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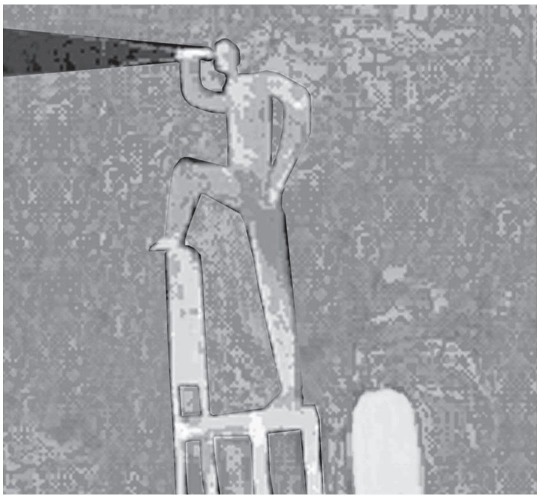
insight



# India's best governed companies – what do they share in common?

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Corporate governance has emerged as the foundation of successful companies, both in India and globally. Today, shareholders, institutional investors, lenders, and other stakeholders demand more information on the capability and integrity of boards and the management of companies they deal with, and the processes these companies follow. After assessing corporate governance practices at Indian companies over the years, CRISIL has identified some common characteristics of well-governed companies. This article discusses the characteristics of companies that have been adjudged as having the 'Highest', 'High' and 'Strong' level of governance and value creation practices by CRISIL[1]. The article also highlights the initiatives undertaken by these companies to improve governance practices and create higher value for stakeholders.

[1] Companies rated by CRISIL as GVC Level 1, 2 and 3, which are in the public domain

*Characteristics of companies with high CRISIL GVC ratings*

### Better market valuations

CRISIL's study on the relationship between the level of corporate governance and market valuations of Indian companies indicates that superior governance results in better valuations. According to CRISIL's analysis *(refer article 'Better Corporate Governance Pays')*, Indian companies with high governance scores consistently enjoyed a superior governance premium. During the last two years, the adjusted Price to Earning (P/E) ratios of most companies with high CRISIL GVC ratings also indicated a better performance compared with the industry average for 2003-04 and 2004-05 (see table below).

TABLE 1: PE ratio comparison for CRISIL GVC Rated Listed Companies

| CRISIL GVC Rated Listed | | 2004-05 | | 2003-04 | |
|---|---|---|---|---|---|
| | | Company | Industry | Company | Industry |
| Companies | GVC Rating | P/E | P/E | P/E | P/E |
| Bharti Tele-Ventures Ltd | GVC Level 1 | 68.5 | 24.9 | - | 39.9 |
| Dabur India Ltd. | GVC Level 2 | 13.9 | 7.6 | 15.3 | 7.6 |
| Hero Honda Motors Ltd | GVC Level 1 | 13.5 | 14.4 | 13.3 | 15.6 |
| HDFC Bank Ltd. | GVC Level 1 | 17.4 | 4.6 | 14.8 | 4.6 |
| HDFC | GVC Level 1 | 17.5 | 16.5 | 18.7 | 17.0 |
| Infosys Technologies Ltd | GVC Level 1 | 20.7 | 13.0 | 19.8 | 13.0 |
| Kanoria Chemicals & Industries Ltd | GVC Level 3 | 5.8 | 4.6 | 4.6 | 4.6 |

*Source: Prowess*

### Satisfied stakeholders

Until recently, value creation was primarily associated with satisfying the equity shareholder, given shareholders' voting rights and power to influence the board constitution. The concept of equitable value creation for all stakeholders including debt-holders, employees, customers, suppliers, and society is now gaining momentum. Corporates have borne the brunt of feeble relationships with these stakeholders in the form of operational disruptions, lawsuits, a weak customer profile, and a lower brand value.

Most CRISIL GVC-rated companies are firms with strong business risk profiles that have consistently dominated their respective markets in India. Strong and equitable value creation for each of their stakeholders has undoubtedly been a contributing factor in these companies' continued success. This reinforces CRISIL's belief that unless companies create value for other stakeholders, shareholder wealth creation will not be sustained in the long run.

The table below illustrates the value creation initiatives of three companies with high CRISIL GVC ratings:

Table 1: Examples of Value Creation by companies with high CRISIL GVC ratings

| HDFC Bank (CRISIL GVC Level 1) | Dabur India Limited (CRISIL GVC Level 2) | Infosys Technologies Limited (CRISIL GVC Level 1) |
|---|---|---|
| • High economic value benefits shareholders<br>• Consistently high credit rating **'AAA/Stable'** provides comfort to depositors and debt-holders<br>• Effective customer service and high customer satisfaction levels<br>• High employee satisfaction: low attrition rates and stock options to all employees<br>• Employment generation levels compare well with industry benchmarks<br>• Exceeded 40 per cent priority sector target for the last five years | • Returns to shareholders have exceeded the cost of capital for the last two years<br>• Credit rating remains in the high safety category at **'AA+/Positive/FAAA'**, providing comfort to investors<br>• High and consistent market shares in major product categories, indicates high customer satisfaction<br>• Compensation levels and growth (at 20 per cent over the last three years) in average compensation are high<br>• High value creation for society as the manufacturing processes are eco-friendly and use traditional systems of medicine | • Returns to shareholders have exceeded the cost of capital by a margin of 15 per cent for the last seven years and dividend payment record has been consistent<br>• Credit rating is the highest at **'AAA/Stable/P1+'**, indicating high credit quality<br>• Process innovation, good planning, quick training of employees has led to high quality output and customer satisfaction<br>• High value creation for over 45,000 employees by providing high level of job satisfaction and financial incentives<br>• Contribution to society is mainly through employment generation, export of services, and several social projects |

### Well-informed investors

The investors of all companies with high CRISIL GVC ratings were well informed about the operating and financial performances and other business practices of the companies they invested in. Most of these companies hosted informative and user-friendly web sites, disclosing information on financial statements, related party transactions, and giving updates on operational performance and governance issues. Moreover, few companies with high CRISIL GVC ratings went beyond regulation while adopting disclosure standards (see box below).

### Going beyond the call of duty...

***Infosys Technologies Limited*** **(CRISIL GVC Level 1)**

The financial transparency and disclosure standards of Infosys are among the world's best. The company's commitment to disclosure and governance practices is much beyond regulatory requirements. This is demonstrated in its voluntary compliance with all US Securities laws. Moreover, the company reports its financials in compliance with the requirements of Generally Accepted Accounting Principles (GAAP) of seven countries it operates in. Infosys also submits all its Securities and Exchange Commission (SEC) filings

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within 60 days, even though listing guidelines in the US allow for more time.

***Dabur India Limited*** **(CRISIL GVC Level 2)**
Dabur India Limited has initiated an explicit dividend policy; the company voluntarily publishes half-yearly annual reports and hosts the same on its website. The company has also defined the eligibility criteria for its board members in its annual report.

***Indian Farmers Fertiliser Cooperative Limited (IFFCO) (CRISIL GVC Level 2), Kanoria Chemicals & Industries Limited (CRISIL GVC Level 3)***
Majority of the CRISIL rated corporates such as IFFCO and Kanoria Chemicals & Industries have outlined a code of conduct for its directors on the board; the code of conduct also covers confidentiality and ethical issues.

In the recent past, governance and accounting scandals in companies such as Enron, REFCO, Worldcom, and Tyco have led to increased stringency in regulations. For instance, the Sarbanes-Oxley Act of 2002, along with other reforms, has made norms of auditing, internal controls, transparency and board oversight for US companies stricter. In India, Securities and Exchange Board of India (SEBI) is monitoring the implementation of the listing agreement; the agreement includes Clause 49 of corporate governance that is likely to be enforced by January 1, 2006.

CRISIL, however, believes that regulation alone cannot enforce strong disclosure practices and cannot stop companies from holding back critical information. All companies operating with a long-term vision should strive to reach higher levels of disclosure and transparency. CRISIL believes that such proactive measures will enhance investor and market confidence, and thus create value for all stakeholders.

## Strong Boards

Another common feature among companies with highly rated GVC companies is the effective constitution and strong functioning of their respective boards. Most of these companies have strong and optimally sized boards, with a good balance of independent and executive directors (refer Table 2(i) Board Constitution). Moreover, these boards have the right mix of various capabilities required for governing the company, taking into account the size, industry nature, and growth objectives.

Besides adhering to the regulations, these corporates have undertaken various initiatives (see table below) to improve the functioning and relevance of various board sub-committees, particularly by appointing audit and nomination committees. Most companies have appointed at least one financial expert to facilitate effective oversight of the management's financial reporting.

Table 2(i): Board constitution

| No. | Name of company | Board Size | No of IDs | % of IDs | % IDs in AC | RC Present | NC Present |
|---|---|---|---|---|---|---|---|
| 1 | HDFC | 13 | 9 | 69% | 100% | Yes | No |
| 2 | Kanoria Chemicals & Industries Limited | 10 | 7 | 70% | 100% | No | Yes |
| 3 | Dabur India Limited | 10 | 4 | 40% | 100% | Yes | Yes |
| 4 | Infosys Technologies Limited | 15 | 8 | 53% | 100% | Yes | Yes |
| 5 | Bharti Televentures Limited | 14 | 7 | 50% | 60% | Yes | No |
| 6 | HDFC Bank Limited | 11 | 7 | 64% | 100% | Yes | Yes |
| 7 | Hero Honda Motors Limited | 16 | 9 | 56% | 100% | Yes | No |
| 8 | IFFCO | 23 | - | Electoral Process | - | No | No |

*ID- Independent Directors
AC- Audit Committee
RC- Remuneration Committee
NC- Nomination Committee

Table 2 (iii): Initiatives undertaken for strengthening of boards

| Infosys Technologies Ltd (CRISIL GVC Level 1) | Dabur India Ltd (CRISIL GVC Level 2) | HDFC (CRISIL GVC Level 1) | Bharti Tele-Ventures Ltd (CRISIL GVC Level 1) |
|---|---|---|---|
| • Constituted various board sub-committees comprising non-executive independent directors<br>• Has a lead independent director which represents and acts as spokesperson for the independent directors as a group | • Formulated policies for evaluation of performance of the board and its members<br>• In process of transforming Dabur India Limited from a promoter-managed company to a professionally governed one | • Transparent and well- diversified ownership structure with no block shareholders<br>• The board constitutes a large proportion of non-executive directors who are eminent personalities with rich functional and vertical experience | • Well-reputed board with adequate representation from all shareholders<br>• The Chairman takes written feedback from every board member at the end of each board meeting |

CRISIL believes that contribution of boards to providing strategic direction to their companies' long-term vision should be enhanced. This can be done through 'board retreats', where board members can focus actively on issues of long-term growth and strategy, rather than on operational issues.

## Capable management

The quality of the management team and operating processes are key determinants of any company's abilities with respect to value creation. For instance, the management of Bharti Tele-Ventures Limited has demonstrated its capability of increasing shareholder value significantly within a short span.

CRISIL believes that to create value for shareholders, companies need to not only demonstrate good governance and sound strategy, but to implement key policies and procedures effectively. This is only possible with a capable management team. Hence, it is critical that the top management have the proven and requisite execution capabilities, and display strong management skills. It is equally important for the management to be proactive in identifying potential threats and opportunities, devising timely solutions and strengthen their second line. Companies with high CRISIL GVC ratings such as Kanoria Chemicals & Industries Limited have increased their focus on strengthening of their second rung of management as a part of its succession planning initiatives.

## Commitment to values

Commitment to values and ethical business conduct is yet another feature shared amongst companies which high CRISIL GVC ratings. Most of these companies have values such as trust and integrity embedded in their organisational culture: policies for anti-insider trading and protecting whistle blowers have been built-into the organisational system. Most companies have also done well in terms of corporate social responsibility (see box below):

> ***Indian Farmers Fertiliser Cooperative Limited (IFFCO): Promoting farmer welfare (CRISIL GVC Level 2)***
> IFFCO earmarks up to 5 per cent of its net profits for donations and 1 per cent for a co-operative education fund. It has undertaken extensive social welfare projects such as the Kisan Sewa Fund (for relief and rehabilitation), Indian Farm Forestry Development Cooperative (IFFDC), and IFFCO Foundation (charitable trust). It also launched the Sankat Haran Bima Yojana insurance programme, which is linked to product purchases by farmers.
>
> ***Kanoria Chemicals & Industries Limited (CRISIL GVC Level 3)***
> Kanoria Chemicals & Industries Limited runs training centres for women in fourteen adopted villages. The company also supports a school of 350 students.

## Conclusion

As the above examples demonstrate, superior governance yields numerous tangible benefits for companies that practice it, resulting in higher levels of value creation. Several of these benefits would escape the radar of conventional financial measures, or traditional governance metrics. Companies that are in for the long haul therefore need to think in terms of a tool that enables a more holistic view of the organisation and its influence. CRISIL's GVC ratings and diagnostic services provide a unique means for arriving at a balanced and well-rounded assessment of a company's capability to achieve sustainable business performance, and benchmarking against highly successful peers globally.

## Annexure 1: CRISIL GVC Rating Methodology

CRISIL GVC ratings are an opinion on the capability of firms to create wealth for all their stakeholders while adopting sound corporate governance practices. Hence, the CRISIL GVC methodology comprises an assessment of the firm's governance practices as well as its track record in creating wealth for all its stakeholders. The methodology is briefly discussed below:

### Governance

It is assumed that adequate systems and processes can ensure wealth creation for shareholders and its uniform distribution across shareholder classes. Therefore, an assessment of governance processes, transparency and disclosure levels and other requisite checks and balances is undertaken. The assessment focuses on whether the corporation is indeed run to benefit shareholders and whether such benefit is shared uniformly across all classes of shareholders as outlined below.

- **Equitable treatment of shareholders:** Includes disclosure of shareholding pattern, ownership concentration and its likely impact on equitable treatment, disclosure of disproportionate control provisions, anti-insider trading mechanisms and the like.
- **Ownership rights of shareholders:** Includes articulation and documentation of ownership rights, anti-takeover provisions, and ease and effectiveness of shareholder participation at meetings.
- **Financial and operational transparency and disclosure:** Includes adequacy of audit procedures and independence of auditors, extent and quality of disclosures to all stakeholders, timeliness and ease of access to information for all stakeholders, among other things
- **Composition of board:** Includes composition of the board and its sub-committees, selection process for board members, functioning of the nominations committee, succession policies for board members, relevant competencies at the board, board compensation, and independence of board and adequate representation of all shareholders.
- Functioning of board: Includes the functioning of the board and its sub-committees, extent of management oversight exercised by the board on behalf of shareholders, contribution of independent directors and the like

### Value creation track record

Stakeholders are identified and it is assumed that the company's value creation track record for each is a measure of the strength of that relationship. Such value creation may be monetary or non-monetary. An indicative identification of stakeholders and the parameters used to evaluate respective value creation are:

- **Shareholders:** The measures used include return on invested capital compared to weighted average cost of capital, dividend payout ratio and the like.
- Debt holders: The parameters primarily relate to relative debt protection measures. These include credit rating and upgrades in ratings, among others.
- Customers: The parameters include customer satisfaction levels, other surrogate measures like market share and cost savings passed on to customers.
- Employees: The parameters considered include absolute salary levels, adjusted growth in average annual salaries.
- Suppliers: The factors considered include the relative change in credit terms, record of passing on benefits like higher realisations to suppliers and the support extended to suppliers, among others.
- Society: Here, the measures include total direct taxes paid, employment generated, expenses on social infrastructure, environmental and social impact cost, and fair practices.