA [1]

- the high standards of corporate governance are the investors' requirements for the public companies;
- corporate governance remains of great concern for institutional investors, with strengthening the quality of accounting disclosure as the top priority;
- investors are willing to pay a premium for stocks of the better-governed companies (premiums averaged 12-14% in North America and Western Europe; 20-25% in Asia and Latin America; and over 30% in Eastern Europe and Africa), moreover they investors tend to pay a higher premium for good governance in an emerging market firm than what they would pay for a similar company within a developed market;
- investors still put corporate governance on a par with financial indicators when evaluating investment decisions;
- lack of transparency is a red flag for emerging market investors, while board independence is a low-level concern for them.

The importance of the various corporate governance characteristics for the emerging market investors, as reported by the IFC's Survey, are presented in table 1 and table 2. As can be seen from them, the disclosure, related party transactions and shareholders' rights are among the main concerns.

Table 1 – Corporate governance characteristics for emerging market investors [8]

Governance characteristics	Very important	Moderate importance	Little importance
Disclosure	100%	0%	0%
Related party transactions	90%	10%	0%
Board structure / Board independence	3%	48%	48%
Shareholder rights	83%	17%	0%
Board process	0%	3%	97%
Separate Chairman and CEO	52%	41%	7%

Table 2 – Specific governance characteristics of importance [8]

Governance Characteristic	Very important
Disclosure in general	100%
Disclosure in English	31%
Quarterly disclosure	59%
Willingness of senior management to meet	100%
Motivations of controlling group/management	100%
Succession planning and compensation structure	59%

In general, the effective corporate governance acts as a signal for investors to buy shares and pay premium for them, as a proper corporate governance system reduces risks, or at least increase the probability of the successful crisis solving. The behaviour of the investors backs the golden rule that investment comes to the place, where the rights of the shareholders are protected and ensured. In order to protect the shareholders a number of the leading stock exchanges suggests requirements on the corporate governance for the listed companies. For example, for the NYSE the company should comply with the requirements of the SEC, for London Stock Exchange – the guidelines of the British Combined Code.

IFC claims that “Sound corporate governance helps businesses attract investment on better terms. Companies are more accountable to investors and responsive to stakeholder concerns. They also operate more efficiently and are able to better manage risks” [12].

So, Ukrainian companies who plan IPOs should understand the need to build their reputation in the area of corporate governance if they are to have a successful listing.

The main problems associated with corporate governance in Ukraine involve corporate ownership, shareholder rights, transparency, and disclosure. The Law “On Companies” offers scant protection for minority shareholders against insider dealing, asset stripping, profit skimming, and share dilution. Corporate finance is restricted. Some examples of shareholder rights abuses include limited disclosure, capital restructuring without shareholders' consent, and shareholder voting fraud [4].

Even though some action have been taken to strengthen corporate governance in the country (for example, the Ukrainian Securities Commission introduced national Ukrainian Corporate Governance Principles to meet the international standards of sound corporate governance) there are gaps, which should be filled mainly by policy-makers, legislators, authorities. And although the Government of Ukraine has listed improving the investment climate as a top economic policy goal since 2004, the country still has a low ranking (137 out of 183 economies) in the Bank’s Doing Business Report for 2013, which does not reflect any fundamental change in the investment climate with FDI being poor in recent years [4].

The analysis of the specific features of the modern corporate ownership, which determine the investment decisions in Ukraine, should also be backed by the retrospective of ownership structure back to 1998-2001 during an after-privatization period of time, which reflects relevantly the transition character of the business mechanisms. For example, Kostyuk [17] investigates that this after-privatization period in Ukraine included several CG flaws in contrast with the best practices. He concludes that the share of insiders in the structure of corporate ownership in Ukraine remarkably increased within that period, while the share of outsiders remained almost the same, leading to the conclusion that the privatization has led to transferring the corporate ownership from the State to insiders. However, real owners in the context of the transition economies such as Ukraine are very often under the shadow of

nominal owners. Moreover they are usually the main players of the corporate control market as the oligarchs of large Ukrainian financial-industrial groups having essential financial resources and influential political and business links. The concentration of corporate ownership is controlled mainly by two groups of investors – management (executives) of the companies and institutional investors [17]. The concentration of capital in Ukraine is one of the highest among the countries of Central and Eastern Europe

Furthermore as a general trend for many countries with the transition character of the economy the high corporate ownership concentration is linked with a weak transparency and responsibility of the dominant shareholders. One of the main post-privatization features of the ownership structure is the lack of disclosure and clear transparent picture as it's difficult even to determine actual and nominal owners [2]. The majority of shares is in the hands of insiders, thus the structure is an extremely concentrated.

Indeed, the Ukrainian privatization took place in the environment, which was in no way favourable for investor protection, especially in the aspect of institutional support of minority shareholders. The reason behind is that the collapse of Soviet coordination and control systems led to the challenge of establishing a new pattern of institutions aiming at supporting the decentralization. Moreover, for a long period of time Ukraine simply hadn't had the proper corporate law and commercial code, while other neighbouring countries succeeded in this transformation (e.g. Poland, Czech Republic etc.) [19]. Moreover in the specific case of Ukraine - ownership concentration is positively associated with company's performance, especially for companies with the foreign owners rather than domestic ones [19].

According to Kostyuk [14]: "in Ukraine employee shareholders perform much worse than other groups of shareholders". This is mainly caused by the weak legal protection of employee shareholders rights and as result opportunities of the executives to destroy employee shareholder activism.

In terms of the model of corporate governance, Ukraine is still in a transition period. The typical organizational architecture of Ukrainian companies contains Annual shareholders' meeting, Supervisory board, Management board, and Operating and Control committees, which are typical characteristics of the Continental model. However, there is no Employee board in the organization of Ukrainian companies, which turns out to be a similarity with Anglo-Saxon model. The number of members in supervisory board is closely connected to the concentration of ownership. The more concentrated the ownership in the company is, the fewer members the supervisory body has. In cases when the controlling shareholder exists, the supervisory body could have fewer members, and all of them will act in the best interests of the major shareholder [17].

The interlocking directories are quite popular in Ukraine. About 59 percent of directors follow this practice. Executives usually combine sitting on board of his company together with the supplying or buying partners' companies. That is why it is hard to find independent directors, and, as Kostyuk [17] states, only 8 percent of directors in the Ukraine are independent. Statistically, 42 percent of Ukrainian companies have no independent directors on their supervisory boards at all. About 31 percent of Ukrainian companies have not more than one independent director on the board [18].

Women representation on Ukrainian boards is really weak. This could be explained by Ukrainian mentality. However, a large majority of Europeans believe that women have the necessary qualities and skills to fill the top-positions and represent gender diversity [9]. Another feature of the board practices is weak audit. Audit committees are not widely spread among the Ukrainian companies. So, the audit functions are put on the supervisory body,

which consists of shareholders' representatives.

To sum it up, theoretically, one of the main incentives to establish good corporate governance practices is the need for outside finance [18]. Obviously foreign investment as a source of financing is of the highest importance for Ukraine within its transition. Thus one of the main directions is to establish the corporate governance, which will help outside investors to feel themselves confident and comfortable with Ukrainian environment, in other words the mechanisms of corporate governance applied should ensure adequate return for outside investors and protection.

As Lazareva et al. [18] state that "most theorists and practitioners agree that improving the quality of corporate governance and increasing transparency would help firms in The Commonwealth of Independent States' (CIS) countries to attract outside finance and would eventually accelerate the development of CIS economies". Hence this aspect should become a force towards Ukrainian development, paying a particular attention to the institutional and legislative support.

Ukrainian minority shareholders lack the knowledge of their rights connected with shares, so even if the ownership of the company is to some extent dispersed, the minority shareholders are not active.

Directors on the board mainly specialize in sales, as consequence of Soviet Union education and need of labour market. Executives lack specific knowledge of i.e. risk management, promotion, planning, marketing. Increasing executives' the awareness of current trends and theoretical issue could improve quality of corporate governance. Moreover, the total amount of liquidity paid in cash brings the company to inadequate liquidity allocation. So, introducing equity-based instruments into the structure of executive pay after the legislation changes could make a real difference.

Executives' motivation as a mechanism of corporate governance nowadays in Ukraine does not fulfil its functions. So, in order to align shareholders' and executives' interests, the larger percentage of equity-based instruments should be introduced to the structure of compensation package.

Another approach to building the corporate governance system in order to attract the investors is the sustainable development strategy for the company. More and more investors believe that such companies perform better governance quality, better resilience to economic shocks and good market reputation. The change of the CSR towards one of the key business-model components could become a factor of greater investment attractiveness of the business.

**Conclusions and suggestions for further research.** While Ukrainian companies are facing the problems of the investors, quitting the market, being not confident in doing business in Ukraine and experiencing the problems of the unfavourable investment climate, the reform of the corporate governance system can act as a driver to improve the attractiveness of this transition economy. Moreover, the investors would even award the companies which are better-governed with the premium, as the proper corporate governance is a signal for their investments to be allocated, used and controlled effectively. One of the key aspects for consideration by the companies with this regard is the disclosure and transparency. At the same time, the country-level improvements should lie in the area of the legal investor protection. Strengthening law enforcement and promoting the development of financial market and stock exchange as the crucial tasks for enhancing the mechanisms of good corporate governance practices in Ukraine and thus improving investment climate, can be a direction for further research.

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**Корпоративное управление как фактор  
инвестиционной привлекательности Украины**

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Растущая важность корпоративного управления становится глобальным трендом, обусловленным кризисными явлениями и объективной необходимостью корпораций в дополнительном финансировании. Статья исследует проблемы системы корпоративного управления в Украине, которые являются барьерами для инвестиций, а также потенциальные пути их решения. Определены наиболее значимые характеристики корпоративного управления для процесса принятия решений инвесторами. Статья также анализирует соответствие украинских практик применения механизмов корпоративного управления глобальным, которые в свою очередь повышают уверенность инвесторов и их готовность платить премию за компании с лучшим состоянием корпоративного управления. Обоснована важность эффективной системы управления в компаниях Украины как основного фактора принятия решений потенциальными инвесторами. В статье также предлагается анализ необходимости реформ в сфере корпоративного управления, как на корпоративном, так и общенациональном уровне.

*Ключевые слова:* корпоративное управление, инвестиционная привлекательность, инвестиционное решение, раскрытие информации, совет директоров, собственность.

**Корпоративне управління як фактор  
інвестиційної привабливості України**

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Зростаюча важливість корпоративного управління є глобальним трендом, пов'язаним з кризовими явищами, скандалами корпоративного управління, об'єктивною необхідністю корпораций у додатковому фінансуванні і, як результат, конкуренцією за інвесторів. Інвестори цікавляться ринками, які забезпечують не тільки інвестиційні можливості, але і відповідний рівень захисту інтересів та прав акціонерів. Якість корпоративного управління, як комплексу механізмів, за допомогою яких зовнішні інвестори захищають себе від експропріації



контролюючими акціонерами чи менеджментом, впливає на інвестиційні рішення. Більш того, для ринків, що розвиваються, цей фактор стає ще більш вагомим у сприйнятті інвесторів.

Україна, як держава з транзитивним характером економіки та проблемним інвестиційним кліматом з точки зору привабливості, може використовувати покращення у системі корпоративного управління як фактор зацікавлення потенційних інвесторів. Стаття досліджує проблеми системи корпоративного управління в Україні, що є бар'єрами для інвестицій, а також потенційні шляхи вирішення. Визначено найбільш вагомі характеристики корпоративного управління для процесу прийняття рішень інвесторами. Стаття також аналізує відповідність українських практик застосування механізмів корпоративного управління щодо глобальних, які підвищують впевненість інвесторів та їх готовність платити премію за компанії з кращим станом корпоративного управління. Обґрунтовано важливість ефективної системи управління в компаніях України як основний чинник прийняття рішень потенційними інвесторами.

Попередні дослідження підтверджують, що інвестори не хочуть інвестувати у країни, що розвиваються, з недостатнім рівнем корпоративного управління. Вони також вірять, що краще корпоративне управління принаймні на рівні компанії, може компенсувати національні недоліки. Проте, відповідні національні реформи в цій сфері зроблять країну більш привабливим напрямом для інвестування.

Зі зростаючою невизначеністю українського бізнес-середовища, доступ українського бізнесу до фінансування обмежений острахами інвесторів, які не впевнені в бізнес-процесах та часто навіть залишають країну. Саме тому, корпоративне управління є критичним фактором покращення привабливості та важливим інвестиційним сигналом, що інвестиції використовуються та контролюються відповідно до очікувань акціонерів. Під час дослідження, було визначено, що інвестори готові навіть платити премію за компанії з більш якісним корпоративним управлінням, що є безумовно важливим мотивом для українських підприємств.

Зроблено висновок, що основним недоліком у покращенні інвестиційної привабливості українських компаній через засоби корпоративного управління, є недостатня відкритість та прозорість. Також на національному рівні незадовільним є правовий захист інвесторів, недосконалість розвитку фінансових ринків та бірж. Перспективним також може стати адаптування під сучасні тенденції використання „стейкхолдерського” підходу до корпоративного управління з розробкою стратегії сталого розвитку підприємства з орієнтацією на довгострокові результати. Наразі все більше інвесторів надають перевагу таким компаніям, оскільки подібна орієнтація, поєднана з якістю управління, забезпечують кращу стійкість до коливань, кризових явищ та шоків, а також сприяю кращої ринкової репутації серед груп стейкхолдерів.

Таким чином, корпоративне управління може виступати одним із критичних факторів інвестиційної привабливості України, проте потребує реформ як на рівні компанії, так і на національному рівні.

*Ключові слова:* корпоративне управління, інвестиційна привабливість, інвестиційне рішення, розкриття інформації, рада директорів, власність.