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Corporate governance indices and firms' market values: Time series evidence from Russia ☆

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Abstract

There is increasing evidence that broad measures of firm-level corporate governance predict higher share prices. However, almost all prior work relies on cross-sectional data. This work leaves open the possibility that endogeneity or omitted firm-level variables explain the observed correlations. We address the second possibility by offering time-series evidence from Russia for 1999–present, exploiting a number of available governance indices. We find an economically important and statistically strong correlation between governance and market value both in OLS and in fixed effects regressions with firm-index fixed effects. We also find large differences in coefficients and significance levels, including some sign reversals, between OLS and fixed effects specifications. This suggests that cross-sectional results may be unreliable. We also find significant differences in the predictive power of different indices. How one measures governance matters.
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1. Introduction

There is evidence that broad measures of firm-level corporate governance predicts higher share prices in emerging markets. This evidence comes from both single-country studies (Black, 2001 on Russia; Black et al., 2006a on Korea; Gompers et al., 2003 on the U.S.) and multicountry studies (Durnev and Kim, 2005; Klapper and Love, 2004). However, most prior work relies on cross-sectional data. This leaves open the possibility that endogeneity or bias due to omitted firm-level variables explain the observed correlations. Here, we address the omitted variable bias issue by offering time-series evidence from Russia for 1999–2005.

The importance of corporate governance to investors in Russian firms has spawned a number of efforts to measure good governance. The Brunswick Warburg investment bank rated governance from 1999–2003; the Troika Dialog investment bank has done so since 2000, Standard and Poor's has published overall "corporate governance" ratings since 2001 and "disclosure" ratings since 2002; the Institute for Corporate Law and Governance (ICLG) rated governance from 2000–2003, and the Russian Institute of Directors (RID) has done so since 2004. Our study exploits these measures. We present results for each measure and for an overall measure that aggregates information from each.

We find an economically important and statistically strong relationship between governance and firm market value (proxied by Tobin's q and, in robustness checks, market/book and market/sales) for a combined governance index (with firm-index fixed effects) and for the Brunswick, Troika, S&P disclosure, and ICLG indices (with firm fixed effects). This work strengthens the case for a causal association between governance and firm market value, because the fixed-effects specification allows us to rule out some (though not all) of the non-causal explanations for this association.

We find large differences between OLS and fixed effects specifications in the estimated coefficients on our combined governance index and the individual indices, with some sign reversals. For example, the Brunswick index is insignificant in OLS but positive and highly significant with firm fixed effects. In contrast, the RID index is positive and highly significant in OLS but insignificant and negative with firm fixed effects. This suggests that prior cross-sectional results may be unreliable. We also find large differences in the predictive power of different indices, and the components of these indices. The strength of particular indices, as predictors of firm market value, typically comes primarily from a limited subset of the components included in the index. How one measures governance matters.

For our combined governance index, we estimate that, with firm fixed effects, a two standard deviation increase in governance predicts an 0.14 increase in ln(Tobin's q), or a 21% increase in share price for a firm with median Tobin's q and leverage. A worst-to-best improvement in governance predicts a 0.45 change in ln(Tobin's q), or an 81% increase in share price.

Estimated economic effects are larger than this for several individual indices. For the Brunswick index, which has the largest coefficient with firm fixed effects, a two standard deviation change in governance predicts an 0.34 increase in ln(Tobin's q) or about a 57% increase in share price; a worst-to-best change predicts an 0.70 increase in ln(Tobin's q), or about a 143% change in share price.

Share prices are the trading prices for minority shares. Our study cannot show whether higher share prices reflect higher value for all shareholders, lower private benefits for controlling shareholders, or some of both. Put differently, we cannot test whether our sample firms were initially out-of-equilibrium and could increase firm value through governance changes, or in an equilibrium in which firm value was already maximized and gains to outside shareholders come at controlling shareholders' expense. However, the voluntary governance improvements by many firms during our study period suggest that the initial situation was out-of-equilibrium, and that the gains to minority shareholders were only partly offset by reduced opportunities for self-dealing by insiders.

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