CG Watch

Corporate governance in Asia

In collaboration with the Asian Corporate Governance Association

Amar Gill
Head of HK Research, CLSA
amar.gill@clsa.com
(852) 26008593

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
(852) 28724048

September 2004

Asia
Special report

CG stars

CLP
Esprit
HSBC
Infosys
Koomin Bank
KT Corp
Public Bank
Siam Cement
TSMC
Wipro

Low-CG SELLS

China Unicom
Kia Motor
PCCW
San Miguel
State Bank of India

Higher-ranking CG markets

Singapore
Hong Kong
India
Malaysia
Korea

Spreading the word

Changing rules in Asia

www.clsa.com

Jointly published by

Asian Corporate Governance Association
Room 3403, 34/F
Citibank Tower
3 Garden Road
Central
HONG KONG SAR

www.acga-asia.org

CLSA Asia-Pacific Markets
18/F
One Pacific Place
88 Queensway
Admiralty
HONG KONG SAR

www.clsa.com

First published in paperback and ebook formats in 2004.

British Library Cataloguing in Publication Data.
A catalogue record for this book is available from the British Library.

Creator	Gill, Amar, editor Allen, Jamie, editor
Title	Spreading the word : changing rules in Asia / edited by Amar Gill, Jamie Allen
Series title	CG watch
ISBN	988-78680-2-7 (paperback) 988-78680-3-5 (ebook : pdf)
Other creators/ Contributors	Asian Corporate Governance Association, issuing body. CLSA (Firm), issuing body.
Dewey decimal classification notation	658.4

CLSA
ASIA-PACIFIC MARKETS

CG Watch

Corporate governance in Asia

ACGA
In collaboration with the Asian Corporate Governance Association

Amar Gill
Head of HK Research, CLSA
amar.gill@clsa.com
(852) 26008593

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
(852) 28724048

September 2004

Asia
Special report

CG stars
CLP
Esprit
HSBC
Infosys
Koomin Bank
KT Corp
Public Bank
Siam Cement
TSMC
Wipro

Low-CG SELLS
China Unicom
Kia Motor
PCCW
San Miguel
State Bank of India

Higher-ranking CG markets
Singapore
Hong Kong
India
Malaysia
Korea

Spreading the word
Changing rules in Asia

www.clsa.com

Contents

Acknowledgements and disclaimer

This report was produced in collaboration with the Asian Corporate Governance Association (ACGA), an independent, non-profit organisation based in Hong Kong and working on behalf of all investors and other interested parties to improve corporate governance practices in Asia. CLSA Emerging Markets is one of the Founding Corporate Sponsors of ACGA. For further information about the Association, including a list of its sponsors and members, see Appendix 5 of this report.

ACGA endorses the methodology used in this survey and contributed to the country analysis. It did not participate in the assessments of companies, for which CLSA retains responsibility.

Spreading the word

Time to take stock – by ACGA

Asian regulators have found it much easier to expand the rule book and adopt international accounting standards than push companies to build strong internal controls and accountability structures. However, the rules still vary significantly between markets, eg, on independent directors, audit committees, reporting deadlines, etc, and this affects the cost to investors of any activism. For robust and effective corporate governance (CG), strong and well-crafted rules are essential.

CLSA/ACGA country rankings

Our ranking methodology the ten markets this year is far more rigorous than in 2003. Singapore, Hong Kong and India (in that order) still come out top for the CG macro-determinants, while Indonesia, China and the Philippines bring up the rear.

Market beta - A function of CG and risk

Various factors drive market performance, but the poorer-CG markets generally seem to be higher beta, and better-CG markets lower beta. In the sharp rally witnessed over the 12 months to June-2004, China and Indonesia have been major outperformers. Over the last five years, however, MSCI Asia ex-Japan has dropped 16.5%, while the top-five CG markets have generated an average return of 3%.

Asia ex-Japan's largest stocks ranked

The Asian large-cap with the highest CG is Infosys, closely followed by CLP, Esprit, HSBC and Wipro. At 81%, the average score for the top-ten CG large-cap is more than double the bottom-CG decile, as represented by the likes of Kia Motor, Hyundai Motor, GAIL of India, SK Corp and San Miguel. Among the top companies, those with solid financials and attractive valuations are TSMC, Siam Cement, ST Engineering, StanChart and Hana Bank. The low CG scores reaffirm our negative ratings on Kia Motor, San Miguel, State Bank of India, PCCW and China Unicom.

Improving risk-reward balance

We find no real correlation within countries between the performance of the top- and bottom-CG quartile stocks over a shorter period of 12 months. However, over the last five years, the top-CG quartile has outperformed and the bottom-CG quartile underperformed in eight of the 10 markets.

Company scoring methodology amended

We made the company ranking more rigorous by introducing negative scoring on 15 out of the 60 questions. We also increased the total number of questions from 57 to 60. The methodology penalises, in particular, companies that have disappointed investors in the past, as well as conglomerates and subsidiaries of other listed companies. The ranking is also supplemented by a ranking of these companies' financials and the implied growth in valuations.

Country surveys from China to Thailand

Our survey of CG developments covers 450 companies in the Asia ex-Japan markets. We highlight the development in regulations, enforcement and general CG culture in each of the markets; the companies that are CG stars and disappointments; and objective criteria - eg, which companies have increased independent directors, whether remuneration has increased faster than profit, and the share of earnings that goes to directors. While in the short term, investors may opt for low-CG companies that are making some changes on the CG front to help drive performance, over the medium term, the best CG companies with the most solid financials should remain outperformers.

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
(852) 28724048

Time to take stock

Is CG reform in Asia moving in the right direction?

When the wave of corporate scandals began hitting the US in 2001 and 2002, some commentators in Asia predicted that this would do significant damage to that country's reputation for good corporate governance and, in turn, slow the pace of governance reform in this region. The first prediction, not surprisingly, proved accurate - US companies no longer stand on quite as high a pedestal as before. The second, however, was wide of the mark - the past two to three years have seen steady growth in new or amended rules around the region, both in areas such as accounting and auditing standards, and in corporate governance regulations more generally. This is in part a response to the Sarbanes-Oxley Act of 2002 from the US and a reflection that a large amount of rule changes still needed to be done in each market. Hong Kong, for example, only produced its first proper code of best practice on corporate governance in early 2004.

Reform has to start somewhere - The rule book and its enforcement

This mountain of rule making in Asia is the reason why the 10 markets in this survey have always scored best in two categories: "rules and regulations" and "IGAAP". A cynic might say that this is to be expected, since writing rules (rather than enforcing them) is what most regulators do best! A more generous interpretation is that reform has to start somewhere - and a new regime of rules is the logical point. Whichever view you take, there appears to be an overwhelming consensus among concerned groups in Asia that what is needed next is not further refinement of the rules, but strong enforcement of those already in place. "We now have plenty of rules. It's time to enforce them" is one of the most common refrains heard in corporate governance debate today.

Rules still vary from country to country

This year's "CG Watch" country survey, however, challenges this strongly held assumption and suggests that some rules may not be as good as they seem. While better enforcement is clearly needed - no one disputes that, nor does our survey - it is striking how much rules still vary from country to country or how weak certain rules still are. The overall impression is that large numbers of new rules have been promulgated in recent years without sufficient thought as to whether they will, in practice, contribute to real improvements in corporate transparency and accountability over time. Now would be a good time to take stock and ask if the reform process in Asia is moving in the right direction and, if not, how it could be improved.

Weak rules of the road

Improvement in accounting rules and disclosure

One positive development in Asia is that there has been a definite improvement in rules relating to corporate accounting and financial disclosure. Virtually all countries in Asia have a policy of bringing their accounting standards into line with international ones, while most are closely following international standards on auditing (ISAs). Most markets have also strengthened securities laws mandating fundamental things such as disclosure of ownership stakes above 5%, prompt reporting of share transactions by directors and controlling shareholders, and continuous disclosure of material transactions (including major connected transactions).

Areas still of weakness in most Asian markets

But the list of continuing areas of weakness is long and includes:

- **Reporting deadlines:** While four countries have moved to a two-month deadline for reporting annual results (Singapore, Malaysia, Indonesia and Thailand), the remainder have not. And some of the latter have not even shortened their annual-reporting deadlines in recent years, most notably Hong Kong, Korea and Taiwan.
- **Class-action lawsuits:** Only one country, Korea, has been bold enough to pass a law allowing fully fledged class actions for securities violations, while two others (China and Taiwan) allow a variation on this theme. One other (Thailand) has a bill under consideration.
- **Voting by poll:** Only two markets (Hong Kong and Taiwan) have brought in rules requiring that major resolutions at annual general meetings be subject to a vote by poll (rather than show of hands). No market as yet mandates poll voting for all resolutions.
- **Definitions of "independent director":** Despite the fact that almost all markets have a national code of best practice based largely on international corporate-governance standards, only four out of the ten include a truly robust definition of "independent director" (and these are not the markets you would probably expect - India, Malaysia, the Philippines and Taiwan). Definitions in other places all have loopholes that allow people quite closely connected with either management or the controlling shareholder to become so-called independent directors.
- **Disclosure of individual director compensation:** Only a few markets have taken up mandatory disclosure of director remuneration by name (as opposed to in "bands" or in aggregate).
- **Independent board committees:** All regulators have shown a degree of ambivalence towards independent board committees, with only the audit committee becoming mandatory in all markets. Some countries require compulsory nomination committees, but then dilute their effectiveness by restricting the scope and power of their operations.
- **Nominating and removing directors:** No market makes it particularly easy for minority shareholders to nominate candidates for the position of independent director. With two exceptions (Singapore and Taiwan), it is not easy for minorities to remove a director convicted of fraud or another serious corporate crime.

A two-wheeled car

Regulators have not pushed for strong internal controls and accountability structures

When comparing the rules that have and have not changed in Asia in recent years, it becomes apparent that regulators and governments are far more comfortable about demanding high standards of accounting, auditing and financial reporting than they are about asking companies to build strong internal controls and accountability structures or allowing minority shareholders to exercise some real influence over firms in which they are part-owners. Nor does the prospect of opening the door to the legal system - and truly permitting it to play a part in resolving securities disputes - offer most governments any joy.

Yet, ironically, regulators continually call upon market players (ie, retail and institutional investors) to do their bit for corporate governance reform - while at the same time not giving them the means to become fully engaged. It is like building a car, but only giving it two wheels!

While the political position that governments and regulators find themselves in is understandable - there are, after all, strong vested interests trying to impede further corporate governance reform in every market - the danger is that weak rules are unlikely to produce good governance. For example, boards of directors are unlikely to function as well as they could if loose definitions of "independent director" allow the wrong people to fill these critical positions. Over the short term it may look like such boards are getting stronger, but at some point investors and others will see through them - and lose confidence in both the companies in question and probably the reform process as well.

Half-hearted rule changes benefit no one

Another piece of irony is that half-hearted rule changes benefit neither the best companies (since they often do far more than the rules require anyway), nor the lesser listed companies (since they are in effect encouraged to aim for a lower standard than would otherwise be the case).

Take the issue of reporting deadlines as an example. Short deadlines of two months for annual results are not too difficult for the better-resourced companies to cope with, since even in markets where deadlines are still four months (such as Hong Kong), several large companies report in less than or just on 60 days, including Bank of East Asia, CLP Holdings and HSBC. Although it may be much tougher for smaller companies to meet such deadlines, doing so would require investment in people and more sophisticated financial systems, which in turn should have numerous spin-off benefits for the company (such as better quality information on which to make management decisions, higher productivity and so on).

Removing the clamps

Further CG reform requires rethinking basic questions

Maintaining the momentum for governance reform over the long term in Asia is likely to require some rethinking on basic questions such as:

1. What large rule or legal-system changes are needed to allow market participants to more fully engage in corporate governance reform and to complement the efforts of regulators? (That is to say, to put "market discipline" on a par with "regulatory discipline" in driving the reform process.)
2. Do any existing procedural rules inhibit investors from exercising their most basic rights, such as voting and participating in AGMs? (The answer in many parts of the region is a clear "Yes".)
3. Are any existing rules inherently self-defeating and incapable of producing the intended outcome? (Weak definitions of "independent director" are a prime example. Stock exchange listing rules put so much supervisory responsibility onto independent directors that to start from a position of weakness seems almost wilfully counterproductive.)
4. Are we creating potential conflicts or managerial inefficiencies within companies by grafting new global best practices onto traditional company law structures without reforming the latter? (A good example here is the introduction of independent directors into the quasi two-tier or dual-board systems of China, Indonesia, Japan and Taiwan. Sensibly, Japan and Taiwan are allowing companies to opt for single boards and to do away with their statutory auditors and supervisors, respectively.)

Investors can also put pressure for change

The list of questions could go on. The point is not that successful reform depends only on the action of governments and regulators. Investors can achieve a great deal even if the cards are stacked against them. Witness the case of Sovereign Asset Management and other foreign and local investors in the SK Corporation annual meeting in March of this year. Companies also need not be held back by weak or poorly designed rules. They can always choose to aim higher - or may be forced to for competitive reasons.

Rules affect the cost of shareholder activism

But rules do influence what is possible. They also affect the cost to investors of any level of activism, including the voting of shares. And they have a marked impact on the average level of corporate governance in any market, as well as the perception of that governance. Getting rules right is therefore important. It is not just a matter of vigorously enforcing the rules we already have. If we want robust and effective corporate governance, we need robust and well-crafted rules.

Amar Gill
amar.gill@clsa.com
(852) 26008593

CLSA/ACGA country rankings

Major improvement in country score methodology

We have made major improvements in the way we rank markets for corporate governance. As in the previous years, the main macro-determinants are: 1) rules and regulations, 2) their enforcement, 3) the political and regulatory environment, 4) adoption of international accounting standards, and 5) the institutional backdrop and CG culture. In previous years, we assigned each country a score from 1-10 for each category to place them in a subjectively correct ranking. The category scores were then weighted to get an overall country score.

This year, the Asian Corporate Governance Association (ACGA) has developed a more rigorous approach, which we have adopted. The ACGA has constructed a template of key macro/regulatory issues by which to score the countries for each of the five macro-determinant categories. For each of these, we worked closely with ACGA to assess the country on eight to 19 issues. We provide the full questionnaire in Appendix 1; a summary of which appears on pages 10-11.

Raising weighting for rules from 10% to 15%; for enforcement reduced from 30% to 25%

The weightings given for the rules and enforcement categories have been amended slightly. The weighting for rules remains low at 15% versus 20-25% for the other categories. The low weighting reflects the maxim that talk is cheap. Rules on a statute book only have real meaning if they are properly enforced and generally followed.

Singapore, HK and India remain at the top

Figure 1

Markets ranked by corporate governance

	Rules & regulations (15%)	Enforcement (25%)	Political & regulatory (20%)	IGAAP (20%)	CG culture (20%)	Country score (2004)	Country score (2003)
Singapore	7.9	6.5	8.1	9.5	5.8	7.5	7.7
Hong Kong	6.6	5.8	7.5	9.0	4.6	6.7	7.3
India	6.6	5.8	6.3	7.5	5.0	6.2	6.6
Malaysia	7.1	5.0	5.0	9.0	4.6	6.0	5.5
Korea	6.1	5.0	5.0	8.0	5.0	5.8	5.5
Taiwan	6.3	4.6	6.3	7.0	3.5	5.5	5.8
Thailand	6.1	3.8	5.0	8.5	3.5	5.3	4.6
Philippines	5.8	3.1	5.0	8.5	3.1	5.0	3.7
China	5.3	4.2	5.0	7.5	2.3	4.8	4.3
Indonesia	5.3	2.7	3.8	6.0	2.7	4.0	3.2

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Regulators the main driver for change

However, we have raised the rules category score from 10% to 15% to reflect the fact that regulators have been the main driver for change. Their efforts *do* lead to noticeable change in company practice – for example, when listing rules shorten reporting timeframes or widen the scope of disclosure requirements, etc. In Korea, for instance, the regulators have allowed cumulative voting for the board, unless companies expressly choose not to adopt it. That means that Korea has 27 companies that allow cumulative voting for board representation – which essentially allows investors with a significant stake of the voting shares to have the same percentage of seats on the board. This is certainly not the practice for most companies elsewhere in Asia.

Enforcement still has the heaviest weight of 25%, but this is down from 30% in previous years to accommodate a slightly higher weight on rules. The other categories are given an equal 20% weight as before.

Singapore, Hong Kong and India take top ranking

Indonesia is bottom, followed by China and the Philippines

We show our country score for each of the categories and the country rankings in Figure 1. Singapore comes out on top with a score of 7.5, followed by Hong Kong with 6.7. Next are India, Malaysia and Korea, followed by Taiwan and Thailand. At the bottom of our ranking is Indonesia, with China just above and then the Philippines.

Malaysia moves up two notches

The rankings of the top-three markets are the same as last year. Malaysia, which has moved up to fourth position, however, is up two notches from last year - partly owing to the higher weight we give to rules this year (from 10% to 15%), on which the country has always scored well. But the improvement in Malaysia's accounting standards, reflected in its score rising from 7.0 to 9.0, is way above the international-accounting-standards score being adopted by others in the middle of our country rankings.

Philippines' ranking up one notch

The names at the bottom of the table have changed slightly. Indonesia stays last, where it was last year, although its scores for enforcement and adoption of accounting standards have moved up. However, the Philippines, which was second from bottom last year, has moved one notch up, largely owing to a much better score on accounting. Both its stock exchange and the securities regulator have improved regulations; the media is freer to report cases of CG abuse; and the Philippines courts and judges are somewhat more competent and able to handle commercial cases (this cannot be said of several other jurisdictions in the region).

Absolute score for China similar to last year

Because the Philippines' rankings have moved up, China slipped down one notch. China's overall score was slightly higher than last year (4.8 versus 4.3), but it still scores poorly for overall institutional support and CG culture, as well as enforcement. In the middle of our country rankings scoring between 5.3 and 6 in rising order are Thailand, Taiwan, Korea and Malaysia. Thailand's score is also slightly higher under our new method for deriving country scores (up from 4.6 to 5.3). (See Appendix 1 for full scores.)

Improvement in the regulatory regime

Shorter period of announcing results

We highlight some of the more objective and key areas being assessed in Figure 2. It is worth noting the push by regulators to improve company disclosure. Singapore, Malaysia, Indonesia and Thailand now require the reporting of annual results within two months of the end of the financial year. Quarterly reporting is now mandatory in most markets other than Hong Kong. (While there is debate on the merits of quarterly reporting, we give this a point in our scoring system because it means more frequent disclosure to the market, which reduces the risk of misleading the market before the result announcements.)

Country macro-determinants assessed under five categories (see Appendix 1 for full questionnaire)

Key parameters to assess country macro CG scores (summary)

Rules and regulations (15%)
- Financial reporting standards against international standards
- Required time within which to announce these results
- Any improvements in rules in recent years
- Disclosure requirements on changes in major shareholder
- Disclosure of material and/or connected transactions
- Whether class action suits are permitted
- Voting by poll at AGM
- National code of best practice
- Whether the code or CG rules have been updated in recent years
- Definition of independent director in the rules
- Whether rules require disclosure of individual director compensation
- Whether the various board committees are required
- Ability of minority shareholders to nominate independent directors
- Ability of minorities to remove directors
- Share options expensing

Enforcement (25%)
- Reputation of regulators for enforcement
- Whether all companies are treated equally
- Whether regulators are sufficiently resourced
- Main regulator's powers to investigate and sanction
- Whether resources for regulator are being increased
- Whether institutional investors exercise voting rights, attend general meetings, nominate independent directors
- Whether minority shareholders have activist groups to pursue lawsuits
- Protection of minority shareholders in the case of M&A, privatisations, connected transactions, etc.
- Whether there is an effective and independent commission against corruption.

Political and regulatory environment (20%)
- Government's policy on CG reform
- Regulatory structure governing the securities market
- Whether the regulator is autonomous of the government
- Amendments to securities laws/listing rules to protect minorities
- Whether the courts are a cost-effective means to settle disputes for minorities
- The capacity of the judiciary to handle such disputes
- Whether the media is free to report on CG abuses

International accounting and auditing standards (IGAAP, 20%)
- Policy of local regulator/accounting body regarding the following of IAS or US GAAP
- Consolidated accounts
- Segment reporting
- Disclosure of audit and non-audit fees
- Disclosure of connected transactions
- Policy regarding following international auditing standards
- Policy on independence of external auditors
- Regulation of the accounting profession

Continued on the next page

Key parameters in assessing country macro CG scores (cont'd)

Institutional support and CG culture (20%)

- Whether companies follow the spirit of good CG
- Disclosure of non-financial reporting practices
- Improvement in investor relations in recent years
- Remuneration of independent directors
- Direction of efforts to strengthen internal controls
- Efforts of reputational intermediaries
- Whether institutional investors are engaged in promoting good CG, formed their own activist organisations
- Existence of CG focus funds
- Whether retail investors are engaged in promoting CG
- Professional associations efforts on CG
- Media reporting on CG reforms and development

Source: Asian Corporate Governance Association

Disclosure of stakes above 5%

All markets other than Taiwan and the Philippines require disclosure of ownership stakes above 5%. Class-action suits can now be undertaken in Korea from January 2005, while Taiwan and China have somewhat similar suits that shareholders can pursue to seek redress. Some of the markets now require disclosure of individual director compensation, with the exceptions being Malaysia, Korea, the Philippines, Thailand and Indonesia. Proper share-options expensing will come into force within the next 12 months in Singapore, Hong Kong and the Philippines.

Improvements in enforcement

In enforcement, practically all the markets are investing more resources for the main regulator (ie, the securities commission or equivalent) as well as the stock exchange for investigation and enforcement – although in most places the budgetary increases are incremental rather than substantial. Korea has a standout activist group that litigates on behalf of investors; Singapore has a group that potentially could do the same; while in China, Taiwan and Malaysia, some retail shareholders are willing to launch or participate in litigation against companies.

Assessment for enforcement has broadened to include "private enforcement"

It is worth noting that enforcement scores have changed from last year as we have broadened our assessment to include "private enforcement" by the markets as well as "public enforcement' by the regulator. This has led to higher scores for Malaysia, Korea, Philippines, Thailand and even Indonesia. In contrast, Singapore and Hong Kong score less well than they did last year as "market discipline" remains relatively weak in certain areas, eg, institutional investors exercising their voting rights and attending AGMs, minority shareholders nominating independent directors, etc.

Existence of anti-corruption agency is a key factor

In our scoring, we include whether there exists in the jurisdiction an anti-corruption agency that is seen to be effective: Singapore and Hong Kong are clearly ahead of the other markets in this respect, while in the next three markets in our CG ranking, India, Malaysia and Korea, similar agencies have varying levels of credibility. Of all the macro-ranking issues, the existence of a credible anti-corruption agency is interestingly the most strongly correlated with the market's overall CG ranking.

In all the markets, securities laws and stock exchange rules have been enhanced in recent years to protect minority shareholders. However, we don't see the legal system allowing minority shareholders cost-effective access to courts in Hong Kong, India, Malaysia, the Philippines, Thailand or Indonesia.

Accounting standards are largely in line with international standards, although there are discrepancies in Taiwan, China and Indonesia. In Taiwan, accounts are presented on a consolidated basis only for the finals, but not the interims. In China, while the government's policy is to bring local accounting standards into line with international norms, there are still significant discrepancies. In Indonesia, the adoption of international standards is seen as half-hearted.

Figure 2

Key regulatory/macro-corporate governance issues across markets

CLSA/AGGA country ranking criteria	China	HK	India	Indo.	Korea	M'sia	Philip.	S'pore	Taiwan	Thai
Rules & regulations										
Must companies report their annual results within two months?	N	N	N	Y	N	Y	N	Y	N	Y
Have reporting deadlines been shortened in the past three years?	N	N	Y	Y	N	Y	N	Y	N	S
Is quarterly reporting mandatory?	S	N	Y	Y	Y	Y	Y	Y	S	Y
Do securities laws require disclosure of ownership stakes above 5%?	Y	Y	Y	S	Y	Y	N	Y	N	Y
Do securities laws require prompt disclosure of share transactions by directors and controlling shareholders?	Y	Y	Y	N	Y	Y	Y	Y	S	Y
Are class-action lawsuits permitted?	S	N	N	N	Y	N	N	N	S	N
Is voting by poll mandatory for resolutions at AGMs?	N	S	N	N	N	N	N	N	S	N
Can shareholders easily remove a director who has been convicted of fraud or other serious corporate crimes?	S	S	N	S	N	S	S	Y	Y	N
Will share-option expensing become mandatory over the next 12 months?	N	Y	S	S	N	N	Y	Y	S	N
Enforcement										
Is there an independent commission against corruption (or its equivalent) that is seen to be effective in tackling public- and private-sector corruption?	N	Y	S	N	S	S	N	Y	N	N
Political & regulatory environment										
Is the statutory regulator (ie, the securities commission) autonomous of government (ie, not part of the ministry of finance)?	S	Y	S	N	S	S	S	S	S	S
IGAAP (or "accounting & auditing")										
Do the rules require disclosure of consolidated accounts?	Y	Y	Y	Y	Y	Y	Y	Y	S	Y
Do the rules require segment reporting?	Y	Y	Y	S	Y	Y	Y	Y	S	Y
Do the rules require disclosure of audit and non-audit fees paid to the external auditor?	Y	Y	Y	N	Y	Y	S	S	Y	S
Do the rules require disclosure of connected transactions?	Y	Y	Y	Y	Y	Y	S	Y	Y	Y
Does the government or the accounting regulator have a policy of following international standards on auditing (ie, the standards promulgated by the International Federation of Accountants in New York)?	Y	Y	S	S	S	Y	Y	Y	S	Y
Institutional mechanisms & CG culture										
Are institutional investors engaged in promoting better corporate governance practices?	N	S	S	N	S	S	N	S	S	S
Are any retail investors engaged in promoting better corporate governance practices?	N	Y	S	N	Y	S	N	Y	N	N
Have retail investors formed their own shareholder activist organisations?	N	N	Y	S	Y	S	N	Y	N	N

Y = Yes; N = No; S = Somewhat; Source: CLSA Asia-Pacific Markets; Asian Corporate Governance Association

Most markets now require disclosure on audit and non-audit fees paid to external auditors

In all markets other than Indonesia, the rules require (or soon will) disclosure on audit and non-audit fees paid to external auditors. While rules on connected party transactions are in place, they are somewhat weak in the Philippines and China. Auditing standards are pretty much in line with international standards, other than in China. On efforts to regulate the accounting profession, Singapore comes out ahead.

Institutional mechanisms lacking

However, we find that in none of the countries do institutional investors form private CG activist groups. Except in Japan (which is not covered in this year's report), there are no CG focus funds. Some retail investors groups have been formed to promote CG in Singapore, Korea and, to some extent, India and Malaysia. Activist organisations for retail investors have been formed in Singapore, India and Korea, and somewhat similar organisations are also now to be found in Malaysia and Indonesia. Professional associations are seen promoting CG training and awareness in all the markets, but somewhat less so in China and Indonesia.

Most of the change driven by regulators

The conclusion is that there have been general improvements in the CG environment for the markets covered in this report. Most of that change is still being driven by the regulators – a situation basically unchanged since the Asian crisis. Investors are, in most countries, not organised or seen as actively pressing for change. While some countries have groups that pursue companies that transgress, notably in Korea, in most countries shareholder activism is still lacking. Retail and institutional investors, with some exceptions, generally see good CG as a matter for others to pursue. Management, feeling little pressure on CG from minority shareholders, are thus inclined to view it as a matter of complying with the rules, rather than a high priority with most investors.

For companies, commitment to best CG standards will be the exception rather than the norm

Unfortunately, this means that, as we argued in *CG Watch 2003*, real commitment by the companies remains the exception rather than the norm in Asia (and probably other regions as well). The benefits of good CG in terms of reducing risks, focusing on core operations rather than diluting the existing businesses, and sharing the economic value generated equally with all shareholders, will remain an uncertainty for most companies. The exceptions that are apparently taking CG more seriously, however, are generally rewarded with better stock performance as we see in the following sections.

Amar Gill
amar.gill@clsa.com
(852) 26008593

Market beta – A function of CG and risk

Evidence that poorer CG markets are higher beta, while markets that are improving CG see outperformance

When markets are rising – as they have done in the last one to three years to mid-2004 - the lower-CG countries tend to outperform; when they decline – eg, the last five years - the worst CG markets seem to fall further, while the better CG markets are more resilient. Particularly over a five-year period, we find returns favouring those that have seen significant regulatory improvement. Korea, Malaysia and India are the only markets showing any real positive returns in our sample over the last five years. The sample size of ten markets used in this survey is hardly statistically adequate, but the evidence suggests that CG is a determinant of market performance, particularly over the medium term.

In the 12 months to mid-2004, Asian markets have performed well, even if most of the gains came in the earlier six months to December 2003. MSCI Asia ex-Japan is up 27% over the 12 months to June 2004. For the 24 months previous to that, the regional MSCI benchmark has been about flat - and thus is up 26% over the last three years. Over the last five years, however, the MSCI Asia ex-Japan is down 16.5%.

When markets are performing strongly, weaker-CG markets tend to outperform

We find that when markets are performing strongly, it is the markets with lower CG that have rallied the hardest. Over the last 12 months, the bottom-five markets ranked for CG provided an average return of 32% - powered by Thailand (+48%) and China (+38%), the two best-performing markets for this period in the sample. The upper half of the markets for CG had an average return of 27%, 5ppts lower than the performance of the bottom-half CG markets.

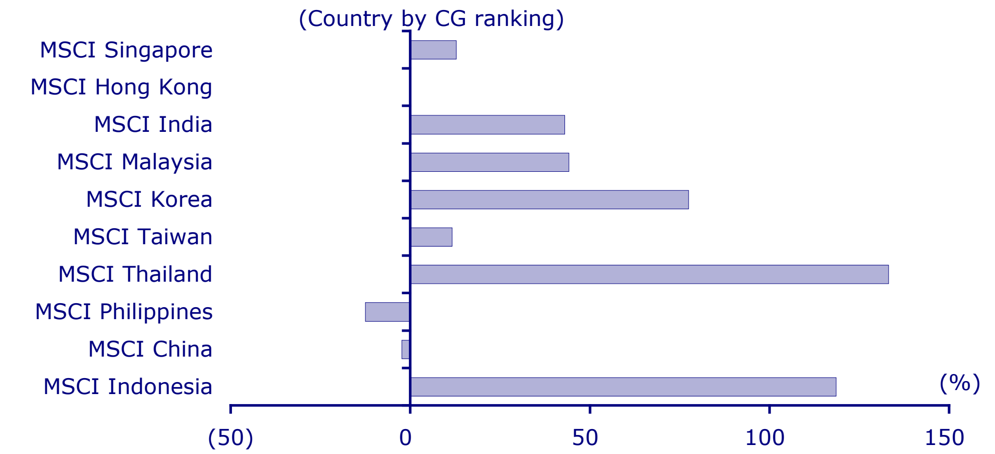
Over the last three years, during which the MSCI Asia ex-Japan has gained 26%, the bottom-five CG markets rose by an average of 50% - driven by Thailand (up 133%) and Indonesia (gaining 119%). The top-five markets for CG rose by a more moderate 36% and the top-three by a relatively paltry 19%.

Last 3 years, bottom-CG markets have tended to outperform

(HK was flat for the period)

Figure 3

Performance of markets ranked by CG - Three years to June-2004



Source: CLSA Asia-Pacific Markets, Datastream

Poor-CG markets severely underperform when markets are falling

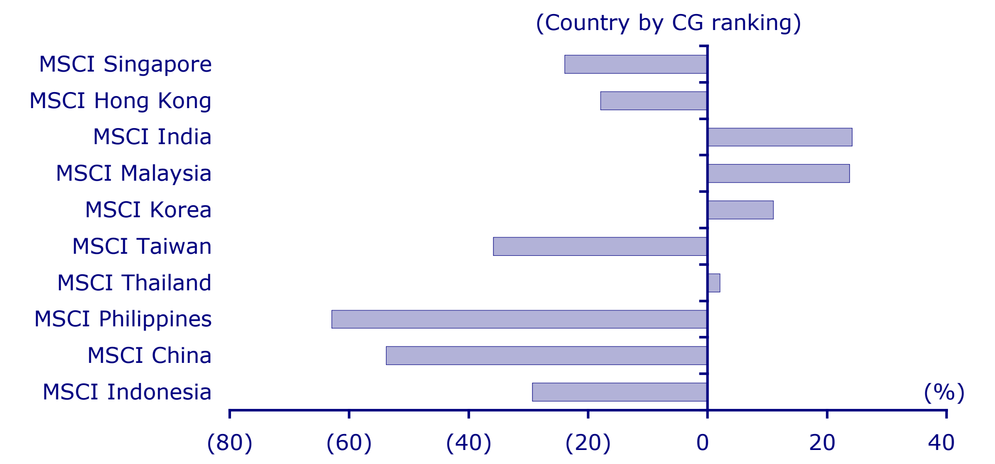
However, taking a five-year view, over which period the regional index is down 16.5%, we find that the poorest markets for CG fared much worse. The bottom-half CG markets fell by an average 36%. The worst performance

Over the last 5 years, when markets have generally fallen, we see resilience in the higher CG markets

came mainly from the markets that ranked in the bottom three, which fell by an average 49% (MSCI-Philippines is down a thumping 63% and the China index down 54% for this period). The top-half markets for CG have risen 3% over the last five years, which is creditable against the decline for the regional index. The best-performing markets are those ranked third and fourth by our country rankings: both India and Malaysia are up 24% for the five years.

Figure 4

Performance of markets ranked by CG - Five years to June-2004



Source: CLSA Asia-Pacific Markets, Datastream

Improving CG environments - eg, India, Malaysia and Korea - have also seen good market performance

It is noteworthy that India, Malaysia and Korea, the three markets that have seen major improvements in their CG environment over the last few years - as the country sections below describe - have outperformed the MSCI Asia ex-Japan index over the last three and five years. These are the only markets in our sample that have had positive gains over the last five years, up by 11-24%. Other than Thailand's very small positive return (+2%), the other markets are all down for the five-year period.

Low-CG markets are high beta; conversely for high CG markets

Figure 5

Performance of markets ranked by CG – One, three and five years to June-2004

MSCI perf.	% 1Y	% 3Y	% 5Y
Singapore	28.0	12.8	(23.9)
Hong Kong	31.2	(0.2)	(17.9)
India	34.2	43.0	24.2
Malaysia	16.6	44.2	23.8
Korea	24.7	77.5	11.0
Taiwan	21.1	11.7	(35.8)
Thailand	47.8	133.1	2.1
Philippines	22.9	(12.5)	(62.9)
China	37.7	(2.4)	(53.8)
Indonesia	28.4	118.5	(29.3)
Asia ex-Japan	27.3	26.1	(16.5)

Source: CLSA Asia-Pacific Markets, Datastream

Higher CG markets have underperformed when markets rebounded

Obviously, various factors drive market performance, but one can surmise from this analysis that poorer-CG markets are higher beta, while better-CG markets are lower beta. When the markets declined, as they did from the late 1990s to the middle of 2003, the worse markets for CG were the biggest losers, and the better-CG markets either declined by less or actually managed to eke out gains. When the markets in the region rose, as in the last 12 months, the markets with the poorer CG gained more, while the better-CG markets returns were overall underperformers.

Performance a function of risk aversion

When markets are falling and investors' risk aversion rises, one can expect those markets with better CG to outperform. Conversely, when markets are rising and investors focus more on potential returns than risk, they may be inclined to move into markets with poorer CG. The risks in these markets may be greater, but they may have fallen excessively in the earlier period of decline and thus offer greater value – and hence higher potential returns when the markets turn up.

Better CG stocks tend to outperform, and poorer CG underperform, over the medium term

In the following sections where we examine the performance of stocks within markets, we similarly find that for shorter periods (eg, one year), various other factors come into play - and it is difficult to show much of a relationship between CG and stock performance. But the longer the timeframe – ie, for three years, and more so for five years - we find a stronger correlation between the better-CG stocks outperforming within their markets and their poor-CG stocks underperforming.

Asia ex-Japan's largest stocks ranked

Infosys again the top- CG company in our coverage

Of the largest 100 companies by market cap in our universe, the top-10 for CG are Infosys (with an 87% score, the highest in our universe), closely followed by CLP, Esprit, HSBC, Wipro, Public Bank, Kookmin Bank, KT Corp, TSMC and Siam Cement. With scores close to 80% are StanChart, Li & Fung, BAT, Maybank and Hana Bank. Figure 6 shows the top-30 ranked companies for CG among the larger stocks by our ranking system (sorted by market ranking).

Minor score differences may not capture real difference in CG commitment; but there's a big difference between CG scores at the top and bottom among large caps

While we have a numeric for the CG score for each of these companies, differences of just a few points are as much a function of the scoring system as anything else. However the scores and rankings do give a representation of which are the better, average and worse companies for CG in the markets covered. The range in CG among the big caps is reflected in the 81% average score for the top decile of this group, while the bottom decile of this group scores just under half of this. (We explain our methodology for scoring the companies in the next section.)

In the top 10 are companies from India, HK, Malaysia, Korea and Thailand

Figure 6

Top-30 in Asia markets (sorted by country for each decile)

Company name	Country	Country CG rank	Recommendation
CLP Holdings	Hong Kong	1	SELL
Esprit Holdings	Hong Kong	3	BUY
HSBC	Hong Kong	4	U-PF
Infosys	India	1	BUY
Wipro	India	2	BUY
Public Bank	Malaysia	1	O-PF
Kookmin Bank	Korea	1	U-PF
KT	Korea	2	U-PF
TSMC	Taiwan	1	BUY
SCC	Thailand	1	BUY
ST Engineering	Singapore	3	O-PF
StanChart	Hong Kong	5	O-PF
Li & Fung	Hong Kong	6	U-PF
HDFC	India	4	BUY
BAT	Malaysia	3	U-PF
Maybank	Malaysia	4	O-PF
Maxis	Malaysia	7	BUY
Hana Bank	Korea	4	O-PF
Samsung Fire & Marine	Korea	5	U-PF
UMC	Taiwan	2	BUY
OCBC	Singapore	4	U-PF
DBS Group Holdings	Singapore	5	O-PF
HK Electric	Hong Kong	13	SELL
Johnson Electric	Hong Kong	14	SELL
Hindustan Lever	India	6	BUY
Bharti	India	8	BUY
Samsung Electronics	Korea	6	BUY
POSCO	Korea	7	BUY
KT&G	Korea	10	O-PF
Shinhan Financial Group	Korea	12	O-PF

Source: CLSA Asia-Pacific Markets

Markets not among the top rankings can produce standout companies

Most of the names in our top list are as one would expect. Infosys has essentially maintained its top ranking since our scoring began in 2001. Yet again it is a prime example of a company in a market where the overall CG environment may not be the very top (India ranks third after Singapore and Hong Kong), but where there are still companies with top-class governance.

Public Bank has one of the highest scores in our sample

Some of the other names in the top 10 are slightly more surprising. Public Bank, run by a visionary banker Teh Hong Piow, a legend in Malaysia/Singapore, has appointed a co-chairman who is truly independent (a retired civil servant). The number of independent directors on the board has risen over the last three years - now seven non-executive directors, ie, 80% of the nine board members, of which six are independent. The group reports quarterly results within three weeks of the period-end - by far the fastest in the industry. Each quarterly result is accompanied by a briefing to analysts and the media – another first for Malaysian banks. Management provides clear ROE and CAR targets; senior management are easily accessible to investors and the analyst community; and the audit partner is rotated every five years. On many of our categories, Public Bank comes through where most of the region's larger banks falter.

KT Corp is again in the top-10 large caps

KT Corp owes its high score (similar to last year) to its efforts to move to a best-practice structure upon full privatisation in August 2002, when it moved beyond the chaebol or 'old Korea' legacy. Following the privatisation, the potential conflicts of interests between minorities and owner-managers - as at so many other Korean companies - was essentially removed. Indeed, management is highly incentivised with a bonus system tightly linked to EVA™ and relative share-price performance. It is one of the few companies in our coverage universe that allows cumulative voting for directors and also has an independent chairman. Eight of the board's 12 directors are outsiders. The board has the full complement of audit, nominating and recommendation committees. There is some controversy over whether the government would prefer to see the telcos invest more; but KT Corp is on track to meet its promise to reduce capex to 15% of sales.

Kookmin Bank's high foreign ownership seems to have made a difference

Kookmin Bank also scores highly among the banks. Partly due to its large foreign ownership, it now complies with international standards in terms of disclosure and timely reporting. It was the first bank to hold simultaneously translated English-analyst briefings every quarter, which are also cast on the internet. Levels of disclosure stand out. While there are issues to deal with, in terms of asset quality, it has become far more focused on satisfying its shareholders, by setting clear goals and more practical targets than in the past.

Siam Cement has a unique shareholding/ management structure

Siam Cement, the top-scoring Thai company, appearing as it does in the top-10 in our whole universe, is unique for Thailand. Its founding shareholder (Thai Royal family) retains a passive majority stake. The company has long been supervised by an independent board of directors and run by professionals with no vested interest. Chumpol Na Lamlieng, Siam Cement's CEO for the past 11 years, has been instrumental in driving changes within the group. He previously held a directorship in Singapore's Sembcorp and Singtel, and is currently Singtel's chairman.

These are some of the examples where management/controlling shareholders have made a difference putting in place CG standards that are at the very top in Asia. A number of smaller companies also score highly, as can be seen in the individual country sections. However, the incidence of management making a big effort to improve CG is still pretty much the exception rather than norm, which is why these companies stand out.

The bottom-10 companies have CG scores averaging below 40%

At the bottom of the table among the large caps, however, are Kia Motor, Hyundai Motor, Gas Authority of India (GAIL), SK Corp, San Miguel, Mega FHC, the Oil and Natural Gas Corp of India (ONGC), State Bank of India, Hon Hai and Mobis. These companies have average CG scores below 40% – reflecting the vast difference in CG levels in the region.

Increase in independent directors reflects extra resources put in place for CG

Because of the different methodologies used to score companies this year (see section below), making meaningful comparisons between this year's scores and the last becomes difficult. However, one objective way of seeing whether a company is taking CG more seriously is looking at whether there has been an increase in the number of independent directors. Over the last three years, we find that the large-cap companies shown in Figure 7 have done so, with notable increases by ICICI Bank of India (seven additional independent directors following a reverse merger exercise) followed by DBS and UOB of Singapore (increasing by five).

Companies in India, Singapore, Taiwan, Korea and Hong Kong have been adding independent directors

Figure 7

Large caps that have increased two or more independent directors

	Country	Increase in independent directors	Independent directors >50% of board
ICICI Bank	India	7	✓
DBS Group Holdings	Singapore	5	
United Overseas Bank	Singapore	5	✓
Philippine Long Distance Telephone Co	Philippines	4	
Wharf	Hong Kong	4	
Infosys	India	3	✓
TSMC	Taiwan	3	
OCBC	Singapore	3	
SKT	Korea	3	
Quanta	Taiwan	3	
Public Bank	Malaysia	2	✓
SCC	Thailand	2	✓
Samsung Electronics	Korea	2	✓
KT&G	Korea	2	✓
Johnson Electric	Hong Kong	2	
Cathay Pacific	Hong Kong	2	
SingTel	Singapore	2	✓
MediaTek	Taiwan	2	
S-Oil Corporation	Korea	2	✓
Huaneng Power	China	2	
China Unicom	China	2	
Reliance Industries	India	2	
PCCW	Hong Kong	2	✓
Hon Hai	Taiwan	2	
SK Corporation	Korea	2	✓

Source: CLSA Asia-Pacific Markets

Performance of stocks sorted by CG among the large caps

Lower CG companies have tended to underperform over the medium-term

When we sort the 100-largest stocks by CG we find evidence - as in previous years' studies - that the better-CG companies tend to see stock-price outperformance over three and five years. Lower-CG companies have generally underperformed the better-CG names over the medium term, although a handful of the poorer-CG stocks have driven bottom-quartile CG-stock performance above the second and third quartile.

In a sharply rising market, bottom-CG stocks have outperformed among the large caps

In the last year (to the end of June 2004), however, we get a result that is consistent with our conclusion on markets: when markets are rising sharply, lower-CG stocks tend to outperform. The bottom-CG quartile of the large caps came in with an average return of 56% over the last 12 months, ahead of all the other quartiles. The bottom quartile on average outperformed the sample of larger caps by 12ppts, and the bottom half outperformed the top half by 4ppts. The top-CG quartile stocks were on average the least strong performers within this 12-month period.

Top quartile outperformed over 3 and 5 years; but bottom quartile also a strong performer in these periods

Figure 8

Stock performance of corporate-governance quartiles

(%)	Performance to 30 June 2004		
	One year	Three years	Five years
First CG quartile	31	139	138
Second CG quartile	53	57	89
Third CG quartile	36	40	43
Fourth CG quartile	56	120	140
Average of top 100 large caps	44	91	105
MSCI Asia ex-Japan index	27	26	(16)

Source: CLSA Asia-Pacific Markets

Over the last three and five years, however, we have seen outperformance from the top-CG stocks. The 100-largest stocks in our universe have provided an average return of 91% over the last three years. The top-CG quartile have outperformed by 48ppt. However, the fourth-CG quartile performed better than the two middle quartiles, with a tripling in value for Mobis and ONGC. On average, the top half of the CG companies still outperformed the bottom half by 19ppts over three years.

Bottom-half CG stocks among large caps underperformed the top half by 20ppts

For the last five years, the average performance of the top-quartile-CG big caps (+138%) has also been higher than the average for these top-100 market-cap names (+105%). However, for this period, again the bottom quartile was also quite a strong outperformer, with these stocks rising on average by 140%. The two top-performing stocks in the bottom quartile over the last five years are Mobis (up 6x), Huaneng Power, ONGC and Shinsegai (all up around 3x). Nevertheless, sorted by CG, the bottom half of these large-cap stocks on average underperformed the top half by 20ppts.

Outperformance of higher-CG stocks not apparent over shorter period when markets are rising

The result of this sample of Asia ex-Japan's largest stocks would seem to indicate that, while the top-CG companies tend to outperform, but this is not apparent in shorter periods when markets are rising. However, over slightly longer periods - ie, three and five years – better-CG stocks tend to outperform. This certainly does not rule out strong performance of particular stocks in the lower (or bottom) CG quartiles, which can throw out the correlations of stock performance and CG rankings. The sample is not large and some lower-CG stocks rising by a few hundred percent can push up the average performance of stocks in the lower-CG quartiles. This is to be expected given that CG is clearly not the only driver of stock rerating.

Still, over time we find that among the big caps, good-governance companies tend to outperform both the overall sample and the regional index. These stocks should naturally carry less risk; if they also provide good returns relative to the overall sample and against the regional benchmark (eg, MSCI Asia ex-Japan), we conclude that choosing high-CG stocks for Asia ex-Japan portfolios is a strategy that pays off over the medium-term. This does not diminish the potential for strong returns from some companies with low CG, where other factors could be in play. Particularly during periods of sharply rising markets, higher-beta, lower-CG stocks tend to be the stronger performers.

Improving risk-reward balance

Within the markets, high CG stocks tend to outperform over 3-5 years

Again, within countries we find no real correlation between the performance of the top- and bottom-CG-quartile stocks over a shorter period of 12 months. However, over the medium-term, high-CG stocks have tended to outperform, while poor-CG stocks have clearly underperformed over the last five years.

In Indonesia, the top CG quartile outperformed strongly over 1, 3 and 5 years

Over the 12 months to June 2004, the data on CG stock' performance against market averages are not strong - the top-CG quartiles outperformed only in five of the 10 markets. However the outperformance was as much as 105% in Indonesia, and in these five markets the top-CG quartile outperformed by an average 31%. The top-CG quartile underperformed in the last 12 months in five markets (India, Korea, Malaysia, Philippines and Thailand), but by just 1-19%, or on average by a less significant 9%.

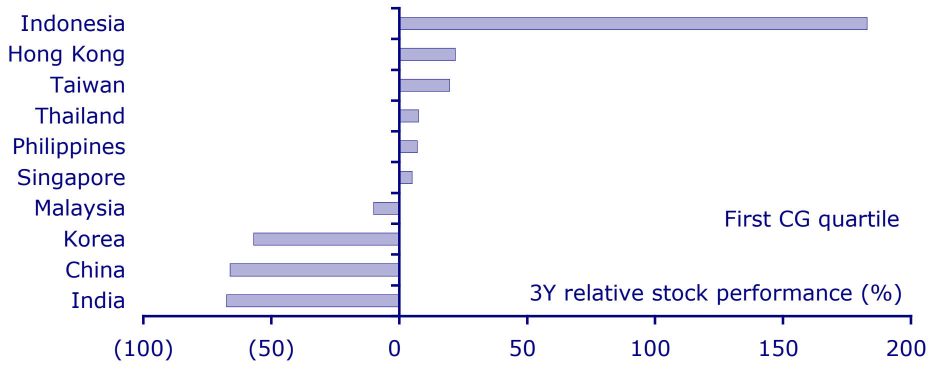
The bottom-CG-quartile stocks have underperformed in six of the markets over the last 12 months, most clearly in Indonesia, Singapore and Malaysia - but the lowest-quartile stocks outperformed in four markets (Korea, China, Thailand and the Philippines).

Top-CG-quartile stocks outperformed in 7 of the 10 markets over 3 and 5 years

However, over the last three years, the top-CG-quartile stocks outperformed in six over the 10 markets and, over the last five years, in eight. The bottom-CG quartile underperformed in seven of the markets over the last three years, and in eight of the markets over the last five years.

Figure 9

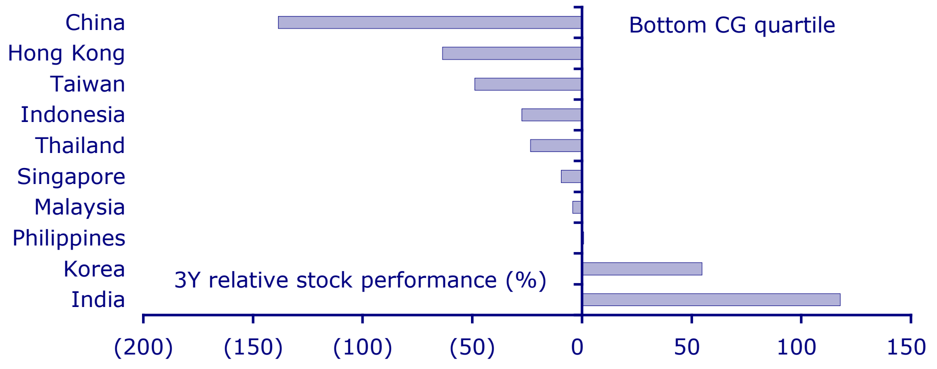
Relative perf of top-CG quartile against country sample - 3 years to Jun-04



Underperformance of the bottom-CG quartile stocks in the last 3 years in China, HK, Taiwan, Indonesia, Thailand, Singapore and Malaysia

Figure 10

Relative perf of bottom-CG quartile against country sample - 3 years to Jun-04



Source: CLSA Asia-Pacific Markets

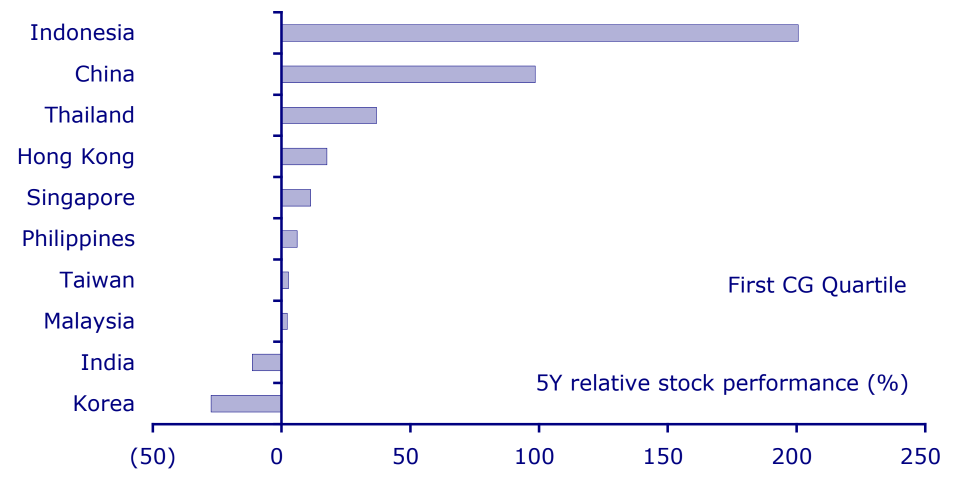
Over the last three years, Indonesia has seen the strongest outperformance among the top-CG companies (+183% for the top quartile), then to a lesser extent Hong Kong and Taiwan, with Thailand, the Philippines and Singapore just outperforming. However the top-CG quartile underperformed severely in India, China and Korea, and to a lesser extent in Malaysia, over the three years.

The bottom-CG quartile in China underperformed by 138% over the last three years, Taiwan and Hong Kong by 50-60%; Indonesia and Thailand by around 25%; and Malaysia and Singapore 10%. The lowest quartile basically moved in line with the country sample in the Philippines, but outperformed strongly in India (+118%) and Korea (+55%).

Last 5 years, top-CG stocks have outperformed strongly in Indonesia, China, Thailand, HK - also outperformed in Singapore, Philippines, Taiwan and Malaysia

Figure 11

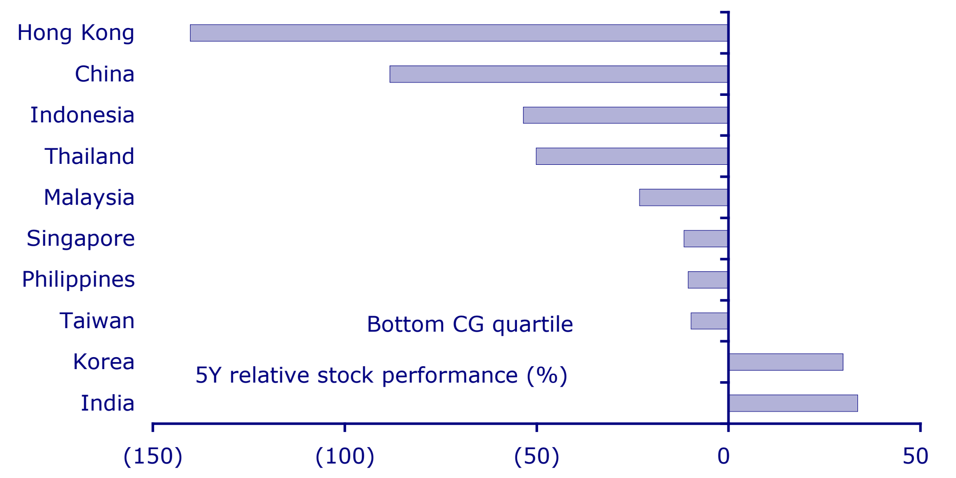
Rel performance of top CG quartile against country sample - 5 years to Jun-04



Last 5 years, bottom CG stocks have underperformed significantly in HK, China Indonesia, Thailand and Malaysia; to a lesser extent in Singapore, Philippines and Taiwan

Figure 12

Rel performance of bottom CG quartile against country sample - 5 years to Jun-04



Source: CLSA Asia-Pacific Markets

Top CG quartile stocks outperformed as much as 201% in Indonesia; 37% in Thailand and 18% in HK over last 5 years

Over the last five years, the top CG quartile outperformed in eight of the 10 markets. The outperformance was as much as 201% in Indonesia, 99% in China, 37% in Thailand, 18% in Hong Kong and 3-11% in Singapore, Malaysia, Philippines and Taiwan. The top-quartile stocks underperformed their respective country samples in India over five years (by 11%), but more severely in Korea (27%). The bottom-quartile underperformed over the five years in all but Korea and India - the underperformance was 50-140% in Hong Kong, China, Indonesia and Thailand.

Relatively small sample size, hence sector- and stock-specific factors can spoil correlation between CG and stock performance

Our sample size ranged from 16 in the Philippines to 66 in India, reflecting the number of stocks under core coverage in each of the markets. The sample size is not large within the markets, averaging 44, or 450 across the ten markets surveyed. Hence, we find that within each country, sector- or stock-specific factors can easily lead to strong performance of certain stocks, which spoils the correlation by CG quartiles.

Figure 13

Relative performance by CG quartiles against country samples - One, three and five years to June 2004

Average of all Quartiles										
1yr	**Hong Kong**	**China**	**India**	**Korea**	**Malaysia**	**Singapore**	**Philippines**	**Thailand**	**Indonesia**	**Taiwan**
First CG Quartile	14.4	26.7	(0.9)	(13.4)	(1.1)	8.8	(8.0)	(19.3)	104.8	0.5
Second CG Quartile	0.9	(18.5)	9.9	(25.5)	15.7	4.5	23.3	67.4	10.8	6.7
Third CG Quartile	(3.7)	6.1	(16.7)	10.1	(6.1)	3.5	(23.1)	(60.2)	(24.8)	(4.1)
Fourth CG Quartile	(11.5)	(14.2)	8.4	28.6	(8.6)	(17.9)	7.7	12.3	(25.6)	(4.0)
3yr										
First CG Quartile	22.0	166.2	(66.1)	(67.5)	(10.0)	5.1	7.1	7.6	182.9	19.7
Second CG Quartile	56.1	(12.5)	345.7	9.9	6.3	0.6	5.9	224.9	(28.4)	52.5
Third CG Quartile	(14.4)	(107.2)	(141.0)	(37.3)	7.9	4.5	(13.9)	(208.9)	(24.9)	(22.1)
Fourth CG Quartile	(63.7)	(27.8)	(138.4)	117.8	(4.3)	(9.5)	0.8	(23.4)	(27.4)	(48.8)
5yr										
First CG Quartile	17.6	(58.9)	98.5	(11.4)	2.2	11.3	6.1	36.9	200.7	2.7
Second CG Quartile	121.7	92.6	24.7	(12.2)	16.3	5.8	6.4	40.5	(54.3)	14.2
Third CG Quartile	1.0	(2.9)	(34.8)	(7.5)	4.8	1.6	(2.0)	(27.5)	(20.5)	(6.6)
Fourth CG Quartile	(140.2)	(33.7)	(88.2)	33.7	(23.2)	(11.6)	(10.5)	(50.1)	(53.5)	(9.8)

Source: CLSA Asia-Pacific Markets

Nevertheless picking good CG stocks pays off in the medium-term

Nevertheless, we find is that for the last one, three and five years, the bottom-CG-quartile stocks underperformed in 6-8 of the 10 markets. The top-CG-quartile stocks outperformed in eight of the 10 markets over the last five years. While on a shorter period of up to 12 months, good CG may be overwhelmed by other factors in determining stock performance. But over a longer period, eg, three to five years, good CG companies tend to outperform and poor CG companies underperform in most markets.

Why CG is correlated to stock performance?

Is it just a statistical correlation?

Correlations between good/improving CG and share-price outperformance do not in itself prove causation. However, there are good reasons to believe that the correlations that we have found in our CG reports since 2001 will be maintained, as we also emphasised in our earlier CG reports.

High CG reflects quality of management

A key reason is that CG is a reflection of quality of management**.** The highest calibre management clearly realise that high CG standards are not the only thing investors are seeking, but they also need to keep checks and balances in their company for long-term, sustained, high operating performance, while preventing corporate abuse and mismanagement. Nothing can deter mismanagement like maintaining the highest standards of transparency. And top-quality management tend to focus on financial returns as well. As we demonstrated in our *Saints and Sinners* 2001 CG report, high-CG companies tend to have high ROE and EVA™ ratios. As long as they are the largest value creators in their respective markets, they will remain outperformers over time. Quality of management is the key explanatory factor that ties companies with good CG together with superior financial ratios and share-price outperformance.

Investors now able to choose across markets for best-run companies

A second reason for the correlation is that investors are not constrained to particular markets and can avoid stocks and markets where CG is poor. In the early nineties, dedicated country and region funds were popular products. However, investors found that many of the emerging-market investment vehicles they chose were disasters. Had the investors kept their money in their home markets, most would have seen much better returns.

While conceptually the idea of spreading out one's investment geographically and diversifying into emerging markets appeals as a means towards better performance and spreading the risk, the end-investor has much less confidence in being able to pick the right country or region. Hence, this responsibility is being moved to the institutional fund manager.

The end-investor places funds in international or global accounts, rather than specific country or regional funds. It is then up to the fund manager of these accounts to determine which countries and companies to invest in. The institutional fund manager is not constrained in the way the fund manager of a country fund would be, in terms of choosing from what might be the best of a poor lot of companies for CG in a given market. The investor can gain the same exposure to a particular industry from companies in other countries where CG standards might be higher.

CG itself is becoming an investment criterion to reduce risk

The huge menu of possible stock investments open to the global/international fund manager means the investor will be more reluctant to invest in companies with poor CG standards, especially if he cannot monitor the developments at each of the companies as closely as can a country-dedicated fund manager. Investors are generally more alert to the need of investing in companies with a minimum acceptable level of governance standards, particularly given the poor CG record during the Asian crisis, when CG fiascos led to huge deratings of some stocks (and of some markets). CG becomes an investment criterion that determines how much investors are willing to pay up for a stock.

When longer-term international funds are a bigger influence over relative performance, better CG stocks would tend to outperform

To the extent that stocks' medium-term performance is driven more by investors with a longer-term perspective running regional/international funds rather than country specific funds, these investors are likely to gravitate to the stocks with better CG. Thus, while we find that poorer CG markets do well when markets are rising, and better CG markets are more resilient when market direction is down, nevertheless within markets we find that over the medium-term (three to five years), stocks with the best CG tend to outperform.

In the initial market rebound, when hedge funds and country specialists dominate, the riskier stocks might initially see a bigger bounce

Within a shorter period of one year, hedge funds and country-focused portfolio managers are likely to rush into the more risky stocks that may have been oversold. Hence, we have seen that over the previous 12 months, the negative correlation between CG and stock performance in rising markets was the case (consistent with what we found between markets). But once valuation anomalies are taken out after the initial rebound in the market, better-CG companies seem then to have stock outperformance when the longer-term funds move in and more strongly influence relative stock performance.

Company scoring methodology amended

Seven categories

As in previous years, our corporate-governance score is based on seven key categories – discipline, transparency, independence accountability, responsibility, fairness and social responsibility. Under each of these categories, we assess the companies on issues that are key to good corporate practice. The questionnaire is in binary form to reduce subjectivity and is filled in by the analyst covering each company based on the best information available. (Our questionnaire is presented in Appendix 2.)

Our CG assessment summarised

The CLSA CG score is based on how we rate a company on 60 issues under seven main aspects that we take to constitute the concept of corporate governance. The following is a summary of what we assess in our CG ranking.

Public commitment to CG and financial discipline

I. Discipline

- ❑ Explicit public statement placing priority on CG
- ❑ Management incentivised towards a higher share price
- ❑ Sticking to clearly defined core businesses
- ❑ Having an appropriate estimate of cost of equity/capital
- ❑ Conservatism in issuance of equity or dilutive instruments
- ❑ Ensuring debt is manageable, used only for projects with adequate returns
- ❑ Returning excess cash to shareholders
- ❑ History of corporate restructuring reflecting poor management
- ❑ Business decisions made without undue influence of government
- ❑ Disclosure of financial targets

Ability of outsiders to assess true position of a company

II. Transparency

- ❑ Timely release of Annual Report
- ❑ Timely release of semi-annual financial announcements
- ❑ Timely release of quarterly results
- ❑ Prompt disclosure of results with no leakage ahead of announcement
- ❑ Clear and informative results disclosure
- ❑ Accounts presented according to IGAAP
- ❑ Prompt disclosure of market-sensitive information
- ❑ Accessibility of investors/analysts to senior management
- ❑ Website where announcements updated promptly
- ❑ Sufficient disclosure of any dilutive instruments
- ❑ Waivers applied on disclosure rules for the market

Board is independent of controlling shareholders and constituted separately from senior management

III. Independence

- ❑ Board and senior management treatment of shareholders
- ❑ Chairman who is independent from management
- ❑ Executive management committee comprised differently from the board
- ❑ Audit committee chaired by independent director
- ❑ Remuneration committee chaired by independent director
- ❑ Nominating committee chaired by independent director
- ❑ External auditors' non-audit fees; rotation of audit partners
- ❑ No representatives of banks or other large creditors on the board

Proper accountability of management to the Board

IV. Accountability

- ❑ Board plays a supervisory rather than executive role
- ❑ Independent directors nominated by minority shareholders
- ❑ Independent, non-executive directors at least half of the board
- ❑ Increase in independent directors over the last three years
- ❑ Quarterly board meetings
- ❑ Board members able to exercise effective scrutiny
- ❑ Audit committee nominates and reviews work of external auditors
- ❑ Audit committee supervises internal audit and accounting procedures

Record on taking measures in case of mismanagement

V. Responsibility

- ❑ Acting effectively against individuals who have transgressed
- ❑ Record on taking measures in cases of mismanagement
- ❑ Measures to protect minority interests
- ❑ Mechanisms to allow punishment of executive/management committee
- ❑ Share trading by board members fair and fully transparent
- ❑ Board small enough to be efficient and effective
- ❑ Material related-party transactions
- ❑ Controlling shareholder known or believed to be highly geared
- ❑ Controlling shareholder's primary financial interest is the listed company

Treatment of minorities

VI. Fairness

- ❑ Majority shareholders treatment of minority shareholders
- ❑ All equity holders having right to call general meetings
- ❑ Voting methods easily accessible (eg, through proxy voting)
- ❑ Quality of information provided for general meetings
- ❑ Guiding market expectations on fundamentals
- ❑ Issuance of ADRs or placement of shares fair to all shareholders
- ❑ Controlling shareholder group owning less than 40% of company
- ❑ Priority given to investor relations
- ❑ Total board remuneration rising no faster than net profits

VII. Social responsibility

Labour and environmental issues

- Explicit policy emphasising strict ethical behaviour
- Not employing the under-aged
- Explicit equal employment policy
- Adherence to specified industry guidelines on sourcing of materials
- Explicit policy on environmental responsibility
- Investments/litigation that reflect poorly on management integrity

Questionnaire designed to give a numeric for ranking purpose

The questionnaire was designed to give a numeric for a company's ranking on each of the seven CG criteria, and a weighted overall CG score for the company. This figure, stated as a percentage, would reflect our view on a company's CG level, but also provide a ranking for each within its market and within its sector across the markets.

Changes in the 2004 CG questionnaire

Problems in comparing scores with previous years

This year, apart from providing a more rigorous basis for our macro country scores on CG, we have also amended the questionnaire on the companies which had been essentially unchanged since 2001. This leads to problems of comparing scores with previous years, but we believe the advantages of rectifying some of the drawbacks found in the questionnaire outweighed this disadvantage.

Previous scoring did not rank a company negatively when it had transgressed, only giving a zero score

The main change in the methodology to scores the companies is that this year we included negative scoring for 15 questions. The reason is that under the previous scoring system, a company that transgressed on a major issue does not get the score on a particular question, but typically each question has only 1.7% of the total score. That means a company can make up points on a number of the questions that relate to the form of corporate governance, and that could give it a respectable overall score. Even though on certain key issues its commitment to corporate governance is revealed negatively, its overall score comes out at a level that in many cases seemed too high. The scoring system was not sensitive enough to transgressions, being mainly a tally for how much a company is able to present a front of good CG.

Fifteen questions now have a negative score, ie, if a company had a negative answer then instead of just getting a zero, it gets a negative score equal to one-quarter of the total score for that CG category. We list the key issues that carried a negative scoring in our 2004 questionnaire on the next page.

Up to three questions with negative scoring under each CG category

Under the discipline category, three questions now have negative scoring (questions 3, 5, 9 – see Appendix 2 for the full questionnaire). Similarly, three questions have negative scoring for the transparency category (questions 15, 16, 21). For the independence assessment, two questions have a negative scoring (22, 25), and one (33) for the accountability section. For the responsibility section, three questions (40, 43, 45), and for fairness another three (46, 51, 54), were similarly scored. None of the questions under the social responsibility category carried negative scores.

15 questions now have negative scoring

Questions with negative scoring in the 2004 company CG assessment

Q3: Has the company diversified into non-core businesses (over the last 5 years)?

Q5: Has the company issued equity, or warrants/options, for acquisitions or financing projects where there has been controversy over whether the project/acquisition is financially sound, or whether the issue of equity was the best way to finance the project, or where it was not clear what the purpose was for raising equity capital? Has the company issued options/equity to management/directors at a rate equivalent to a more than 5% increase in share capital over three years?

Q9: Is the company able to make business decisions within regulatory/legal constraints but without government/political pressure that restricts its ability to maximise shareholder value?

Q15: Are the financial reports in any way unclear or uninformative?

Q16: Are accounts presented according to internationally accepted accounting standards? Have there been any controversial accounting policies?

Q21: Has the company applied for a waiver on disclosure rules?

Q22: Have there been controversies over whether the Board/senior management have made decisions in the past five years that benefited them at the expense of shareholders?

Q25: Is there an audit committee and are there any doubts about the effectiveness of the committee, including whether it is chaired by an independent director, has an independent director with financial expertise and more than half of the audit committee made up of independent directors?

Q33: Has the number of independent directors on the Board reduced over the last three years?

Q40: Have there been any controversies over whether the Board and/or senior management have taken measures to safeguard the interests of all, not just the dominant, shareholders?

Q43: Does the company engage in material related-party transactions?

Q45: Is the controlling shareholder's primary financial interest other than the listed company?

Q46: Have there been controversies over decisions by management where controlling shareholders are believed to have gained at the expense of minorities?

Q51: Have there been any controversy over the company issuing depositary receipts that were seen to have benefited mainly the major shareholders; has the company or major shareholders issued/sold shares at near peak prices without prior guidance on why the shares might be fully valued?

Q54: Has the remuneration of the board increased faster than net profit?

Appendix 3 shows those companies where the CG score was reduced by 15 points or more because of negative scoring. Of the largest 100 companies under our coverage by market cap, the biggest changes in score because of negative scoring are indicated in Figure 14. Among the companies where negative scoring reduces the CG score by 20 points or more are Kia Motor, Hyundai Motor, SK Corp, GAIL, Mega FHC and Reliance Industries. It is worth noting that because these companies score negatively on a number of the key questions, they are also generally at the lower end of our overall large-cap CG ranking.

Figure 14

Large caps in Asia ex-Japan with biggest change in score from negative scoring

Company	Change in score due to neg adj (%)	Quartile
Hyundai Motor	26.3	4
Kia Motor	26.3	4
SK Corporation	23.3	4
Reliance Industries	22.5	4
Mega FHC	22.5	4
GAIL	22.5	4
SKT	18.8	2
ICICI Bank	18.8	3
Telkom	18.8	4
Tenaga	18.8	4
Mobis	18.8	4
State Bank of India	18.8	4
ONGC	18.8	4
San Miguel Corp.	18.0	4
Baoshan I&S	17.9	4
PCCW	16.9	4
S-Oil Corporation	15.8	4
Samsung Electronics	15.0	2
United Overseas Bank	15.0	3
MISC	15.0	3
Woori Financial Group	15.0	3
Telekom Malaysia	15.0	3
KEPCO	15.0	3
Tata Motors	15.0	4
Shinsegae	15.0	4
Huaneng Power	15.0	4
China Mobile (HK)	15.0	4
IOC	15.0	4

Source: CLSA Asia-Pacific Markets

New questions in the 2004 questionnaire

The questionnaire was expanded from 57 questions to 60. Five questions were merged, ie, there are eight new questions. These were to pick up some areas that are relevant to governance, but not captured in our previous questionnaire. The new questions are enumerated below.

Eight new questions in this year's questionnaire

New questions in the 2004 company CG assessment

(Q8): Does the company have a history of restructuring, mergers, demergers or spin-offs that reflect either mismanagement, the abandonment of earlier strategies, booking of exceptional gains when operating profits are weak or an intention to hide losses?

(Q9): Is the company able to make business decisions within regulatory/legal constraints, but without government/political pressure that restricts its ability to maximise shareholder value?

(Q20): Does the company provide sufficient disclosure on dilutive instruments?

(Q21): Has the company applied for a waiver on disclosure rules of the market?

(Q33): Has the company increased/reduced the number of independent directors in the last three years?

(Q43): Does the company engage in material related-party transactions?

(Q44): Is the controlling shareholder known or widely believed to be highly geared?

(Q45): Is the controlling shareholder's primary financial interest the listed company?

Types of companies penalised in our CG score

Trade-off in objective scoring and assessing management commitment

No system of scoring is perfect as there is an inevitable trade-off between scoring companies on the formal structures of CG in place (board committees, number of independent directors, number of board meetings, reporting results and releasing annual reports within the given time frames, etc) and the questions that assess the commitment to CG (track record on treatment of minorities, effective action taken in the past to correct for mismanagement, etc). The former are the more objective assessment, but the latter are more subjective. Trying to move beyond scoring a company on just the objective formal criteria necessarily means incorporating some questions that require an element of judgement, ie, subjectivity.

26% of the score requires judgement of the analyst

In our scores, 16 of the 60 questions involve an element of judgement on the part of the analyst. In total, these questions account for 26% of the score. However, even on the more objective questions, some companies (less often, fund managers as well) would dispute the relevance of some of the questions and whether they should be marked negatively on those criteria.

Conglos, subsidiaries of other listed companies, govt-controlled entities tend to be penalised

For instance, most conglomerates would score negatively on the question on whether a company sticks to its core business. Many of these will also have material related-party transactions and be penalised on that as well. A company that is a subsidiary of a public-listed company is also disadvantaged on the question of whether the controlling shareholder's primary financial interest is the company in question. Government-controlled entities would also score negatively on this question, given that the government's main financial interest is usually the broader drivers of the economy rather than the profit of a particular listed company that it has privatised.

Is SRI part of CG?

Some fund managers may also wonder if issues under corporate social responsibility should also be assessed when scoring for CG. The SRI proponents would certainly see these as relevant in assessing the overall responsibility and integrity of management, but those who perceive CG more narrowly, focusing on sharing equally in the value created by a company, will be inclined to take such issues out of CG assessments. We have given this area a lower weight in our overall scores: 10% compared to the 15% score for other sections. However, the scores can be redone without these questions (indeed taking out any given question that one might not think directly relevant).

Questions with negative scoring typically reduce the average scores by 10ppt

Finally this year's scoring might raise controversy on the weight of the questions with negative scoring. The 15 questions with negative scoring essentially knock off 3.75 points for each question (one-quarter of the score for any of the given CG aspects subject to a minimum score on any category of zero). Theoretically, a company that scores negatively on these questions can see their scores reduced by a maximum 56 points for these questions. In practice, we find that, with negative scoring, the average score has been reduced by 9.5ppts and the maximum reduction in our total sample is 35ppts.

However, given the questions where negative scoring is applied (see page 28), it is hard to argue that a company that has scored negatively for a number of these questions should be getting much of a score anyway.

Issue of scoring accuracy

There is also the issue of scoring accuracy just as there is in forecasting. Analysts are not trained to assess on CG, and hence may not always be alert to the negative actions of a company that would have counted as a transgression. Still, we believe that with the annual CG effort that all our analysts participate in (each company is scored by the analyst that covers it, with his score cross-checked by the research head, the relevant sector head), they become more sensitive to CG issues.

Helps to identify value traps

Small differences of a few points in the scores are not necessarily a real difference in a company's actual CG commitment. Nevertheless, the scoring is an attempt to provide a ranking of which are the better companies for CG as best as we can tell, those that are around the middle, and those that are in the lower tier for CG. This information should be useful to fund managers in helping to identify the risks in his portfolio and those stocks that are value traps: cheap but, because of poor CG, likely to remain so.

The accounting and returns checklist

This year's scores also come with an accounting and returns checklist

Together with our CG exercise this year, we have also assessed the companies' financials. This is not incorporated into the CG score itself, but rather is a separate checklist to ascertain which companies have the strongest financials in the market. This accounting and returns checklist is made up by examining the following four areas.

Four key areas assessed

Quality of accounts, demands on shareholders and the P&L:

- Qualification on recent accounts by external auditors
- History of frequent capital raisings
- Increase in DPS over the last three years
- Increase in the payout ratio in the last three years
- Margins as compared to the industry
- Effective tax rate compared to the statutory rate

The balance sheet:

- Change in inventory number of days
- Percentage of debtors over six months
- Change in debtor days
- Guarantees and contingent liabilities to shareholder funds
- Total debt to shareholder funds

Cash and cashflows:

- Interest cover
- Cash to debt due within a year
- Positive FCF
- FCF ratio to net profit
- Goodwill amortisation as percentage of net profit

Return ratios:

- Change in last three years' ROE
- ROE minus cost of equity
- Projected change in ROE over next two years

Template for banks is adapted. Scores are based on a percentage

The score is then stated as a percentage for a maximum score of 100 and a minimum of 0. Figure 15 shows the table that is used for the companies other than the banks, and how the score is derived. For the banks, questions 8-10 as well as 12-16 were omitted and the scores recalibrated on the questions that did apply, to get an equivalent score from zero to 100.

Best companies have good CG and financials

In determining the best companies in which to invest, both good CG and good financials are certainly key. That, however, leaves the question of whether the market is already paying up fully for these stocks. To assess this, we look at valuations from the perspective of the implied growth factored in the share price. We derive this by subtracting the earnings yield on the stock (based on calendar 2005 earnings) from the company's cost of equity.

We use earnings yield to determine what is priced in

Just as, using the dividend discount model, the implied growth rate in dividends can be derived from the cost of equity of a company less its dividend yield, similarly the implied long-term growth rate in earnings can be shown as its cost of equity less the earnings yield. If a stock is at an earnings yield that is higher than its cost of equity, the market is pricing in negative growth, ie, declining earnings, into the future. We use the calendar-2005 earnings yield, the forward year of earnings, to gauge what share prices are implying for long-term growth beyond our forecast for the coming year. This gives a yardstick to ensure investors are not overpaying for quality.

As long as the implied earnings growth in the stock value is low enough against what is intuitively seen as the potential long-term growth for a company (or at least the growth for the medium-term that can be forecast and likely to be eventually priced in), it gives assurance that the price being paid on the stock is reasonable. In each of the country sections that follow, this is used to indicate the stocks that are priced attractively.

Figure 15

Accounting and returns checklist

Q	Checklist	Criteria
1	Appetite to raise funds	>2x in last 3 yrs =-2; Infrequently = 0; Never in 5 yrs = 2.
2	Qualification of accounts by auditors	Qualification of accounts in any of last 3 years = -2. No qualifications = 0.
3	Non-op income (incl. associates) as % of PBT	<20% = 2; 20-30% = 0; >30% = -2.
4	FY03 DPS / FY00 DPS (x)	<1 = -2; 1 = 0; 1-1.1 = 1; >1.1 = 2.
5	FY03 payout ratio/ FY00 payout ratio (x)	<1 = -2; 1 = 0; >1 = 2.
6	Ebitda % compared to industry average	Significantly different = -2; around industry average = 0.
7	Effective tax rate / corp tax rate	< 0.8 of corp tax rate = -2; 0.8 or above of corp tax rate = 0. If effective tax rate is positive, ie net tax writeback to boost earnings = -2.
8	Inventory (no of days) % chg YoY	Increased yoy by > 15% = -2; increased between 0 - 15% yoy = 0; declined yoy = 2.
9	Over 6 mths debtors / total debtors (%)	<10% = 2; 10-25% = 0; > 25% = -2.
10	Debtor (no of days) % chg YoY	Increased yoy by > 15% = -2; increased between 0 - 15% yoy = 0; declined yoy = 2.
11	Guarantees provided plus contingent liabilities / shareholder funds (%)	40% or more = -2; Less than 40% = 0. For banks = 0.
12	Total gross debt / shareholder funds (%)	>70% = -2; 35 - 70% = 0; 0 - 35% = 1. Net cash = 2.
13	EBIT /(interest expense + int capitalised) (x)	>4x = 2; 3-4x = 1; 2-3x = 0; 1.5-2x = -1; < 1.5x = -2.
14	Cash & bank balance / 1-yr fwd debt repayment (%)	> 80% = 2; 50 - 80% = 0; <50% = -2.
15	FCF (CF after WC and capex)	> 0 = 0; < 0 = -2. (ie negative FCF is -2)
16	FCF / net profit (%)	< 60% = -2; 60 - 75% = -1; 75-85% = 0; 85-95% = 1; >95% =2.
17	Goodwill amortisation / net earnings (%)	0 -5% = 0; 5-10% = 1; >10% = 2.
18	FY03 ROE/ FY00 ROE (x)	<0.95 = -2; 0.95-1.05 = 0; >1.05 = 2.
19	ROE - COE (%)	>1ppt = 2; 0 - 1 ppt = 1; -1 to 0 ppt = -1; < -1 ppt = -2.
20	FY05 ROE/ FY03 ROE (x)	<0.95 = -2; 0.95-1.05 = 0; >1.05 = 2.

Source: CLSA Asia-Pacific Markets

Large caps with good financials and attractive valuations

For the largest companies in our universe, the table below shows the top-30, and gives the A&R checklist score, earnings yield on calendar 2005 earnings and the implied growth in the stock values. From these better-CG companies, and with good financials, those that are factoring low or negative earnings growth into the future that stand out are TSMC, Siam Cement, ST Engineering, StanChart, Hana Bank, UMC, DBS Group and KT&G. These companies, attractively valued in the current subdued market sentiment, but with good CG and solid financials, are likely to provide strong returns over the medium term and rate as BUYs/Outperforms.

Other high-CG big caps that appear to be at undemanding valuations on our FY05 estimates, but currently have negative ratings, include CLP, HSBC, Kookmin Bank and KT Corp (implied earnings growth less than 3% to negative into the future). Among the other high-CG large caps, we have positive recs on Esprit, Infosys, Wipro and Public Bank, but with each of these stocks, the market is already pricing in long-term growth of between 4% and 9.5%, arguably already reflecting the quality of management and CG.

Of the large caps, the low CG score reaffirms our negative recommendations on Kia Motor, San Miguel, State Bank of India, PCCW, China Unicom, China Mobile and Huaneng Power.

A number of high-CG companies from Korea, Taiwan and Singapore are at low implied growth

Figure 16

Large caps with high CG and financials score, and implied growth

Company name	Country	Cal 05 yield (%)	Implied earnings growth (%)	A&R Score	Rec
CLP Holdings	Hong Kong	8.3	1.7	69.1	SELL
Esprit Holdings	Hong Kong	5.7	4.3	95.6	BUY
HSBC	Hong Kong	7.2	2.8	57.4	U-PF
Infosys	India	5.2	9.0	94.1	BUY
Wipro	India	4.7	9.5	85.3	BUY
Public Bank	Malaysia	6.2	4.8	72.1	O-PF
Kookmin Bank	Korea	11.9	(0.9)	38.9	U-PF
KT	Korea	15.5	(4.5)	60.3	U-PF
TSMC	Taiwan	10.8	(0.8)	60.3	BUY
SCC	Thailand	10.8	0.4	63.2	BUY
ST Engineering	Singapore	6.3	2.2	70.0	O-PF
StanChart	Hong Kong	7.1	2.9	63.2	O-PF
Li & Fung	Hong Kong	6.4	3.6	58.8	U-PF
HDFC	India	8.6	5.7	72.2	BUY
BAT	Malaysia	5.8	5.2	67.6	U-PF
Maybank	Malaysia	7.0	4.0	67.6	O-PF
Maxis	Malaysia	7.3	3.7	57.4	BUY
Hana Bank	Korea	17.0	(6.0)	69.4	O-PF
Samsung Fire & Marine	Korea	8.6	2.4	80.6	U-PF
UMC	Taiwan	11.3	(1.3)	66.2	BUY
OCBC	Singapore	6.7	1.8	64.7	U-PF
DBS Group Holdings	Singapore	6.9	1.6	56.0	O-PF
HK Electric	Hong Kong	9.5	0.5	35.3	SELL
Johnson Electric	Hong Kong	4.9	5.1	55.9	SELL
Hindustan Lever	India	6.7	7.5	80.9	BUY
Bharti	India	6.3	8.0	61.8	BUY
POSCO	Korea	22.8	(11.8)	72.1	BUY
KT&G	Korea	13.8	(2.8)	83.8	O-PF
Samsung Electronics	Korea	22.4	(11.4)	76.5	BUY
Shinhan Financial Group	Korea	17.1	(6.1)	63.9	O-PF

Source: CLSA Asia-Pacific Markets

Hui Li
hui.li@clsa.com
(852) 26008590

China – Measurement problems

Incremental improvements in CG made in 2003 and 1H04

In 2003 and 1H04, corporate-governance developments in China focused on improving and broadening information disclosure among domestic listcos. This supplemented a solid platform laid down in January 2002, when the China Securities Regulatory Commission (CSRC) and State Economic and Trade Commission (SETC) promulgated the Corporate Governance Guide for Chinese Listed Companies. However, corporate governance remains a work in progress in China.

Private enterprises have had their share of governance issues

Credibility and related corporate-governance issues of HK-listed China private enterprises have remained a major talking point over the past year. Highly publicised cases, where the company's senior management has faced regulatory investigations, include Shanghai Land, Far East Pharmaceutical and Wah Sang Gas. Analysts raised doubts about the honesty of Asia Aluminium's management after it gave a very optimistic earnings guidance prior to offering secondary equity - which the company then missed by a wide margin when it announced FY03 results.

SOEs' governance continues to improve

For HK-listed, state-owned and state-affiliated enterprises, however, corporate transparency and investor communication have generally continued to improve. Leaders here include the transportation (aviation, expressways and ports) companies, who voluntarily disclose monthly operating data. Despite its growing pains in the international equities market since its listing, China Life has shown an inclination to heed analyst requests and improve information disclosure. The main governance issues for SOEs remain the inherent conflict of interests between state and minority shareholders, as well as on related party transactions.

Domestic market governance is evolving

For listcos in the domestic A- and B-share markets, the promulgation of new regulations by the CSRC and other PRC regulatory bodies since 2001 has led to a solid corporate governance infrastructure, with information disclosure comparable to international accounting standards. However, it is still doubtful whether many listcos prioritise shareholder returns and accountability in every aspect of their decision-making. Overall, the enforcement of governance regulations remains more reactive than proactive (ie, after a violation has become public knowledge), although this appears to be changing. The PRC government recently initiated an audit of the most senior management of nine of its large SOEs, including CNOOC, Sinopec, China Unicom and China Netcom, as an example. However, the execution of the auditing result remains to be seen.

Delong's blow-up signals domestic governance has a way to go

The recent blow-up of A-listed, private-sector conglomerate Xinjiang Delong, which reportedly misappropriated US$725m in funds via aggressive acquisitions, over-leverage, poor risk management and questionable legal behaviour, signals that domestic corporate governance still has a way to go. However, we believe a repeat collapse of a company of Delong's scale is unlikely in the near future.

Self-governance rules - Our top picks cover the main share classes

Mixing strong relative corporate governance and valuations, our top picks include Anhui Conch, China Pharmaceutical, Hengan International, Zhejiang Expressway and Zhenhua Port Machinery. This is a broad mix of two H shares, and one each of red chips, private enterprise and an A/B dual-listed company, who have demonstrated a commitment to corporate governance beyond the regulatory requirement. Correspondingly, avoid First Tractor, Huadian Power, Angang Steel until governance improves.

Regulatory environment & the CLSA/ACGA country CG score

Domestic CG has improved significantly in recent years

The most rapid corporate-governance improvements in China in recent years have been made in the domestic market. In 1Q02, the CSRC introduced quarterly reporting, moving in front of Hong Kong where the current requirement is only for half-year announcements. In January 2002, the CSRC and SETC also promulgated a Corporate Governance Guide for Chinese Listed Companies covering the important issue of (minority) shareholder-interest protection, as well as ethics and codes of conducts for senior management. A raft of new regulations covering corporate governance and related issues has since been announced by regulators.

CSRC focused on regulating additional information disclosure in 2003 and 1H04

In 2003 and 1H04, the CSRC focused on improving and broadening information disclosure by listed companies as an extension of the solid platform set by the Corporate Governance Guide. They include additional reporting on the top-ten free-float shareholders, provisions, abnormal income and losses, related-party transactions and asset revaluations, via yearly or timely disclosure.

Supervision and enforcement remain inadequate . . .

As explained previously, however, China is not lacking a solid set of regulations. Rather, its concerns stem more from still inadequate supervision or enforcement of these regulations, as well as top-level senior-management education on shareholder protection and returns focus – either as a SOE with an inherent conflict of interest or a private enterprise with a family-dominated management structure.

. . . particularly for private enterprises

Supervision of overseas-registered private enterprises operating in China, in particular, remains in a grey regulatory area. The scandals of 2002 – Euro Asia's collapse and the auditing of Chaoda's accounts – have continued into 2003 and 1H04, with everything from mismanagement to outright scandal at Shanghai Land, Far East Pharmaceutical, Wah Sang Gas and Asia Aluminium.

Issues at SOEs are relatively minor

For Hong Kong-listed SOEs, corporate-governance concerns are much less in comparison. However, they still include a learning curve for the former managers of state assets to understand their responsibilities to minority investors in terms of rights protection, transparency, investor communications, as well as the prudent use of capital. Admittedly, part of the corporate governance issues for SOEs are related to the split between ownership and management, and the lack of a mandate for investment decisions and management remuneration, hence less accountability for their assignments. A proper guidance of investor expectations would have alleviated the 20-30% share-price plummet TravelSky Technologies and First Tractor experienced on the day they announced their 2003 annual results, as the poor results could be explained rationally.

Governance requires better-educated retail investors

On the other side of the governance equation, we believe more needs to be done domestically to educate retail punters on the proper concepts of investing as opposed to gambling in the market. Currently, the A-share market rewards listings with small size and low liquidity (and those companies tightly held by market makers) with high valuations – which does not help to promote or reward good governance.

Securities industry also needs further regulatory breakthroughs

As evidenced by the recent investigations into the domestic brokerage practice of "unapproved borrowing" of client funds while parked with the brokerage, and the "unapproved collateralising" of clients' bond securities and the funds generated for the house's own trading activities - commonplace at domestic securities house - more regulations are needed in the securities industry as well. This is in the process of being rectified with the promulgation of the:

- Investment Fund Law effective June 2004 – Designed to protect investors and their underlying assets by setting out in detail the eligibility and fiduciary responsibilities of the participants, the structure and operations of securities investment funds and disclosure requirements; and
- Provisional Measure Regarding the Sponsorship Scheme for Stock Offering and Listing effective December 2003. This sponsorship scheme replaces the old verification scheme, and holds the major underwriter of a listed company accountable for the financial statements and information provided to investors in the IPO prospectus.

Figure 17

China ratings for macro-determinants of corporate governance

	Rating (1-10)	2003 rating	Comment
Rules & regulations	5.3	5	Slightly higher score from last year on our new methodology.
Enforcement	4.2	4	Similar score as last year.
Political & regulatory environment	5.0	5	Unchanged from last year.
Adoption of IGAAP	7.5	5	International accounting standards being incorporated, score raised from last year.
Institutional mechanisms & CG culture	2.3	3	Scores weakly with a lower score based on our criteria for this year.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

CG stars

CG scores highly influenced by listing location

In determining the Corporate Governance scores for our CLSA China universe coverage, we find the survey questions skew the results, depending very much on where a given company is listed. The varied listing locations of the companies (Hong Kong, mainland China and the US, mainly for technology companies), lead to correspondingly different listing rules and regulations. Inconsistencies here naturally skewed the results given the survey set-up - for example, the US-listed companies in general scored higher as they are most closely aligned with the international financial reporting standards – but this may not reflect a higher real commitment to good CG compared to other mainland companies.

As importantly, issues such as shareholder returns, the appropriateness of fund-raising activities and whether the Chinese listcos merely pay lip-service to the CG criteria or fully embrace the spirit behind the rules, will need to be independently judged, given the developmental stage of China's equity markets and inherent conflict of interest between state shareholders and minority interests. Matters such as whether a remuneration committee exists and the amount independent director pay as percentage of company profits are rather meaningless for the state-owned enterprises where management lacks material decision-making responsibilities covering such issues.

Conch – Excellent transparency for a SOE

Anhui Conch is the largest and the most profitable cement maker in China. With full-scale support from its state-owned parent company, the listco has good access to technology and financial resources, but does not carry with it the low efficiency and poor transparency issues common to traditional SOEs. The company has also made significant improvements in investor communications.

CTrip – Tighter Nasdaq listing rules

CTrip.com. Chinese tech companies trading on the Nasdaq have a different corporate-governance structure from the traditional SOEs. Take Ctrip as an example. Venture-capital firms demanded board seats before writing a check to the management team. Now only two out of seven board members come from management. The stricter disclosure requirements of the Nasdaq also make the company better than some Hong Kong-traded companies. For example, quarterly reporting is compulsory. The company also gives out an earnings outlook and detailed operating numbers to help investors understand their business.

Hengan – Most transparent private enterprise with a long listing record and easy access to management

Hengan International – Hengan is the largest domestic-personal hygiene product manufacturer in China. In terms of sales value, it ranks second after P&G in China's sanitary napkin industry and comes first in the high-end tissue paper industry. With a long-listing track record and easy access to management, which is forthcoming on its weakness in the highly competitive consumer sector, Hengan stands out from other mainland private enterprises, where corporate governance is a big issue. Hengan is known to provide good guidance on its business growth outlook.

TCL – Volunteers quarterly reporting

TCL - Investors and analysts have easy access to management. Monthly shipment numbers are disclosed to update investors on the business. There's no quarterly reporting requirement in the Hong Kong market, but TCL volunteers quarterly results to investors. Although the company's frequent corporate-finance transactions may raise the concerns of the investment community, TCL is one of the better CG companies among China's consumer durable plays.

ZJE – Solid track record of investor comments and meeting return targets

Zhejiang Expressway has had a solid track record of good communication with the investment community and has been meeting growth, investment return and acquisition targets since its listing in 1997. Its timely monthly operating data release and frequent interactions with the investment community and high transparency make it one of the most reliable blue chips in the China universe. It was selected as "Best Under a Billion" among Forbes Global's 200 Best Smaller Companies for 2003.

ZPMC – Global orientation fuels better understanding of international practice

Zhenhua Port Machinery is an A/B-share dual-listed company with a strong record of corporate governance, perhaps enhanced by its integration with international best practices by virtue of selling an export-oriented product with a 50% global market share. It fulfils all the necessary disclosure requirements in a timely manner, communicates with investors frequently, and is very honest, even about its shortcomings (including detailed explanations of why it paid out a sale discount in its 2003 annual report).

Our top quartile picks (alphabetical order) are Anhui Conch, China Pharm, Hengan Int'l, Zhejiang Expressway and Zhenhua Port Machinery

Figure 18

Stocks in the top two quartiles for China (CLSA coverage)

Top quartile	Second quartile
Anhui Conch	Anhui Expressway
Beijing Airport	Beijing Capital Land
Chalco	BYD Company
China Fire Safety Ent	China Overseas Land
China Pharma	China Vanke
Ctrip.com	CNOOC Ltd
Hengan Intl Gp	Datang Intl Power
Lianhua Supermarket	Global Bio-Chem
Linktone Ltd	Hainan Meilan Airport
Netease	Jingwei Textile Machinery Co
PetroChina	Lenovo Group
Sinopec	Sina.com
Skyworth Digital Holdings	Tsingtao Brewery
TCL International	UTStarcom
Wumart Stores	Weichai Power
Zhejiang Expressway	Weiqiao Textile
Zhenhua Port Machinery	

Source: CLSA Asia-Pacific Markets

Corporate-governance disappointments

China Life – Growing pains as new listing, but improving

China Life - China Life has experienced growing pains since listing in late 2003. The company has been questioned for the way it severed operations for the IPO and disappointed analysts during the 2003 annual results briefing for inadequate disclosure on information necessary for investors' to better value the company. These included a detailed breakdown of new business, an update on actuarial valuation and its key assumptions and sensitivity analyses. However, recent meetings with management lead us to believe that it is aware of these shortcomings, and will be willing to provide improved disclosure to meet analysts' expectations.

Delong – 2004's major blow-up case

Delong - Xinjiang Delong, a private-sector conglomerate run by Tang Wanli, is reported to have misappropriated at least US$725m in funds, via its business model of (fictitious) growth funded through acquisitions, via borrowings through its listed/affiliated companies and its acquired banks and securities houses. The model, dependent on a series of increasingly spectacular deals or acquisitions to fool investors that the company is growing, collapses when the deal momentum slows down and investors take a closer look at cashflows, etc.

In Delong's case, the company violated good corporate governance on many fronts. It acquired stakes in several thinly trade A-share companies in 1996 and propelled their share prices to unprecedented highs (such that investors would be tempted to join the bandwagon), then collateralised the stocks and used the funds generated for further acquisitions. Deal details are withheld from investors, while a particular newspaper report estimated that not more than five people knew the exact financial circumstances of the company. Delong also has billions of Rmb missing from its balance sheet, which has caused alarm given its network of loans and loan guarantees with 40 listed companies and many more unlisted companies.

FEP – Little regard for minority rights

Far East Pharmaceutical - Private enterprise Far East Pharmaceutical's share priced dropped 92.44% on 17 June, 2004 alone, as 140 million of its 564m collateralised shares (25% of total shares outstanding) at Guotai Junan Securities were sold off on rumours that its chairman was missing. Nearly a month later, it was found that the chairman and four senior managers were arrested by the Fujian police for fraud, including the illegal printing of value-added tax receipts and tax evasion.

In addition, Far East Pharmaceutical, despite being cash-rich on the balance sheet, pursued a string of fund-raising activities that included share placements and convertible-bond issues. These activities, together with the exercise of employee-share options, resulted in substantial EPS dilution. The company's strong financial numbers, including ROE and net margin, as well as its clean balance sheet, appear too good to be true.

Shanghai Land – Stock market fraud and illegal acquisition of state land & bank loans

Shanghai Land - Shanghai property tycoon and private enterprise Shanghai Land's chairman Zhou Zhengyi was sentenced to three years in jail in June 2004 for stock-market fraud and falsifying registered capital reports. Zhou was earlier under investigation for illegally acquiring state land and bank loans, from among others the Bank of China. Shanghai Land Holdings Ltd, 75%-owned by Zhou's New Nongkai Global Investments, plummeted by nearly half before its shares were suspended on 2 June 2003.

The allegations attached to Zhou began when a group of Shanghai residents accused him of colluding with local officials to evict them from prime land in the city's posh Jing'an District without fair compensation, and securing a 43,000 square metre (463,000sf) city plot for free. The company also used the equities of three A-listed companies it held indirectly via Nongkai as collateral for a loan, to speculate on the share market.

TSK – Lacking transparency and investor guidance

TravelSky Technologies - TravelSky's investor relations department has room for improvement, included transparency and a lacklustre effort to guide the investment community on its profitability outlook. The company gave a one-off Rmb120m discount to the airlines in 2003, but failed to disclose it prior to its annual results announcement, leading to a final result 40% below consensus. In addition, despite being cash-rich, with net cash of Rmb2.5bn without any apparent capex needs, the company has steadfastly refused to increase its payout beyond 40%. However, management has recognised that its corporate governance needs improving and has said it is taking appropriate actions. A similar story could be said for First Tractor, in terms of poor investor communications and guidance, and a high cash balance.

WSG – Under SFC investigation, although exact reasons unclear

Wah Sang Gas - Trading in private-enterprise Wah Sang Gas has been halted since December 2003 when it became known that the company was under SFC investigation. The exact details for the investigation are still unknown – the company stated operational reasons, the local press cited issues with individual management, while delays in annual and quarterly result releases dates might have also had an effect, although the company's chairman is currently being held by the police for violations to do with foreign-exchange management. The whereabouts of its subsidiaries' funds are also being investigated.

Furthermore, the company's auditors also resigned in the middle of a share-offering plan prior to the share suspension, which would have otherwise raised HK$150m for expansion. This secondary offering is now on hold indefinitely.

Financials checklist

Companies with better financials tend to be defensive or industry leaders

Companies coming out at the top of the financials checklist tend to be defensive companies – expressways, port operators, airports, and large-cap industry leaders such as PetroChina and Sinopec. Those coming in the bottom quartile come from across sectors, but they tend to include those with weaker fundamentals. These include Beijing North Star, China Resources Land and Guangzhou Investment in property; Shenzhen Expressways and GZI transport in roads; Huadian Power in IPPs; with the two listed airlines both included as well.

PetroChina, Sinopec, Zhejiang Expressway, Nasdaq-listed CTrip.com and Beijing Airport were the only companies in the top quartile of both the financials and CG checklist. Huadian Power was the only company that came in the bottom quartile for both the financials and CG checklist.

Relative performance of stocks sorted by CG

High-CG stocks tend to be low-beta defensive plays

Stock performance was measured for the intervals of one, three and five years to the end of June 2004, which follows the weak performance of the market for the half-year period to the middle of this year.

The relative performance of stocks in the top CG quartile outperformed the other quartiles for the one- and five-year horizons, while the second quartile had the best performance for the three-year horizon. The reasons for this are the short history of most of China stocks under coverage (most do not have a five-year history) and our method of using simple-averages instead of market-cap weighted averages.

Our CLSA China World Index showed the lowest performance as it was market-cap weighted, and taking into account the impact of large caps such as the telecoms, had low relative performance.

First-quartile relative performance strong for 3-year timeframe

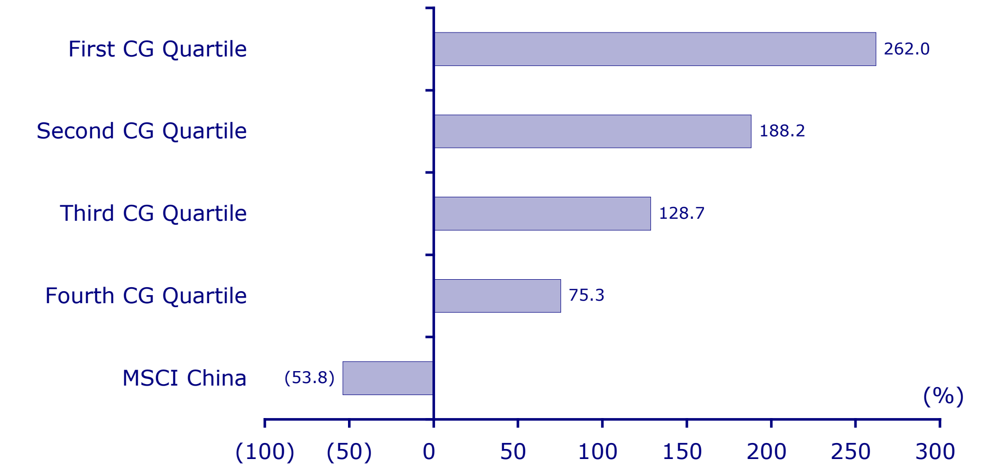
Figure 19

Stock performance of CG quartiles

(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	78.5	136.5	262.0
Second CG quartile	33.3	548.3	188.2
Third CG quartile	57.9	61.6	128.7
Fourth CG quartile	37.6	64.2	75.3
Average of all quartiles	51.8	202.6	163.5
CLSA China World Index	36.1	20.5	13.4

Figure 20

Five-year stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

Companies making efforts to improve CG

No noticeable out/underperformance for stocks where CG score changed

High CG stocks tend to be low-beta defensive plays

There is no noticeable systematic outperformance or underperformance for stocks where CG improved or fell over the last year, although clearly when news was released that raised concerns over corporate governance or fraud, the particular stock took a big hit. While our new scores, which are different based methodology from last year, make comparisons difficult, we can use the increase in independent directors over the last three years (one of the questions in our survey) to indicate which companies are putting more resources into CG. For China, the list is not long, as represented in Figure 21 which, other than the recently listed China Telecom, extends to five other companies. For none of these companies has the number of independent directors risen above half of the total board.

Other than recently listed China Telecom, only a handful of companies have increased independent directors in recent years

Figure 21

Companies that have increased number of independent directors

	Increase in independent directors in last 3 years	Independent directors more than 50% of board?
China Telecom	3	N
China Unicom	2	N
Huaneng Power	2	N
China Pharma	1	N
Hengan Intl Gp	1	N
Tsingtao Brewery	1	N

Figure 22

Negative CG differentiators

Q5 Dilute EPS through options etc	Q25 Without perceived safeguards in audit committees	Q43 Material related-party transactions	Q44 Controlling shareholders believed to be highly geared	Q54b Directors' remuneration rose faster than NP in past five years
Angang New Steel	Brilliance China	Angang New Steel	Datang Intl Power	China Resources Ent
Baoshan I&S	China Mobile (HK)	Baoshan I&S	Great Wall Automobile	Shanghai Industrial
Beijing Airport	China Res Power	Brilliance China	Huadian Power	Tong Ren Tang
Beijing Capital Land	China Shipping Dev	China Eastern Airlines	Huaneng Power	CNOOC Ltd
Beijing North Star	China Telecom	China Merchants		PetroChina
Chalco	China Unicom	China Resources Ent		Sinopec
China Eastern Airlines	Datang Intl Power	China Shipping Dev		Huadian Power
China Merchants	Great Wall Automobile	China Southern Airlines		TravelSky
China Mobile (HK)	Huadian Power	CNOOC Ltd		
China Resources Ent	Huaneng Power	Conch		
China Southern Airlines		Denway Motors		
China Telecom		First Tractor		
China Unicom		Global Bio-Chem		
China Vanke		Great Wall Automobile		
Global Bio-Chem		Guangzhou Inv		
Guangzhou Inv		GZI Transport		
GZI Transport		Hainan Meilan Airport		
Jiangsu Expressway		Maanshan Iron and Steel		
Jiangxi Copper		PetroChina		
Jingwei Textile Machinery		Shanghai Industrial		
Linktone Ltd		Sinopec		
Shenzhen Expressway		Tong Ren Tang		
Sina.com		TravelSky		
Skyworth Digital Holdings		Weichai Power		
TCL International		Weiqiao Textile		
Tong Ren Tang				
Tsingtao Brewery				
UTStarcom				
Weichai Power				
Wumart Stores				
Yanzhou Coal				

Source: CLSA Asia-Pacific Markets

Figure 23

Positive CG differentiators

Q23 Independent non-executive chairman	Q31 Independent directors nominated by minorities	Q32 INEDs make up more than half the board	Q33 Increased no. of independent directors since 2000	Q48 Cumulative voting for board representation
Ctrip.com	None	BYD Company	Anhui Expressway	None
Linktone Ltd		Conch	Beijing Capital Land	
UTStarcom		Jingwei Textile Machinery	Beijing North Star	
		Lenovo Group	China Pharma	
		Netease	China Unicom	
		Skyworth Digital Holdings	Guangzhou Inv	
		TCL International	GZI Transport	
		UTStarcom	Hengan Intl Gp	
			Huaneng Power	
			Jiangsu Expressway	
			Tsingtao Brewery	
			Zhejiang Expressway	
			Zhenhua Port Machinery	

Average director's remuneration is 1.4% of net profit

Figure 24

Q54a – Directors' remuneration

Directors' remuneration/company net profit average for China sample - 1.37%			
Companies with highest directors' remuneration/net profit in 2003 (%)			
First Tractor	6.1	Global Bio-Chem	4.3
GZI Transport	5.3	Shanghai Industrial	2.9
Guangzhou Inv	5.2	China Overseas Land	2.7
Beijing Capital Land	4.5	Lenovo Group	2.6
Brilliance China	4.4	Hengan Intl Gp	1.9
Companies with lowest directors' remuneration/net profit in 2003 (%)			
PetroChina	0.002	China Mobile (HK)	0.051
Sinopec	0.015	Jiangsu Expressway	0.053
China Telecom	0.023	CNOOC Ltd	0.096
Huaneng Power	0.048	Baoshan I&S	0.104
Great Wall Automobile	0.049	Huadian Power	0.117

Source: CLSA Asia-Pacific Markets

CG picks

CG picks have a consumer or "people" bias

Companies in the top-CG quartile with a mix of reasonable A+R score and implied earnings growth predominately come from the consumer sectors. These include China Pharma, Hengan International, Netease, Skyworth Digital and Zhejiang Expressway. Large-caps PetroChina and Sinopec are also picks thanks to their high A+R scores, despite lower implied earnings growth given the already high oil prices.

Figure 25

Top CG companies – Financials and valuations

	CG quartile	A+R score	Implied earnings growth (%)	Rec
China Pharma	1	60.3	(4.9)	O-PF
Hengan Intl Gp	1	51.5	1.4	BUY
Netease	1	55.9	5.7	BUY
PetroChina	1	63.2	0.1	BUY
Sinopec	1	66.2	(1.4)	BUY
Skyworth Digital Holdings	1	48.5	0.9	O-PF
Zhejiang Expressway	1	70.6	1.6	O-PF
Zhenhua Port Machinery	1	50.0	1.5	BUY
CNOOC Ltd	2	51.5	4.9	O-PF
Datang Intl Power	2	61.8	2.1	BUY
Global Bio-Chem	2	52.9	4.1	BUY

Source: CLSA Asia-Pacific Markets

Companies in the bottom corporate-governance quartile, with a mix of average A+R score and implied earnings growth, and a negative recommendation include Huadian Power, First Tractor, China Resources Enterprise and Angang New Steel.

Amar Gill
amar.gill@clsa.com
(852) 26008593

Hong Kong – Consultation on consultation

New SFO amendments next year promise to be a major change

While new listing rules introduced earlier this year give some added comfort to investors, more meaningful changes are likely to come in the amendments to the Securities and Futures Ordinance, set to be tabled in Legco next year. Other countries have put already in place much tougher regulations in the last few years, Hong Kong has been relatively slow, partly owing to the lengthy consultation periods, consultations held on the consultations, and so on . . .

Companies CG - A wide range

Some of the companies nevertheless have CG standards comparable with companies anywhere else in the world. HK Exchange, itself a public listed company, has an independent director in David Webb, who is undeniably independent and appointed by minorities. In earlier years, Mr Webb championed the creation of a minority shareholder activist group. CG at companies like CLP, Esprit, HSBC, StanChart and Li & Fung are world-class. At the bottom of our rankings are property companies, whose scores have been penalised because of the Hong Kong accounting standard on property provisions/revaluations, which are inconsistent with international standards. Many are also mini-conglomerates, which the CG-scoring system also penalises. PCCW is close to the bottom of the CG scoring, dogged by issues of disclosure from last year.

Perceived CG issues at the banks

One of the most controversial transactions from a CG perspective is the flotation of Dah Sing Bank, which some investors have seen as disadvantaging them for the sake of the family maintaining control. However, the controlling family was also diluted in the spin-off, and unlike minorities did not get the upside from the option to subscribe for shares in the separately listed bank. BoC-HK is also dogged by legacy problems that have resurfaced for the second year in a row.

Concern over cheap privatisations will abate as market rises

The key issue for investors in the early part of last year was the privatisation proposals that were seen as pricing assets at a discount to their underlying value, which the controlling shareholders had a better position of assessing than the minorities. Nevertheless, all the privatisation bids of these bigger listed companies failed to get enough votes at the EGM, a positive in terms of investors being able to reflect their views (which may have been less certain in other markets where controlling shareholders may have used proxies to swing the vote). With the market recovering, the earlier concern over cheap privatisations should now ease.

Regulatory environment and CLSA/ACGA country CG score

HK still ranks second on our macro-CG criteria for markets in the region

Under the more rigorous ranking system for the macro scores this year, there is a dip in the score on rules and regulations, as well as on institutional mechanisms and the acceptance of CG in the business culture - there is a shallower decline in the score on enforcement. The score for adoption of international accounting standards remains unchanged, while the country score for political and regulatory environment has moved up. Overall, like last year, Hong Kong ranks second among the countries that we rated, behind Singapore.

Figure 26

Hong Kong ratings for macro-determinants of CG

	Rating (1-10)	2003 rating	Comment
Rules & regulations	6.6	8.0	Lower score based on new scoring criteria. Still lacks advanced financial disclosure rules.
Enforcement	5.8	6.5	Slightly reduced score on the new criteria. Weak involvement of investors in exercising their rights.
Political & regulatory environment	7.5	6.5	Higher score achieved in the more rigorous new scoring criteria. Gained from recent improvements to regulatory structure.
Adoption of IGAAP	9.0	9.0	Unchanged from prior year score.
Institutional mechanisms & CG culture	4.6	7.0	Reduced score on the more rigorous criteria. Falls due to ambivalence of companies, lack of investor activism, unengaged reputation intermediaries.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Rules and regulations can be improved

The areas under rules and regulations where Hong Kong does not meet the best standards include the fact that companies are not required to report annual results within two months; reporting deadlines have not been shortened in recent years; quarterly reporting is not mandatory; only recently have audit committees been made mandatory, but nomination and remuneration committees are not required by the regulations (indeed some of the largest companies do not have them); and class-action suits are not part of the legal system (while there have been some changes encouraging derivative action suits, in practice these will likely remain expensive, with the investors not directly able to get any compensation even if they successfully pursued this route).

CG culture not as strong as might be perceived

The score for CG culture and institutional mechanisms has also fallen given the lack of effort by "reputation intermediaries" – eg, investment banks, accountants and lawyers to promote high CG standards in clients about to be listed (for most it would run counter to gaining business from mainland companies with chequered records coming to the market); neither institutional investors nor retailers have formed their own CG activist organisations (the Webb initiative for a minority shareholder CG group is now dead), nor have any CG focus funds been formed. The efforts by listed companies on CG seem still mainly to be a matter of generally conforming to minimum standards rather than truly embracing the spirit of good CG, while investor relations have not seen major improvements with regard to more regular meetings, quality of communication and online disclosure.

Private enforcement largely absent

For enforcement, the score is slightly lower than last year under our more rigorous methodology given that minority shareholders do not in practice nominate independent directors, activists are not willing to launch lawsuits against companies and/or directors given the prohibitive cost and poor cost-reward equation; while some investors vote, but most do not attend company AGM/EGMs, except for matters involving privatisations (see below).

Score for political and regulatory environment has moved up

However, by our scoring criteria for the political and regulatory environment, Hong Kong's score has moved up. Here the main regulator – ie, the SFC - is pretty much independent of the government (it is not part of the finance ministry, and able to think for itself). Both securities laws and the listing rules of the exchange have been amended to enhance minority shareholder protection. The judiciary is certainly capable of handling these disputes (unlike other jurisdictions where this can be an issue), and the media is quite free to report on CG abuses.

New accounting standards will cause earnings volatility

Controversy in accounting for property provisions and revaluations

On the adoption of international accounting standards, Hong Kong continues to score highly. The one area where there is controversy on accounting standards relates to property companies. The Hong Kong accounting standard has allowed property companies to generally take changes on revaluation of their properties through to reserves on the balance sheet without charging through the P&L, so long as there is a sufficient positive surplus accumulated on reserves against which to charge provisions. Only Hong Kong Land follows the international standard, which requires all such charges and revaluations to be taken through the P&L. Thus most of the property companies have scored negatively on adoption of international accounting standards, which is a "negative scoring" introduced into our methodology this year. The property companies have thus moved down in our rankings this year almost entirely because of a change in the scoring system rather than any real slippage in their governance standards.

Next year, the accounting standard will change

There is controversy whether the surpluses or charges for property revaluation going through the P&L is the right way to present the accounts: it will lead to much greater volatility in reported earnings that become subject more to capitalisation rates and the current business environment on the companies' overall assets rather than reflecting the profitability of operations. However, this debate becomes moot from next year. New accounting standards for Hong Kong will follow IAS and require the property companies to take all such charges/revaluations through the P&L.

Other accounting changes coming through next year will also require the marking to market of all securities held, including derivatives, which will lead to greater volatility in reported earnings, particularly for the banks.

New accounting standard also on goodwill amortisation . . .

The new accounting standards will, however, allow greater flexibility in amortising goodwill: if it is deemed that there is no impairment in the value of the intangible asset, then it need not be expensed. This is likely to mean that most of the goodwill on acquisitions will remain on the balance sheet indefinitely, and might even encourage M&A activity for Hong Kong companies, as they will not have to worry as much about presented accounts post acquisitions if goodwill need not be amortised.

. . . and expensing options

Another major change from next year is that companies will have to expense options issued. It is worth noting that options issuance is not a major problem for Hong Kong companies. Controlling shareholders who also run the business are not inclined to dilute their interests by issuing options to professional management. Hence, the major companies - including practically all the developers, including Cheung Kong as well as Hutchison and other conglomerates, and the power companies - do not issue options.

Many companies will see the accounting standards offset each other

The bigger listed companies that do issue options to management are PCCW, Li & Fung, Esprit and HSBC. Interestingly, these companies also have sizeable goodwill on the balance sheet that they amortise annually, and thus will have the benefit next year of not having to continue with the goodwill expense, which for most of them will offset the options expense that they will start to record. Most have come out to say that they will not change their policy on issuing options.

HK Exchanges' new listing rules

New listing rules

With effect from 31 March 2004, new listing rules have come into force after an earlier period of consultation. The most significant new regulations are:

- The minimum number of independent non-executive directors increases from two to three, of which at least one must have appropriate professional qualifications, accounting or related financial management expertise.
- Additional guidelines introduced to assess the independence of directors.
- Audit committees are made mandatory (until this March they were not in Hong Kong, although most listed companies had them), and these committees will have to appoint a qualified accountant to ensure that proper financial reporting procedures and internal controls are in place, and listing rules with regard to financial reporting and accounting-related issues are followed.
- A new category of notifiable transaction is created, called "very substantial disposal", on these shareholders will be given an opportunity to exercise voting rights and express views at a general meeting to approve such transactions.
- Another new category of notifiable transaction is being created for reverse takeovers to deal with backdoor listings.
- Disclosure obligations have been added to introduce recommended management discussion and analysis for annual and interim reports.
- Companies will not be allowed to place new shares at a discount of 20% or more unless they satisfy the Exchange that the company is in a serious financial difficulty and the only way it can be saved is by an urgent rescue operation. Companies are required to obtain independent shareholders' approval for second or subsequent general mandates for new shares issuance in any one year.
- Voting by poll is now required for connected transactions and other transactions which need shareholder approval. Shareholders and associates who have a material interest are to abstain from voting.
- Trading of a stock will be suspended if the company fails to meet the minimum public float requirement.
- Trading will also be suspended if a company fails to publish periodic financials as required by the listing rules.

Listing criteria relaxed

More controversially, the listing rules were also amended to make listing easier for companies that do not have much of a track record. Alternative financial standards to the profit requirement (previously companies needed two years of profit to be listed). Alternative tests are being introduced based on market capitalisation, revenues and/or cashflows that would allow IPOs for companies that would otherwise not qualify given the lack of a profit track record. Once again, this raises the question of whether a listed exchange, operating to maximise profit, is a suitable regulator to determine which companies get listed given the risk that standards might be compromised in order to maximise listing fees.

Over the longer term it could, more worryingly, intensify the regulatory contradiction that exists in Hong Kong: the government and stock exchange are keen to list as many PRC companies as possible, while local regulators (the SFC and HKEx) have limited powers to investigate corporate malfeasance in the mainland and, hence, successfully prosecute Chinese companies or managers that have perpetrated a major fraud. There seems to be a high likelihood that this strategy will blow up in Hong Kong's face over the next few years.

Changes coming in the securities law

Who should enforce?

The media has played up somewhat the debate over whether some of the listing rules should be enforced by the Securities and Futures Commission (SFC) rather than by HK Ex itself. The reason for the controversy is the potential conflict of interest for the HKEx, a listed-for-profit organisation, which has the incentive to increase listings in the market, but has also had the responsibility of enforcing the listing rules. The perceived conflict is that the quality of companies listed on the market may be compromised for the sake of quantity and big new listings still to come from the mainland.

Dual filing system for IPOs in place

What is already in place is called the dual filing system. Both HK Ex and the SFC get the filings for IPO. The SFC's responsibility is to detect any non-compliance with statutory listing requirements. While the HK Ex is the responsible for administering the listing process, the SFC has the statutory power to object to a listing application.

SFC likely to get additional powers

The government has recommended that the SFC also be vested with additional powers to impose civil sanctions on "primary targets" ie issuers, directors as well as corporate officers. The SFC will be responsible for referring breaches to the Secretary for Justice who will decide whether to bring criminal prosecution or to advise the Financial Secretary to consider civil proceedings under the Market Misconduct Tribunal.

Important listing requirements to get statutory backing

The government's latest paper recommends giving more important listing requirements statutory backing. That is, there could be criminal action for breaches of the more serious listing regulations relating to financial disclosure and notifiable transactions. The more important listing requirements are to be codified in statutory rules by the SFC. Amendments to the Securities and Futures Ordinance are expected to be tabled in LegCo by early 2005. There may yet be another round of lobbying the Legco to water down the provisions, but ultimately these amendments are intended to give real teeth to the SFC to pursue action against corporate transgressors.

SFC to enforce statutory listing rules; HK Ex enforce non-statutory rules

The division of responsibilities between the HKEx and SFC will thus become clearer: the SFC will be responsible for enforcing statutory listing requirements, while HKEx will continue to enforce non-statutory listing requirements (such as entry requirements, ongoing listing conditions, the code of best practice on CG, and so on).

CG issues – Privatisation bids

Privatisation bids were an issue when market was depressed

The biggest CG issue that investors have had to face in the market over the last year or so has been the bids to privatise currently listed companies. Admittedly these were proposed before the major market rally in 2H03. Nevertheless, they highlight a serious disadvantage for minorities when the decision to privatise, the timing, the business performance in the period just prior to the bid and the offer price are all at the discretion of controlling shareholders who are in a much better position to determine the true underlying value of the assets in question.

While the overall economic environment might well have been the main reason these stocks were at substantial discounts, a controlling shareholder intent on privatising a business has every reason to downplay recovery prospects and keep reported performance subdued in the period prior to the delisting proposal.

Asymmetry of information

The asymmetry in information of insiders versus investors can be seen in the pricing the stock gets in the market and the premium that controlling shareholders might be willing offer. This premium would presumably still value the stocks below what the insiders consider to be their true economic value, for the privatisation bids to be worth the effort and expense.

Figure 27

HK market - Privatisation proposals

(HK$)	Date of announcement	Price at offer	Offer price	Revised offer	Current price
Henderson Investment	5-Nov-02	5.95	7.35	7.60	7.50
Kerry Ppt	11-Apr-03	6.00	8.50	9.50	13.00
JCG	21-Jul-03	3.85	4.61		7.05
Guoco	29-Mar-04	59.75	58.00		66.50

Source: CLSA Asia-Pacific Markets

The privatisation bids were voted down

The three major privatisation bids that were decided in early 2003 – on Henderson Investment, Kerry Properties and JCG - were all at substantial premia to the market prices then prevailing. (The more recent privatisation offer for Guoco was below the market price and was made essentially to follow listing requirements after the controlling shareholder had increased its stake from buying over the interest of the Kuwait Investment Office, then the largest minority investor.) In each case, the privatisation bids were rejected by large institutions who also perceived the real value to be higher than the offer price.

. . . but there was a cost to the institutions involved

All of these stocks are now trading much higher than the privatisation offer level. Yet, to reject the privatisation bids involved a large cost for most of the investors. After seeing the stocks rally from the market price before the offer was made up to the offer price, it was almost certain that a vote to reject the bids would see the stocks fall back again. And this indeed happened to the values of Henderson Investment and Kerry Properties after the bids were voted down. The institutions voting against the offer were taking on the cost of relative underperformance in the period just after the bid when their substantial holdings would get marked down by the market.

Arbitrage opportunities provided to hedge funds

Meanwhile, the fund managers involved would face the double irony that their decision to hold out for what they see as a higher longer-term value, and incur a short-term cost in terms of relative performance, allows hedge funds to make quick profits. When there are signs that the longer-term institutional investors are not willing to take the privatisation bid, the hedge funds have an opportunity to long a stock if it is seen that the offer price might be raised (as was the case for Henderson Investment). And if the final offer is nevertheless rejected, the hedge funds get another opportunity to gain by going short a stock that moves back towards where it was trading prior to the privatisation bid being made.

Engineering conditions for a privatisation?

The risk that controlling shareholders might engineer conditions that depress the value of the stock before making a privatisation bid may well be an area that the regulators need to examine to ensure that if this is subsequently discovered, appropriate remedies can be pursued by investors. Still, the fact that all these privatisation bids failed is a positive, reflecting that the minorities in Hong Kong genuinely do have the ability to block such proposals, unlike other jurisdictions where on paper they have the right, but in practice controlling shareholders will use nominees to guarantee the outcome in their favour. It also sends a message that controlling shareholders will need to offer larger premia if they are to consider such bids in the future.

CG issues – The Dah Sing Bank spin-off

Was it to maintain family control?

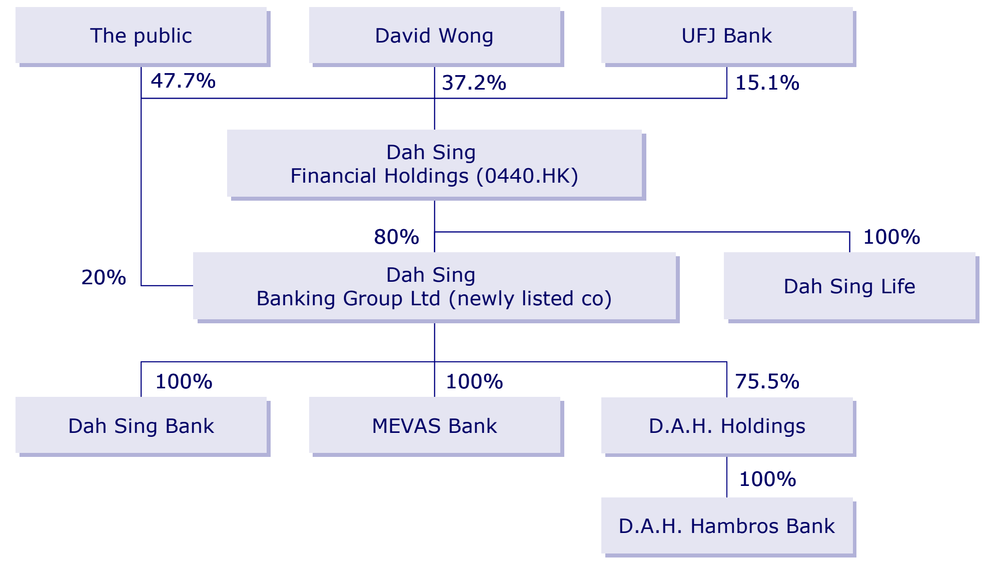
A more recent transaction that raised questions on corporate governance was the spin-off by Dah Sing Financial Holdings (DSFH) of its banking operations into the now separately listed Dah Sing Banking Group (DSBG). It is widely perceived that the main reason for the exercise is for the controlling shareholder, David Wong and his family, to maintain their existing 37% interest in DSFH, even if at a later stage the group is involved in a bank acquisition and issues shares in consideration. Through having a separate banking unit, which is presently 80%-owned by the listed parent, the subsidiary, DSBG, can issue shares and allow the interest of DSFH in the bank to come down from 80% to even as low as 50%. The controlling interest of the major shareholders in the listed parent, and ultimately their control of the separately listed banking arm, will remain.

Other ways of raising capital

Some also argue that the potential premium for DSFH in being a possible merger target gets taken out by separately listing its banking arm. Others maintain that a rights issue would have been a more appropriate means of raising capital in advance of a possible acquisition.

Figure 28

Dah Sing Group structure - After the IPO



Source: CLSA Asia-Pacific Markets

Dilution faced by all shareholders, including the controlling family

Different perspectives, however, give different angles on the matter. (And here we are in a position to understand the perspective of the controlling shareholder, having been one of the advisors in the spin-off.) The controlling shareholder views that his control over the group, the stability it has brought, and the direction that has been provided, have been instrumental to the success of the group. Hence it is in the interest of all shareholders that this stability is maintained. Also, there is an immediate dilution to DSFH from this proposal, but this dilution is faced by all shareholders, including the controlling family. Indeed, the controlling shareholder faced a disadvantage in this transaction vis-à-vis the offer that was made to other shareholders to participate in the IPO of DSBG: the controlling shareholder was not offered shares in DSBG to maintain a free-float of 20% (the exchange had allowed an exemption from the standard 25% float requirement for the listing given the likelihood that the free float would be increased at a later stage when the bank embarks on M&A).

Minorities could have had gains from DSBG which the controlling shareholder could not participate in

Other investors who participated in the IPO have since made a profit of 16% within seven weeks on the shares of DSBG offered at a listing discount. Investors were, and are, able to continue to buy the shares of DSBG, while they are at a discount to fair value. The controlling shareholder, however, is prevented from doing so given the restrictions on maintaining the free float.

DSBG could still theoretically be taken over by another entity. That is no different than before the listing of the banking arm: if an acquisition premium was offered for the bank via its listed entity DSBG, DSFH as the largest shareholder would still benefit, as would in equal proportion all the shareholders of DSFH. And if indeed the controlling shareholders would prefer to be an acquiror rather than selling off the bank, then any potential acquisition premium in the valuation of DSBG was inappropriate, and the major shareholders, in any case, have never signalled any intention to dispose the bank.

Special dividend to reduce financing burden compared to a rights

While there is some dilution in EPS for DSFH from the spin-off, the impact was offset for minorities via provision of a special dividend that allows them to part-pay for the subscription of shares in DSBG if they chose to participate in the IPO. Thus, the financial burden on minorities from this transaction is lower than would have been the case from a rights issue.

The view of the controlling shareholder would be that the long-term benefits for the group from making a suitable acquisition, which the present structure facilitates, more than offsets the short-term impact of dilution at the parent company. The interest of the controlling shareholders remains through the parent company, and they suffer proportionately as much as any other shareholder from this dilution. Other shareholders who are not willing to accept the dilution at the parent company level have the option of moving either to holding the bank subsidiary shares directly and/or reducing their stake in the parent.

Ultimate judgement depends on the second step

Ultimately, in our view, the group will have to make a reasonably sizeable acquisition within a relatively short time frame to justify the spin-off. That acquisition has to be at reasonable terms and to offer real synergies; but the track record of the group in making two earlier acquisitions (Hong Kong Industrial and Commercial Bank in 1987 and Wing On Bank in 1993) and the successful integration of these acquisitions gives comfort that the next step – an acquisition - can be executed to the satisfaction of all investors. Disgruntled shareholders of DSFH are presently judging the group on the basis of just the first step – the separate listing of the bank – without yet having the benefit of details of the second step to judge the ultimate merit of the whole exercise. Meanwhile those who were not disgruntled and were willing to take the shares in the subsidiary at its IPO and/or soon after in the market, are already sitting on handsome gains in a deal that was priced to the benefit of investors (which the controlling shareholders could not participate in).

CG issues – What should a bank chief be paid?

CEO resigned in disgrace in 2003

Bank of China (Hong Kong) was only listed in 2002, but in two consecutive years following its listing, it has had more than its fair share of scandal relating to senior officials. In 2003, the then CEO, Liu Jinbao, was made to resign, was called back to Beijing and then investigated for dubious loans to a Shanghai developer and his group, which included a listed arm in Hong Kong. BOCHK responded by carrying out an interim audit and commissioning a special committee to investigate. The special committee report was submitted in Sept 2003, which recommended that the Bank enhance the top management team to support the Chief Executive. BOCHK was quick to appoint a new Chief Operating Officer and also a new CEO. The Credit Committee approval procedure was also revamped: a new Credit Assessment Committee created to improve on the previous system was riddled with conflict between business generation and risk management handled by the same individuals. The search for a Director of Risk, however, has so far failed to bring in any suitable candidates.

This year, two deputy CEOs are being investigated

This year, two deputy chief executives, are being investigated by judicial authorities in the mainland in connection with alleged unauthorized distribution for personal purposes of certain funds belonging to the controlling shareholder of former constituent banks. These funds, however, were not, according to reports, part of the assets of the existing listed bank or its subsidiaries/customers, and the alleged expropriation occurred before the bank was listed.

Salaries are much lower

The special committee of 2003 also recommended human resource and compensation policies conducive to ensuring the best candidates are placed and retained in key positions. This comes to light as the bank reported that the current CEO was paid HK$2.5m in 2003 (versus HK$5.5m to his disgraced predecessor the year before). BEA's chief executive, David Li, in comparison took home HK$17.5m and Vincent Cheng of Hang Seng Bank received HK$7.7m last year. If the most senior executive at one of the largest banks in Hong Kong receives barely US$300,000, his underlings certainly less, and all getting a small fraction of their counterparts' in the territory, then the temptation to take a slice while handling loan amounts in the hundreds of millions will clearly be present. This easily leads to fraud, as is still endemic in mainland companies (see the China section of this report). Good CG must involve having a compensation policy that not only attracts the required talent to an organization, but also deters against fraud.

Compensation needs to be competitive

The difficulty, of course, is having remuneration figures of the Hong Kong-listed subsidiary that are out of line with the parent operating in the mainland. But just as various other banks have star employees paid much higher than their managers and directors, similarly existing banks with operations in an environment as open as Hong Kong will need to create compensation structures that are competitive and deter fraud from the very top. Unless these issues are addressed, problems that so far seem to have been attributed as "legacy" pre-IPO issues might resurface as fresh problems in post-IPO operations.

To buy or not to buy - Companies that have disappointed?

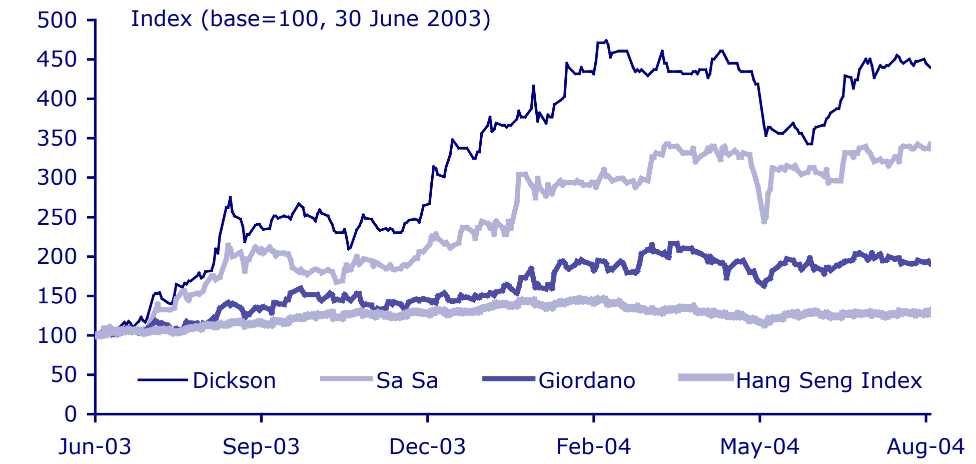
Some of major beneficiaries of recovery are companies with poor CG record

Investors in Hong Kong face a dilemma when some of the main beneficiaries of the recovering economy are companies that have a chequered CG track record. A major driver of the economy currently comes from the impetus of mainland visitors, as restrictions on individual travel by mainlanders into

Hong Kong are lifted. These visitors are coming to Hong Kong to shop, and many are going for branded goods which, because of duties in China, are cheaper in Hong Kong where there is also assurance of authenticity.

Figure 29

Dickson Concepts, retail stocks and the HSI



Source: CLSA Asia-Pacific Markets

Should an investor get back into Dickson?

A prime beneficiary of this inflow of visitors is Dickson Concepts, which owns the Seibu departmental store; is opening (under the HK-listed company) a 60,000 square-foot Harvey Nicholls in Central next year; and also owns and retails a host of other luxury brands in Hong Kong. However, Dickson Concepts' privatisation of Harvey Nicholls in 1999, and the HK$130m fee that the private company charged the listed arm for creating a portal and related services, still rankles with many investors. Even today, the company provides no breakdown on its operations - a proper model of its businesses is impossible for analysts to construct. Yet the stock has been a star performer since the middle of 2003, with the improved fortunes of the company confirmed in the doubling of earnings for the year to March 2004.

Should investors ignore the track record and just buy such stocks when there is a lack of suitable plays on the retail sector in Hong Kong?

Similar dilemma in the property sector

Similar dilemmas are faced in other sectors of the market, for instance properties. Although for property there are various listed entities to choose from, some of the major beneficiaries are companies that in the past have disappointed investors either in terms of governance or the share-trading of insiders. New World Development and Chinese Estates are two groups that also have had a chequered record - the former is rationalising its operations and reducing debt whilst its core property portfolio certainly has a higher current value with the recovery in the sector. The latter owns key retail properties that are seeing a surge in rents located in Causeway Bay, etc, and also has a development arm that is enjoying higher selling prices and margins. The share prices of both have rallied strongly and outperformed not just the market, but the property index as well.

Greater upside from third-tier companies at larger discounts

Certainly when there is a rerating of a sector, the stocks that are at the largest discounts see the biggest gains. This is partly because the better run companies at narrower discounts to start with come closer to perceived fair value sooner, while these risky names remain at large discounts. Thus, while a bluechip name like SHKP, which narrows a 30% initial discount to NAV to 10%, thus sees a 30% rise in absolute value. A stock that starts off at say an 80% discount (as some of these were during the height of Sars last year) to move to a 60% discount means a doubling in value; and from that level of discount, they might still look like they have more upside than the bluechip names that are at narrower discounts.

A matter of risk against returns

Dickson Concepts, even after its massive outperformance, remains at a discount against the rest of Hong Kong's retail sector; similarly New World and Chinese Estates against the property sector. These stocks will probably remain at discounts against the sector valuations, but these discounts could narrow as investors become willing to take more risk for potentially greater return. Investors chasing performance, and particularly those whose performance is also benchmarked against peers, will probably feel pressed to again take positions in these companies. To the extent that the management of these groups improve – which the better business conditions would encourage – the investors will be well-rewarded. But if these groups disappoint again, it would be a reminder that there is no free lunch. Higher potential returns come only through assuming higher risk.

CG stars

Average CG score for HK companies 65%

The average score of our Hong Kong sample is 65% - not too different from last year's average score of 66%, despite the changes in the questionnaire. While many companies scored close to each other, the differences in scores that go into the ranking is as low as 0.1-ppt. Differences of even a few percentage-points can easily be attributed to the weights given to the different questions, rather than any real difference in the CG commitment of the companies. Still, there was quite a range in scores between the top companies and the bottom, which we would take as reflecting the different levels of CG for these companies. The top quartile companies in the Hong Kong ranking scored an average of 76%, while the bottom quartile had an average score of just 54%.

Figure 30

Stocks in the top two quartiles for Hong Kong (CLSA universe)

Top quartile	Second quartile
CLP Holdings	Johnson Electric
HK Exchanges	Techtronic
Esprit Holdings	Clear Media
HSBC	SCMP
StanChart	Noble Group
Li & Fung	Ports Design
Orient Overseas	Bank of East Asia
Linmark Group	Lee & Man Paper
Wing Hang Bank	Dah Sing Financial
Giordano	Cafe de Coral
HK Electric	CRA
Wing Lung Bank	Hang Seng Bank
Sa Sa	Cathay Pacific
Vitasoy	Lung Kee
	Swire

Source: CLSA Asia-Pacific Markets

CLP, Esprit, HSBC, StanChart, Li & Fung right at the very top

In the top quartile, many of the names are not surprising: CLP, Esprit, HSBC, StanChart and Li & Fung are among the very top for CG in the market. HK Exchanges comes in also with a high score, near the very top: it has 22 pages

Also in the highest quartile are OOIL, Wing Hang Bank, Giordano, Wing Lung, SaSa, Vitasoy and Johnson Electric

in its annual report detailing its efforts to ensure high CG, presumably making it an example of the highest standards for the other companies in the market to follow. It is, for instance, the only company in the market with independent directors nominated by non-controlling shareholders, and it is also one of the few companies in the region to open itself for a CG scoring by S&P, which also gave it a high score. HK Electric also comes into the top quartile, somewhat below CLP, but the highest score for companies in the Cheung Kong group.

Other than the expected names, some of the medium- and smaller-cap companies also came in the top quartile for Hong Kong, including OOIL, Wing Hang Bank, Giordano, Wing Lung Bank, SaSa, Vitasoy and Johnson Electric. Meanwhile, some of the large property groups, as well as PCCW, are in the bottom quartile. Size obviously is not a key factor in determining the CG rankings, at least for Hong Kong with some of the smaller companies making a bigger effort to meet the best standards.

Figures 31-32 illustrates some of the more objective criteria in the CG scoring, showing various criteria where smaller-cap companies figure, while some of the bigger names in the market are conspicuously absent.

Figure 31

Negative CG differentiators

Q5	Q25	Q43	Q44	Q54b
Dilute EPS through options etc	**Without perceived safeguards in audit committees**	**Material related-party transactions**	**Controlling shareholders believed to be highly geared**	**Directors' remuneration rose faster than NP in past five years**
Noble Gp	Fountain Set	Cathay Pac	Kingboard	Esprit Holdings
Kingboard	Texwinca	Citic Pac		Swire
Next Media	HK Land	KMB		TVB
Yue Yuen	Oriental Press			First Pacific
	Next Media			BOCHK
				Wharf
				PCCW
				Cafe de Coral
				SHKP
				Hang Lung Gp
				ASM Pacific
				Hang Lung
				Henderson Land
				Kerry
				Sino Land
				Cheung Kong
				New World Dev
				Noble Group
				HK Land (US$)
				KMB

Source: CLSA Asia-Pacific Markets

Figure 32

Positive CG differentiators

Q23	Q31	Q32	Q33	Q48
Independent non-executive chairman[1]	**Independent directors nominated by minorities**	**INEDs make up more than half the board**	**Increased no. of independent directors since 2000**	**Cumulative voting for board representation**
HK Exchanges Noble Group MTRC KMB	HK Exchanges	MTRC Hang Lung Prop	CLP Holdings Esprit Holdings Li & Fung Orient Overseas Wing Lung Bank Johnson Electric Techtronic Clear Media Noble Group Dah Sing Financial Cathay Pacific Swire Smartone TVB First Pacific BOCHK Wharf PCCW	None

[1] Independent of management, not necessarily of controlling shareholder. Source: CLSA Asia-Pacific Markets

Some companies pay directors as much as 4x the country sample average

From our Hong Kong sample, directors' remuneration is on average 4.9% of total earnings. Among the companies that pay a lot more than these are Noble Group and Lung Kee (over 20% of earnings), while Linmark, Vitasoy, Fountain Set, PCCW, First Pac and Texwinca last year paid their directors 10-15% of earnings. The listed entity that paid the least to its directors in our sample is BoC-HK, followed by HSBC and Hang Seng Bank, while the likes of SHKP, CLP, OOIL, MTRC, HK Gas and Swire paid them no more than 1% of earnings in 2003.

Noble and Lung Kee seem generous to their directors, while the bigger banks are the other extreme

Figure 33

Q54a – Directors' remuneration

Directors' remuneration/company net profit average for Hong Kong sample: 4.9%			
Companies with highest director remuneration/net profit in 2003 (%)			
Noble Group	24.3	PCCW	13.0
Lung Kee	23.0	First Pac	12.0
Linmark	15.0	Texwinca	11.0
Vitasoy	15.0	Sino Land	9.9
Fountain Set	13.0	Clear Media	9.9
Companies with lowest director remuneration/net profit in 2003 (%)			
BoC-HK	0.1	CLP	0.7
HSBC	0.2	OOIL	0.8
Hang Seng Bank	0.2	MTRC	0.8
SHKP	0.4	HK Gas	0.9
HK Electric	0.5	Swire	1.0

Source: CLSA Asia-Pacific Markets

Financials checklist

Financials checklist to back the CG scores

In this year's CG survey, we also ranked the financials of a company by the quality of its earnings, the cashflow, balance sheet and returns generated. (See pages 31-32 for a detailed explanation of the accounting and returns calculations applied.)

Correlation between good CG and strong financials

In general we find a correlation between high CG and good financials and vice versa. The exceptions are company specific – eg, CLP has the highest standards of CG, but significant non-consolidated earnings, receivable issues for some of its operations outside Hong Kong, and non-recurrent earnings paid out earlier, which brought down the payout ratio to 2003. Hence its financials ranking is only in the middle of the Hong Kong sample. Meanwhile, OOIL, which also has a high CG score, has a geared balance sheet and also has to make guarantees for ships that are leased.

However, the companies that are in the top quartile in Hong Kong on both CG as well as the ranking on financials are Esprit, HK Exchanges, HSBC, StanChart, Li & Fung and Giordano; while the likes of Sasa, Wing Hang Bank and Wing Lung Bank are in the top-CG quartile and within the upper half of our financials ranking.

Property companies disadvantaged in the scoring

At the other end of this league table are the companies that, within our Hong Kong sample, are in the lowest quartile for both CG and financials. These are mainly the property groups. Most are punished on their CG scores given the strong penalty in this year's scoring for accounts not consistent with international standards (on taking provisions or revaluation surpluses direct to the balance sheet without going through the P&L). Meanwhile, their financials were deteriorating over the last three years, which affected their scores on recent years' trends on dividends, payout ratios and ROE, Many of them would for the last financial year still be operating on a very thin cover for interest expense. These companies, practically without exception, will, however, from FY04 start enjoying fast improving financials.

Relative performance of stocks sorted by CG

Better CG stocks have on average outperformed

Shares of companies in the upper half of the CG rankings outperform those in the lower half, on a one-, three- and five-year view. But one stock spoils a perfect result by quartiles. Techtronic comes in practically at the top of the second quartile, with a score less than 2-points below the bottom company in the top quartile (Vitasoy). But, it has been the strongest performing stock in the Hong Kong universe, up 90% in the last year, 8.4x in the last three years and 15x over the last five years. The quartile that Techtronic would get into would necessarily see the average performance pushed up substantially. If we were to take Techtronic out, the other stocks in the second quartile come in with an average return of 37% for the last year, 62% for the last three years and 120% over the last five years. We would then have indeed found a near perfect correlation of stock performance sorted by CG quartiles.

Figure 34

Stock performance of CG quartiles

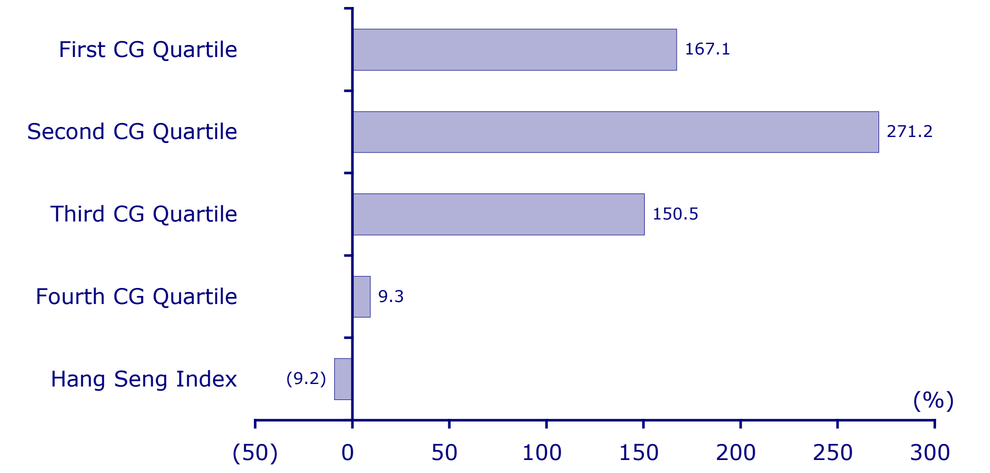
(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	58	107	167
Second CG quartile	44	141	271
Third CG quartile	40	71	151
Fourth CG quartile	32	21	9
Average of all quartiles	43	85	150
Hang Seng Index	28	(6)	(9)

Source: CLSA Asia-Pacific Markets

Higher CG stocks have on average outperformed lower-CG names

Figure 35

Five-year stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

Esprit, OOIL and SaSa top CG companies that have had stock outperformance

In the top quartile, CG companies that have had strong stock performance in the last 12 months, as well as going back three to five years, are Esprit, OOIL and SaSa. In the bottom CG quartile, PCCW is notable for having underperformed on a one- to five-year timeframe. A number of property companies are also in the bottom quartile – penalised mainly for Hong Kong's accounting standard, which has not been consistent with IAS on provisions/revaluations of properties. These stocks have underperformed over the previous three to five years mainly because of deflation - but in the last 12 months, with property deflation over, they have been strong performers.

Companies that have increased independent directors

Increase in independent directors indicates extra resources for better CG

The new scoring methodology makes it difficult to make proper comparisons with previous years' scores – a drawback we felt was justified in order to incorporate the new scoring system now reflecting negative scores for certain questions (see discussion on page 27-28) and incorporating some new areas in the questionnaire. However, one objective method of determining which companies are making some effort to improve CG is by examining whether the number of independent directors has increased over the last three years to end-2003 (which is one of the new questions, ie, Q33 of the questionnaire).

BOC and Wharf added 4 independent directors in last three years

BOC-HK and Wharf have added four additional independent directors to their board in the last three years. Wing Lung Bank, Johnson Electric, Clear Media, Noble Group, Cathay and PCCW have increased independent directors by two.

2/3 of companies that increased independent directors are in upper half of our CG; for all the companies INEDs are still less than half of the board

Figure 36

Companies that have increased independent directors

	Increase in independent directors in last 3 years	Independent directors more than 50% of board
BOCHK	4	N
Wharf	4	N
Wing Lung Bank	2	N
Johnson Electric	2	N
Clear Media	2	N
Noble Group	2	N
Cathay Pacific	2	N
PCCW	2	N
CLP Holdings	1	N
Esprit Holdings	1	N
Li & Fung	1	N
Orient Overseas	1	N
Techtronic	1	N
Dah Sing Financial	1	N
Swire	1	N
Smartone	1	N
TVB	1	N
First Pacific	1	N

Source: CLSA Asia-Pacific Markets

A number of the larger caps have not seen the need to increase the representation of independent directors, and a few have even seen the number independent directors come down. By the new listing regulations that came into effect this March, companies will have to have at least three independent directors. It is worth noting that at the end of 2003, those that still had only two independent directors were HK Land, Yue Yuen, CITIC IFH, Sino Land, Next Media, ASM Pac, Texwinca, Fountain Set, Lung Kee, Café deCoral, Ports Design, ClearMedia and Vitasoy.

Companies that increased independent directors had outperformance in stock values

Companies that have made efforts to improve CG – using the increase in independent directors as a proxy - have also seen their stocks performing strongly. The 18 companies that increased the number of independent directors between 2000 to 2003 saw an average rise in share prices of 140% over the three years we measured to June 2003, against an 81% simple average return for the total 52 stocks we covered in the Hong Kong study that have been listed over three years. The HSI has provided a return of -6% over this three-year period.

Those who increased independents and were also in the upper half of CG rankings had even greater outperformance

Narrowing it down to companies that increased the number of directors, and also scored well enough in the other factors to be in the top half of our CG rankings for Hong Kong – ie, eliminating PCCW, Wharf, BoC-HK, First Pac, TVB and Smartone – takes the average stock performance for the basket of companies to an average 201% over the last three years - way ahead of the performance of the (unsorted) top-two CG quartile average stock returns of 118% and 127% respectively. These 11 companies also outperformed over the last 12 months - on average, their shares are up 57% against the average return of 43% for the whole basket and 28% for the HSI.

CG picks

Our top CG picks are Esprit, HK Exchanges and StanChart

Companies with high CG are by definition more likely to share the value created equally with all shareholders. The companies with solid financials are those that are in a better position to generate value for shareholders rather than creditors. Among the companies with a top-quartile CG and financials ranking, on which we have positive recommendations, are Esprit, HK Exchanges and StanChart. Those in the top CG quartile and within the top half on the financials checklist with positive ratings are Wing Hang Bank and Sasa. Included in our BUY list for better-than-average CG and financials are Cathay Pacific and Café deCoral.

Some of the high CG companies with good financials are at undemanding implied growth in current valuations

Figure 37

The top-10 CG companies – Financials and valuations

	CG quartile	A+R quartile	Implied earnings gwth (%)	Rec
Esprit	1	1	3.8	BUY
HK Exchanges	1	1	3.8	O-PF
Standard Chartered	1	1	1.5	O-PF
Wing Hang Bank	1	1	0.0	BUY
Sasa	1	2	2.3	BUY
BEA	2	1	(0.1)	BUY
Café deCoral	2	1	1.1	O-PF
Cathay Pacific	2	2	(1.2)	O-PF

Source: CLSA Asia-Pacific Markets

Among the companies at the bottom end of the CG table and also with weaker financials, on which we have a negative recommendation, include PCCW and Yue Yuen.

Rajesh Panjwani
rajesh.panjwani@clsa.com
(91) 22841348 x830

India – Tightening the screws

The SEBI committees recommend more changes

India's main stock market regulatory authority, the Securities and Exchange Board of India (SEBI), continues to raise the bar for good corporate governance. Since our last CG report, committees set up by the SEBI have made new recommendations and some of the previously existing norms have been more stringent.

New guidelines for independent directors, power of audit committee

These recommendations relate to guidelines concerning who constitutes an independent director, increasing the powers and responsibilities of the audit committee, protection of whistle blowers, guidelines for monitoring subsidiary companies, improving disclosure on changes in accounting policies, certification from senior management on the veracity of financial statements and changes in regulations for substantial acquisitions and the takeover of shares.

2004 corporate scores are marginally higher

While in 2003 we witnessed a significant improvement in the CG scores for most Indian companies, in 2004 the changes were realtively marginal. Last year was a watershed year in corporate governance, with reporting of consolidated accounts, segmental break-down and related party transactions all made mandatory. Most companies reconstituted their boards to increase the number of independent directors on the board and in audit committees. The SEBI Act was also passed giving it more powers. However, from now on the improvements will likely be more gradual.

Software lead the pack. Old economy too is making strides

Our survey finds that Infosys and Wipro continue to lead the pack of high CG companies in India while Satyam has shown improvement for the second year in a row. All three companies are in the first quartile of CG scores and our financial checklist. HLL, GlaxoSmithkline and Hero Honda also belong to the first quartile of CG scores and financial checklist. BHEL has been the biggest gainer in CG score, moving to first quartile. Likewise Hindalco is another company in the first quartile which gets a high score on our financial checklist. Moser Baer had the biggest fall in CG score due to its fall out with auditors. We also note that five of the seven companies which figure in the bottom quartile in CG scores and financial checklist are PSU banks.

Regulatory environment and CLSA/ACGA country CG score

India's country CG score at 62% ranks it third in the region

The country CG score for India for 2004 is 6.2, or third in the region after Singapore and Hong Kong. While India scores over most other markets in areas of rules, regulations and enforcement, it scores lower than most on adoption of international auditing standards. Ratings for India's macro-CG determinants (in the following table) show a decline over last year. However this decline is mainly due to changes in scoring methodology.

Figure 38

India ratings for macro-determinants of CG

	Rating (1-10)	2003 rating	Comment
Rules & regulations	6.6	8.0	Rules have been made more stringent, but some rules still lacking.
Enforcement	5.8	6.0	SEBI has sufficient powers to ensure enforcement of rules, but weak "private enforcement" of market participants.
Political & regulatory environment	6.3	6.0	The government has a consistent policy of supporting CG and has amended laws to enhance protection of minority shareholders.
Adoption of IGAAP	7.5	7.5	In terms of consolidation, segmental reporting, deferred tax accounting and related party transactions, the gap between Indian and US GAAP is minimal.
Institutional mechanisms & CG culture	5.0	6.5	Greater awareness of and adherence to good CG practices. However there is no CG activist organisation, or CG focused funds by institutional investors.

Source: CLSA Asia-Pacific Markets / Asian Corporate Governance Association

A further twist of the screw

In FY04 a committee constituted by SEBI made wide-ranging recommendations to improve the standards of corporate governance in the country. An important recommendation of the committee was the introduction of a 'whistle blower policy' which aims to protect employees who report concerns about unethical behaviour in a given organisation. The introduction of this clause was triggered by the murder of a government employee who tried to bring certain unethical activities to the government's notice.

The SEBI Committee on Corporate Governance

Committee on Corporate Governance under Narayana Murthy

The SEBI constituted a committee on corporate governance under the chairmanship of Narayana Murthy, founder and chief mentor of Infosys. The committee was entrusted with the task to recommend steps to improve corporate governance in the country. The committee submitted its report on 26 August 2003. Further amendments were made to the report based on the suggestions and representations received from interested parties. The recommendations are now with SEBI to consider but we believe most will become requirements for listed companies, although some of the tougher standards may remain best practice recommendations.

A major step ahead

The committee's report is an important step towards better corporate governance. Key recommendations relate to the terms and conditions to be met by a director in order to be considered an independent director, the role of the audit committee, guidelines for monitoring subsidiary companies, disclosures to be given in case of deviation from accounting principles and a policy on whistle blowers.

Who constitutes an independent director?

Last year SEBI made it mandatory to include independent directors in the boards of listed companies. However the guidelines as to who constitutes an independent director were not clear. The committee has laid out clearer guidelines on this issue and now stipulates that a director should fulfill the following conditions in order to be considered independent:

No material pecuniary relationship

1. Apart from receiving a director's remuneration, an independent director does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies.
2. Is not related to promoters or management at the board level, or at one level below the board.
3. Has not been an executive of the company in the immediately preceding three financial years.

No association with the audit firm

4. Is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years.

Not a material supplier, customer or shareholder of the company

5. Is not, in the opinion of the board, a material supplier, service provider or customer of the company.
6. Is not a substantial shareholder of the company, ie, owning two percent or more of the block of voting shares.

Independent director's term should not exceed nine years

Additionally a director shall be considered to be an independent director only so long as his tenure on the board does not exceed, in aggregate, a period of nine years.

Audit committees – Increasing responsibilities

The audit committee is to meet at least four times a year

The report recommends that the audit committee should meet at least four times a year and that no more than four months shall elapse between two meetings. The role of the audit committee should include:

Ensure that the financial statement is correct, sufficient and credible

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the board, the appointment, replacement or removal of the external auditor and the fixation of audit fees.

Appointments and the replacement of external auditors

3. Approval of payment to external auditors for any other services rendered by the external auditors.
4. Reviewing, with the management, the annual and quarterly financial statements before submission to the board for approval.

Reviewing the adequacy of internal control systems

5. Reviewing, with the management, external and internal auditors, adequacy of the internal control systems.
6. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
7. Reviewing the company's financial and risk management policies.

Encouraging better disclosure

Deviation from accounting policies

Where, in the preparation of financial statements, a treatment different from that prescribed in an accounting standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlined business transaction.

Whistle blower policy

An important recommendation by the committee concerns its policy on whistle blowers. The intention of this clause is that management establishes a mechanism for employees to report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. According to this clause"

a. The company will establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy.
b. The mechanism must provide for adequate safeguards against victimisation of employees who avail of the mechanism.
c. The mechanism must also provide, where senior management is involved, direct access to the chairman of the audit committee.

Guidelines for monitoring subsidiary companies

The committee prescribes the following for subsidiary companies:

I. At least one independent director on the board of directors of the holding company shall be a director on the board of directors of a material non listed Indian subsidiary company.

II. The audit committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

III. The minutes of the board meetings of the unlisted subsidiary company shall be placed at the board meeting of the listed holding company.

Senior management to disclose material transactions

Increasing accountability of senior management

Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for eg, dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Certifications by CEO, CFO

The CEO (either the executive chairman, the managing director or manager) and the CFO (the full-time finance director or any other person heading the finance function) discharging that function shall certify to the board that:

. . . that financial statements present a true and fair picture

They have reviewed financial statements and the cash flow statement and the directors' report and that to the best of their knowledge and belief:

- These statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;
- These statements present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

There are to the best of their knowledge and belief, no transactions entered into by the company which are fraudulent, illegal or that violate the company's code of conduct or ethics policy.

They accept responsibility for establishing and maintaining internal controls.

Regulation for substantial acquisition of shares and takeovers

The SEBI committee submitted its report in Feb 2004

The SEBI formed an internal group in 2003 to closely look into the provisions of the regulations for substantial acquisition of shares and takeovers and suggested measures to take better care of the interest of investors. The group deliberated and submitted their recommendations in February 2004. These included that:

A. The threshold limit for acquisition through off-market transactions shall be limited to 5% of shares or voting rights and any acquisition beyond this through off-market transactions would trigger an open offer obligation.

Acquisition of over 5% stake to trigger open offer

B. An acquirer who holds more than 5% but less than 15% of shares or voting rights shall acquire additional shares or voting rights, only through stock market mechanisms and otherwise, the acquisition would trigger an open offer obligation.

C. However, acquisition through preferential allotment pursuant to a special resolution passed under section 81(1A) of the Companies Act, 1956, would be exempted.

Time taken for open offer reduced from 120 to 90 days

D. Time taken to complete the open offer formalities has been reduced from 120 days to 90 days.

CG stars

Infosys continues to lead the pack . . .

Infosys, consistently one of the highest CG companies in the region in our rankings, continues be the highest scorer in India's, and the Asia Pacific's, CG matrix this year. The company has continued to stay a step ahead of prevailing CG norms and has implemented most of the reforms before they became mandatory. Even today its disclosure standards – detailed segmental data, presentation of accounts as per GAAP of eight countries detailed cost break-ups - are among the best in the industry. Infosys also provides the most detailed manpower data - very important in its space. Age profiles, experience, education levels and gender mix are also all elaborated in detail.

. . . though it loses out on account of a large board, stock options and high cash

The company's policy, as given in its last annual report, is to earn a return on capital employed at least twice the cost of capital. The cost of capital, estimated for 2003 by the company is 14.1%. According to the latest annual report, Infosys is one of the very few companies in India to have a nomination committee. Where Infosys loses out is on the issue of stock options, high cash levels impacting return ratios and a relatively large board with about 15 board members. However, the company has already proactively stopped granting further ESOPs in the FY04 fiscal year.

BHEL has moved up to first quartile

BHEL has been the biggest gainer in CG scores in India this year, moving up from second quartile last year to first quartile in 2004. The improvement in the CG score has been driven by significant improvement in management's communication with investors and the adoption of more stringent accounting policies. Top management is more accessible to investors and organises regular conference calls post-results. The company's disclosure levels on order book, revenues and cost front too has improved.

Better investor contact and stringent accounting norms

The company has adopted a more stringent and objective policy on the provisioning of bad debts and unprovided recievables greater than three years old are now just c.Rs1bn (less than 2% of FY04-end shareholder equity), compared to Rs8-9bn a few years back. With improving profitability and limited capex requirements, the company's balance sheet quality has also improved significantly.

Satyam's CG score improved for the second year in a row

Following on from gains last year, Satyam Computers has seen a significant improvement in CG scores. Better disclosure standards and detailed quarterly reports, which include management discussions, have led to improved clarity on its businesses. The company now articulates its business goals upfront in the annual report, although return ratio targets are still not mentioned.

Tisco, Hindalco and Nalco gain due to higher profits

CLSA's CG scoring procedure gives a positive score for companies for which profits have grown faster than the directors remuneration. In 2004, metal companies reported a sharp improvement in profitaiblity on the back of high metal prices. As a result, earnings Cagr has surpassed the the rise in director's remuneration, providing a boost to the CG scores of these companies. Reliance Energy and Cummins have also gained on this account.

Figure 39

Stocks in the top two quartiles for India (CLSA coverage)

Top quartile	Second quartile
Infosys	Mastek
Wipro	Asian Paint
HDFC Bank	TISCO
HDFC	Concor
Dr Reddy	UTI Bank
Hindustan Lever	Patni
Satyam Computers	Bajaj Auto
Bharti	Wockhardt
Ranbaxy	Grasim Industries
Hero Honda	ABB
Glaxo India	HCL Technologies
Gujarat Gas	Colgate-Palmolive India
Sun Pharmaceuticals	Hughes Software
Castrol	MphasiS-BFL
Hindalco	I-flex Solutions
BHEL	Gujarat Ambuja
Cummins India	ITC

Source: CLSA Asia-Pacific Markets

CG disappointments

Fall-out with auditors has hit Moser Baer's CG score

The biggest CG disappointments in 2004 have been Moser Baer, ACC and Ashok Leyland. Moser Baer has witnessed the largest fall in CG scores in 2004 among our coverage companies, largely due to its controversial and still opaque fall-out with its auditors in mid-2003. Explanations for the fall-out are still unclear, and the company has appointed a local audit firm in the interim. PwC have now been appointed after a gap of nearly 11 months, whereas the understanding at the time of the fall-out was that a new Big-5 firm would be appointed within "weeks".

Disclosure standards – a lot left to be desired

Moser Baer's disclosure standards may be better than its industry peers, but within the India context, they remain much below par. Though DVD share in the topline has risen to double digits, the company still does not formally provide a break-up of CD/DVD shipments, pricing and production. Communication of negative newsflow, including recent changes in billing system for a large section of its clientele, or problems in pricing for the industry as a whole, have lagged.

Unwillingness to raise FII limit drags down ACC's score

The key reason why Associated Cement Companies' (ACC) CG score has deteriorated is the unwillingness of the company's board to increase the Foreign Institutional Investors (FII) investment limit. The FII holding in the company hit the limit of 24% in 2QFY04 and yet the company has not increased the limit without ascribing any particular reason. This move, we believe, has worked against the interests of minority shareholders.

Conflict of interest due to a parent company in the same business

The single largest shareholder (14%) of the company is separately listed Gujarat Ambuja, which is in the same business as ACC. Although both the managements work independently and have benefitted from each other's association, we believe that it could cause potential conflict between the two. ACC's profitability is lower than its peers and various cost cutting initiatives the company is working on will minimise the gap.The company's disclosure standards, however, are above average and it has already started making public the consolidated numbers on a quarterly basis.

Financials checklist

IT majors dominate the top quartile for CG score and financial checklist

The top five companies on our financial check list are Infosys, Nestle, HPCL, GlaxoSmithkline and Concor. All these companies have high return ratios, net cash on books, no significant auditor qualifications, good working capital management, improving dividend payout, reasonably high tax payout and have not raised fresh funds over the last few years. The companies which fall in the top quartile of CG scores as well as financial checklist are – Infosys, Wipro, GlaxoSmithkline, Hero Honda, Satyam and HLL. Other companies which score high on both fronts are Asian Paints, BHEL, Hindalco and Tisco.

Smaller PSU banks dominate the bottom quartile on both lists

The bottom five companies on our financial check list are PNB, Oriental Bank, IOC, Mastek and Moser Baer. The companies which figure in the bottom quartile for both CG score and financial checklist are – BoB, Corporation Bank, PNB, Oriental Bank, Canara Bank, VSNL and ACC.

Relative performance of stocks sorted by CG

No conclusive results on stock performance and CG

Analysis of stock performance of stocks falling under different quartiles does not yield any conclusive results. As can be seen from the table below, low CG stocks (in the fourth quartile) have outperformed all the first three quartiles over the last three and five year periods. However, most of this outperformance can be attributed to two stocks (Bharat Forge and Oriental Bank) which have run up over 500% in the last five years.

The outperformance of fourth quartile stocks is mainly due to two stocks

Figure 40

Stock performance of CG quartiles

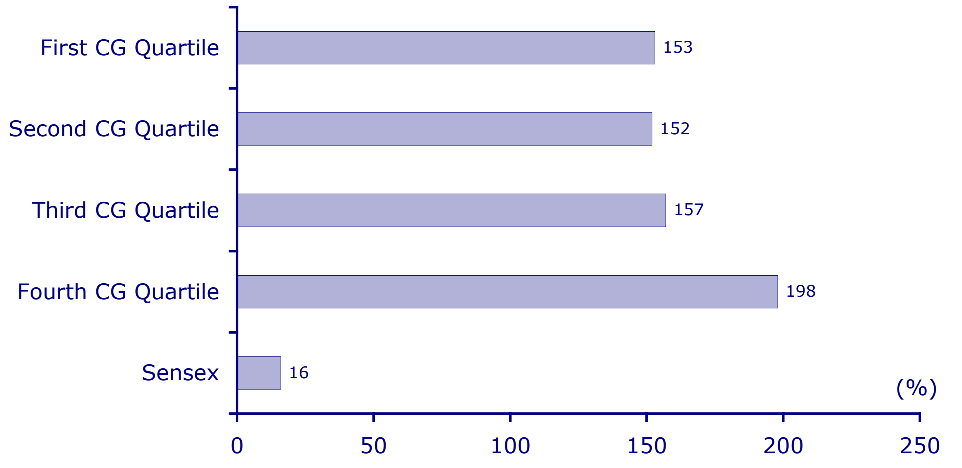
(%)	Performance to 30 June 2004		
	1Y	**3Y**	**5Y**
First CG quartile	52.2	74.1	153.1
Second CG quartile	63.0	151.1	152.3
Third CG quartile	36.4	104.3	157.0
Fourth CG quartile	61.5	259.4	198.2
Average of all quartiles	53.1	141.6	164.5
Sensex	32.9	38.7	15.8

Note: The quartile stock performance is a simple average performance, whereas Sensex is a weighted average index. Thus a sharp run up in the some small stocks can have a big impact on the overall performance of quartiles. This explains the large gap between the performance of quartiles and Sensex.

No discernable relation between CG and stock performance

Figure 41

Five-year stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

Stocks with improved CG have performed better

Though there is no notable pattern in stock performance of low and high CG stocks, the market does seem to have rewarded stocks which have seen CG improvement. The average one-year stock performance for companies which have shown a significant improvement in CG over the last one year is 60.6%, compared to 53.1% for our coverage universe. On the other hand the average stock performance by companies which have seen a significant decline in CG score has been lower at 46.6%.

Stocks with deteriorated CG scores have performed poorly

Figure 42

Companies with CG changes of over 2003-04

	Change in score by 2004 questionnaire (%)	2004 quartile ranking
BHEL	7.1	1
Satyam Computers	6.8	1
TISCO	5.4	2
Cummins India	5.4	1
Nalco	5.4	3
Reliance Energy	5.4	4
Hindalco	5.4	1
MphasiS-BFL	(3.8)	2
Ashok Leyland	(5.3)	4
Infosys	(5.4)	1
ACC	(7.5)	4
Moser	(8.2)	3

Source: CLSA Asia-Pacific Markets

Figure 43

Negative CG differentiators

Q5 Dilute EPS through options, etc	Q25 Without perceived safeguards in audit committees	Q43 Material related-party transactions	Q44 Controlling shareholders believed to be highly geared	Q54b Directors' remuneration rose faster than NP in the past five years
Ashok Leyland	ACC	ABB	ABB	Bajaj Auto
Bharat Forge	Ashok Leyland	Bajaj Auto	Bharat Forge	Colgate Palmolive
Gujarat Ambuja	GAIL	Bank of Baroda	Cummins	Dr Reddy
M&M	Gujarat Ambuja	Bharat Forge		Hero Honda
Moser Bear	HCL Technologies	Corporation Bank		M&M
Patni Computers	I-flex Solutions	Cummins		Oriental Bank
Polaris	ITC	Dr Reddy		PNB
Tata Motors	L&T	GAIL		Tata Tea
Tata Tea	Maruti	Hero Honda		
Zee Telefilms	Mphasis BFL	Hughes Software		
	Polaris	ITC		
	Reliance Energy	L&T		
	Satyam Computers	M & M		
	Tata Power	Maruti		
		MTNL		
		PNB		
		Reliance Industries		
		SBI		
		Tata Motors		
		VSNL		
		Wipro		

Figure 44

Positive CG differentiators

Q23 Independent non-executive chairman	Q31 Independent directors nominated by minorities	Q32 INEDs make up more than half the board	Q33 Increased no. of independent directors since 2000	Q48 Cumulative voting for board representation
ACC	None	Bajaj Auto	Most Indian companies fall under this category	None
Castrol		Bharat Forge		
Gujarat Gas		Cipla		
GlaxoSmithkline		Dr Reddy		
HDFC Bank		Glaxo India		
ICICI Bank		Grasim		
		HCL Technologies		
		Hero Honda		
		HLL		
		Infosys		
		M&M		
		Moser Baer		
		Mphasis BFL		
		Polaris		
		Ranbaxy		
		Satyam Computers		
		Sun Pharmaceuticals		
		Wipro		
		Wockhardt		

Source: CLSA Asia-Pacific Markets

PSUs director's remuneration is very low

Figure 45

Q54a – Directors' remuneration

Directors' remuneration/company net profit average for India sample: 1.2%			
Companies with highest directors' remuneration/net profit in 2003 (%)			
Wockhardt	7.0	Bharat Forge	3.4
Hero Honda	6.5	Gujarat Ambuja	3.0
Hughes Software	4.5	Dr Reddy	2.8
Colgate-Palmolive India	4.0	Gujarat Gas	2.7
Mastek	3.4	Castrol	2.4
Companies with low directors' remuneration/net profit in 2003 (%)			
GAIL	0.05	MTNL	0.02
Nalco	0.05	IOC	0.02
HPCL	0.04	ONGC	0.01
BPCL	0.04	SBI	<0.01
GAIL	0.05	PNB	<0.01

Source: CLSA Asia-Pacific Markets

CG picks

Infosys, Wipro, Satyam are icons of good CG culture

The eight companies in the table below are in the top quartile of our CG matrix, score high on the financial checklist and have positive CLSA recommendations. Three of these are software majors. While Infosys and Wipro have always had very high corporate governance standards, Satyam has improved significantly over the last couple of years. We have a BUY recommendation on all three stocks. Strong fundamentals (next three years earnings Cagr at 28-31%), high earnings and balance sheet quality should drive a rerating.

HLL, GlaxoSmithkline – the MNC effect

HLL, the largest fast moving consumer goods (FMCG) company in India, is ideally positioned to leverage increasing consumer spending. The stock trades at historical low valuations and offers an attractive dividend yield of 4.5%. GlaxoSmithkline is the largest pharma company in India and the best play on the post patent regime. With healthy cash generation and reasonable dividend yield, we are bullish on its long term prospects.

CG picks from India

Figure 46

The top-8 CG companies – Financials and valuations

	CG quartile	A+R score	Implied earnings gwth (%)	Rec
Infosys	1	94.1	6.8	BUY
Wipro	1	85.3	8.1	BUY
Satyam Computers	1	80.9	3.8	BUY
Hero Honda	1	85.3	2.1	BUY
HLL	1	80.9	4.8	BUY
GlaxoSmithkline	1	86.8	7.2	BUY
Hindalco	1	79.4	(1.5)	BUY
BHEL	1	79.4	3.9	O-PF

Source: CLSA Asia-Pacific Markets

Hero Honda, Hindalco, BHEL – flag bearers for old economy

Hero Honda, the world's largest motorcycle producer, continues to enjoy close to 50% share of the Indian market. With efficient operations, strong cashflows and high dividend yield, the stock trades at 10x FY05 EPS. BHEL, the supplier of 65% of power generation capacity in India, is set for a >30% earnings Cagr on an all time high order backlog of US$6bn (3.2x FY04 revenues). Strong order-flow over the next few months and technology tie-ups will drive stock performance. Hindalco, the largest non-ferrous metal company in India, is trading at a significant discount to the market and global peers. Recovery in the copper TC/RC margins will be the key driver of stock performance.

PSU banks – low CG, keep away

Five of the seven companies figuring in the bottom quartile for both CG score and financial checklist – BoB, Corporation Bank, PNB, Oriental Bank, Canara Bank, VSNL and ACC – are public sector owned banks. Mandated disclosure levels for Indian banks are not too high and these mar their scores. As many of these banks are now adopting international accounting standards (US-GAAP) transparency levels will improve and boost the scores. These banks also suffer from risk of the secondment of minority shareholder interest as populist goals of the new government are executed through them.

Michael Chambers
michael.chambers@clsa.com
(6221) 5727822

Indonesia – Better by degrees

Corporate governance practices are improving in Indonesia, but there are still too many instances of companies paying lip service to CG. Foreign-controlled companies again top the list, with Unilever retaining the number one spot.

CG improving . . . slowly

Regulations on independent directors/audit committees were established several years ago and most firms now have at least one independent commissioner. However, many appointees may not be truly independent, and there are few companies with independents in the majority. This should not surprise, given most firms are family (or government) controlled.

Unilever tops CG again

Once again Unilever came out top in our CG poll. Its overall score was lower than in 2003, but this relates to the different methodology used this year. We increased the number of companies covered to 36 from 22 in 2003. Among those added this year, INCO, United Tractors and Dynaplast had strong debuts.

Two banks rank poorly, but showing signs of improvement

Stocks at the bottom of the CG scorecard include two banks. While they offer upside, they are among the lowest of our bank recommendations. These are Lippo Bank, which is emerging from a difficult period, and Panin Bank, which has continued to write-off large amounts of loans seven years after the crisis first hit. In the most recent quarterly result, there were at last signs that huge provisions may have ended. Also scoring poorly was Bumi Resources, although this is in effect a new company. Transparency has been quite good from this company and its score could improve considerably. Semen Gresik, while cheap on some measures, remains beset by issues of ownership and control. It remains a SELL.

Regulatory environment and CLSA/ACGA country CG score

Gradual improvement at country level in CG terms

There have been some improvements in the overall CG score. However, progress has been gradual and there is far more law in place than action. CG requirements remain generally avoidable due to significant loopholes in legal practice and enforcement. The direction of change remains positive and there is evidence of more companies taking CG practices more seriously.

Figure 47

Indonesia ratings for macro-determinants of CG

	Rating (1-10)	2003 rating	Comment
Rules & regulations	5.3	4.5	Rules continue to improve gradually. Reporting deadlines shorter than in some more advanced markets, but in general, disclosure rules and board accountability are weak.
Enforcement	2.7	1.5	Higher score largely due to our new methodology, which takes into account private enforcement by the market.
Political & regulatory environment	3.8	4.0	No improvement in 2004. Implementation, government commitment to CG, and the legal system remain weak.
Adoption of IGAAP	6.0	5.0	Accounting rules are improving. Some efforts to strengthen independence of external auditors and regulation of the accounting profession.
Institutional mechanisms & CG culture	2.7	2.5	CG culture is being implemented, but with many loopholes.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Indonesia lags in enforcement

Areas where Indonesia scores poorly in CG terms include the enforcement of rules and regulations. Even in cases taken to court, the judiciary is often either incapable of handling disputes, or unwilling to do so. Wildcat legal action is an issue, but high-profile cases have not involved listed companies.

CG stars

The good . . .

CLSA covers 36 stocks in Indonesia for the purposes of the CG scoring in 2004, up from 22 a year ago. Most of the top CG scoring companies remain in position, with Unilever continuing to run first. Unilever's vote slipped from a year earlier due to different methodology in the questions. In particular, transparency dropped sharply, while social responsibility and discipline increased. Companies with improved scores include Astra International, Astra Agro Lestari, HM Sampoerna and Gudang Garam.

Of the new companies in the CG report, INCO came out top (ranked no. 3) with its strong management culture and clear policies. A number of smaller other new companies did well. United Tractors is deleveraged and benefits from being majority-owned by Astra International. Dynaplast has always been an open company (albeit small) and Bank NISP has had a fantastic track record despite the Asian crisis, which ravaged Indonesia's banks.

Figure 48

Stocks in the top two quartiles for Indonesia (CLSA coverage)

Top quartile	Second quartile
Unilever	Ramayana
Astra International	Bank NISP
INCO	Tempo Scan
Astra Agro Lestari	Gudang Garam
United Tractors	Berlian Laju Tanker
Dynaplast	Bank Danamon
Indosat	Bank Rakyat Indonesia
HM Sampoerna	Aneka Tambang
Bank Central Asia	Indocement

Source: CLSA Asia-Pacific Markets

Aneka Tambang has slipped in the rankings in 2004, hurt by lower scores for responsibility and fairness. However, it continues to take CG issues seriously.

CG disappointments

. . . and the bad

Companies recording significant declines in their vote included Telkom, still hurt by its inability to file full accounts, and Panin Bank, the results of which remain murky. Several large companies show up in the lower quartiles, but could see improvement in future. Bank Mandiri and Bumi Resources are both undergoing significant changes, and scores could improve in 2005.

Indonesia remains hurt by a legacy of poor governance issues. Not all of these have been solved. The largest company affected here is the APP Group. While we do not cover the group or its listed entities specifically, debt restructuring is moving at a snail's pace. This, despite pulp prices moving to significantly higher levels that should have allowed increased debt servicing.

Room for improvement from some lower-ranked companies

Stocks in the third quartile include some that should improve in 2004 and 2005. Bank Niaga is now controlled by Commerce Asset of Malaysia and is making progress. Perusahaan Gas Negara is a recent listing, but its independence from the government is still unclear. However, there is at least management commitment to improved CG practices.

Financials checklist

Banks rank highly in terms of financial strength

When looking at the financials checklist, Indonesian banks come out top. That may look odd to outside observers given the recent history of Indonesian banks. However, Indonesia's banks have been recapitalised, their CARs are strong and they are reporting high ROEs with still low LDRs. Even better, NPLs are low and very well provisioned.

Ramayana the top ranked non-financial company

Outside the banks, the strongest company is Ramayana with a score of 86.8. Net cash with rising dividends, Ramayana is a very sound company, even if operating in a difficult market for retail.

Bumi ranks low due to gearing . . . a temporary issue

Companies scoring poorly in terms of the financials checklist include Bumi Resources, which is extremely highly leveraged at present. However we expect leverage to fall sharply due to significantly higher coal prices in 2004 and 2005. Perusahaan Gas Negara also scores poorly. It recently raised funds via an IPO, but will continue to seek additional capital over the next 10 years to finance expansion plans.

BCA - Best in CG and financials

Only one company polled in the top quartile in both the CG scores and the financials checklist - Bank Central Asia. With the financial checklist top quartile dominated by banks, a number of high ranking CG scores rest in the second quartile. These include INCO, Dynaplast, Astra Agro Lestari, HM Sampoerna and Unilever.

Companies in the bottom quartile of both lists include Bentoel, Bumi Resources and BFI Finance.

Relative performance of stocks sorted by CG

Top quartile outperforms the market on 1,3 and 5 year view

Stocks in the top quartile of CG scores have dramatically outperformed other stocks over the past one-, three- and five-year periods. However, performance in the lower quartiles is less clear. Second-quartile companies have outperformed on a one-year view, but not on a three- or five-year view. On a five-year view, the second quartile was the worst performing, perhaps because of the recovery in lower ranked stocks after the financial crisis.

Top quartile dramatically outperforms

Figure 49

Stock performance of CG quartiles

(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	149.7	250.3	211.3
Second CG quartile	55.7	39.0	(43.7)
Third CG quartile	20.1	42.5	(9.9)
Fourth CG quartile	19.3	40.0	(42.9)
Average of all quartiles	44.9	67.4	10.6
JCI Index	76.2	97.3	0.8

Source: CLSA Asia-Pacific Markets

Massive outperformance of top CG stocks over last five years

Figure 50

Five-year stock performance of CG quartiles

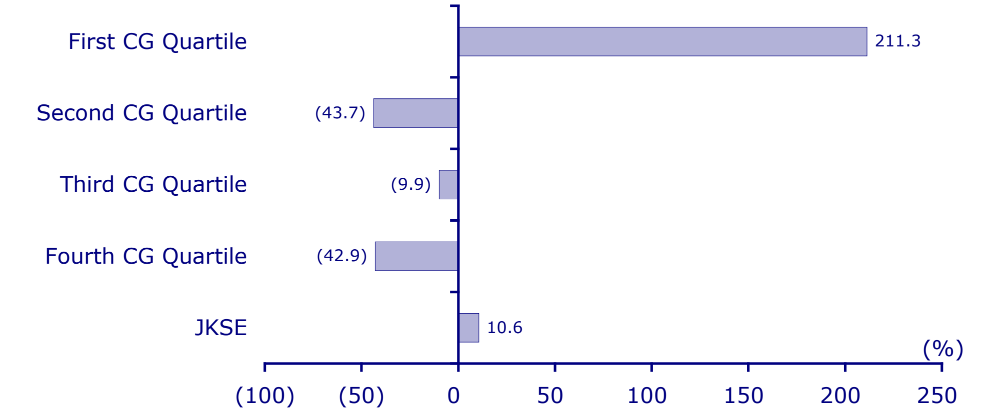


Figure 51

Negative CG differentiators

Q5 Dilute EPS through options etc	Q25 W/out perceived safeguards in audit committees	Q43 Material related-party transactions	Q44 Controlling shareholders believed to be highly geared	Q54b Directors' remuneration rose faster than NP in past five years
Nil	Tempo Scan	INCO	Berlian Laju Tanker	Nil
	Indosiar	HM Sampoerna	Trimegah	
	Bank Panin	Ramayana	Indofood	
	Lippo Bank	Gudang Garam	Surya Citra Media	
		Aneka Tambang	Ciputra Surya	
		Indocement	Bumi Resources	
		Astra Autoparts	Bank Panin	
		Indofood	Lippo Bank	
		Semen Cibinong		
		Bumi Resources		

Figure 52

Positive CG differentiators

Q23 Independent non-executive chairman[1]	Q31 Independent directors nominated by minorities	Q32 INEDs make up more than half the board	Q33 Increased no. of independent directors since 2000	Q48 Cumulative voting for board representation
Unilever	None	Unilever	INCO	None
Astra International		Astra International	United Tractors	
Astra Agro Lestari		United Tractors	Dynaplast	
United Tractors		Indosiar	Bank Central Asia	
Bank Central Asia		Ciputra Surya	Ramayana	
Bank NISP		Bentoel	Tempo Scan	
Bank Niaga			Aneka Tambang	
Astra Autoparts			Perusahaan Gas Negara	
			Trimegah	
			Semen Cibinong	

[1]Not necessarily independent of controlling shareholder; Source: CLSA Asia-Pacific Markets

Ciputra Surya and INCO have added three independent directors in past three years

Companies that have increased independent directors

As we have changed the scoring methodology this year, it is difficult to determine which companies have truly improved CG. However, taking an increase in independent directors as a gauge of resources going into improving CG, the table below shows the companies that have made some effort in this direction. Ciputra Surya and INCO have made the most significant increase in the number of independent directors, with Ciputra now having more than half of its board made up of independents.

Most of Indonesia's coverage has seen an increase in independent directors

Figure 53

Companies that have increased independent directors

	Increase in indep directors in last 3 years	Indep dir more than 50% of board?
Ciputra Surya	3	✓
INCO	3	
Astra Agro Lestari	2	
Astra International	2	✓
BFI Finance	2	
Dynaplast	2	
Indocement	2	
Indosat	2	
Ramayana	2	
Surya Citra Media	2	
Tempo Scan	2	✓
United Tractors	2	✓
Aneka Tambang	1	
Astra Autoparts	1	
Berlian Laju Tanker	1	
Bumi Resources	1	
Gudang Garam	1	
Indosiar	1	✓
Perusahaan Gas Negara	1	
Semen Cibinong	1	
Semen Gresik	1	
Trimegah	1	
Unilever	1	✓

Source: CLSA Asia-Pacific Markets

CG picks

Top CG picks are BCA and Unilever

Our CG picks for companies in both the top CG quartile and top financials quartile is BCA. This a very sound bank with steady progress towards becoming a full-service lending bank. Apart from BCA, we also like Unilever. It has again polled top in terms of CG and its financials score was marked down due to changes in working capital (but for very small absolute amounts). It also lost marks for having a higher-than-industry Ebitda margin. While we do expect the margin to reduce over time, Unilever should retain an advantage over its competitors.

Top CG recommendations

Figure 54

The top-10 CG companies – Financials and valuations

	CG quartile	A+R score	Implied earnings gwth (%)	Rec
Bank Central Asia	1	1	(6.0)	O-PF
Unilever	1	2	2.5	O-PF
INCO	1	2	(27.6)	BUY
Astra International	1	3	(7.7)	BUY
Dynaplast	1	2	(9.3)	BUY
BRI	2	1	(7.0)	BUY
Ramayana	2	1	0.8	O-PF
Bank NISP	2	1	(5.8)	O-PF
Bank Danamon	2	1	(6.5)	BUY
Tempo Scan	2	2	(5.1)	O-PF

Source: CLSA Asia-Pacific Markets

Problems at the bottom of the CG scores

At the bottom of the CG scores are a couple of companies where we believe the CG issues have and will affect share price performance. Semen Gresik remains troubled over its links with Cemex and with its control of the Padang subsidiary. Bentoel, while it has made some progress still struggles to make an impact on the cigarette market. The bottom two banks actually score well in terms of financials. There is definitely room for them to improve over 2004, and the early signs are positive.

James Paterson
james.paterson@clsa.com
(822) 3978437

Korea – Shareholder pressure

The last 18 months have been an active period for CG in Korea, peaking with the SK Corp AGM in March

Sovereign's actions have to some extent helped reduce the infamous "Korea discount"

The inauguration of a new president advocating chaebol reform, emergence of an activist dominant shareholder at SK Corp and massive losses revealed at SK affiliates has meant that the past 18 months have been an active period for Korean corporate governance, peaking with the SK Corp AGM in March. This was a watershed event that brought issues of transparency and accountability to the fore. In the narrow sense, Sovereign Asset Management failed to obtain most of its goals in terms of director appointments and proposed changes to SK Corp's articles of incorporation. However, in a larger sense the episode was a victory for minority shareholders, with SK Corp forced to adopt previously unthinkable measures, such as ejecting controversial directors from the board (with the obvious and notable exception of Chey Tae Won himself) and appointing a new chairman, who is at least nominally an independent outsider.

The fall in holding company discounts directly linked to Sovereign's activism

Sovereign's actions thus put corporate Korea on notice against future abuse and we see it as a factor that has reduced the holding-company discounts this year. Over the past 12 months, the discount to NAV has fallen by 32ppts at LG Corp, 12ppts at Samsung Corp and 53ppts at SK Corp.

Investors should not rule out the possibility that new rules will be introduced to make aggressive proxy actions more difficult in the future

On the negative side, there has been something of a nationalistic backlash against the Sovereign episode (although this is not a phenomenon unique to Korea or to emerging markets). Investors should therefore not rule out the possibility that new rules will be introduced to make aggressive proxy actions more difficult in the future. This may partly explain the Fair Trade Commission's (FTC) move in July to exempt Samsung Group from the total equity investment limitation rule, which restricts the amount chaebol may invest into affiliates. This will allow other Samsung entities to raise their collective interest in Samsung Corp, which it perceives to be at risk from Sovereign-like activism. This is a step back, but a small negative in the grand scheme of things. We also do not believe it sets a precedent to exempt other chaebol from these rules as the government considers Samsung Corp a special case. Indeed the regulation is expected to be reapplied from April 2006.

With the new scoring system, companies can now longer score highly simply by meeting regulatory requirements

Readers will notice a sharp fall in the company governance scores this year, to an average of 57% from 71% in 2003. This reflects our new questionnaire that puts more emphasis on related-party transactions, government interference in company decision making, parent company gearing, cumulative voting, and chaebol-type corporate structures. There is less emphasis on regulatory-led practices, such as reporting earnings within two months and being an equal-opportunity employer. With the new scoring system, companies can no longer obtain high rankings simply by meeting regulatory requirements.

Posco, Hankook Tire and Samsung Electronics are BUYs that scored in the top quartile of both our corporate governance and accounting scoreboards

There are some clear picks from this year's scores. **Hankook Tire** and **Samsung Electronics** are BUYs that ranked in the top quartile of both our corporate governance and accounting scoreboards. We also believe these stocks are cheap; their stock prices imply long-term earnings growth of -10%, -3% and -9%, respectively. The scoring exercise also highlights the attractiveness of **Hana Bank** and **KT&G**. These two stocks are in the top-quartile in the financial and governance lists, and we rate them Outperform.

Regulatory environment and CLSA/ACGA country CG score

Korea introduced numerous governance reforms in post-crisis years

Korea introduced significant governance reform in the post-crisis years, requiring companies with assets exceeding 2tr won to make 50% of their board members outside independents, and appoint audit committees. Over the past year, there have been fewer major regulatory changes, with the impetus for change more driven by the SK Corp battle already referred to, in addition to ongoing activism from the PSPD (People's Solidarity for Participatory Democracy) - a private lobby group for shareholders' rights.

Figure 55

Korea ratings for macro-determinants of CG

	Rating (1-10)	2003 rating	Comment
Rules & regulations	6.1	7.0	Lack of quarterly consolidated reporting, late disclosure of annual financials, limited requirements with regard to board committees.
Enforcement	5.0	3.5	Korea sees a decline here due to the perception by investors that the regulators have a weak commitment to enforce governance rules and regulations. A lack of activism and voting by institutional shareholders also negatively impacts the score. However, this year's score is higher than last year because it covers "private enforcement" as well as enforcement by the regulator.
Political & regulatory environment	5.0	5.0	Korea introduced numerous reforms and regulations in the post-crisis years. However, more could be done. Some inconsistencies in government direction towards CG and doubts over commitment of the new president.
Adoption of IGAAP	8.0	7.0	Most international standards are followed. The Federation of Korean Industries recently claimed that up to 20% of listed companies were guilty of falsifying accounts on some level. However, in most of these cases it was the auditor who discovered the transgressions, suggesting the audit system is working to stop at least the most egregious issues.
Institutional mechanisms & CG culture	5.0	6.5	Listed companies have not broadly adopted the spirit of corporate governance, in addition to the letter. Investor relations at the "big 8" firms is world class. However, many smaller companies do not even take investor meetings. No corporate governance focus funds, no CG groups founded by institutional investors. Our more rigorous assessment this year brings down the score from last year.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Korea still does not require companies to provide quarterly consolidated financials

Korea scores in the middle of the country rankings, behind Singapore, Hong Kong, India and Malaysia, but marginally ahead of Taiwan, most of the Southeast Asian markets and China. With regard to "rules and regulations" Korea is hampereed by the following issues:

1. Quarterly consolidated financial statements are not required. The market looks at companies on a parent-only basis, and this is also how companies manage their operations. In many cases, management has no idea how margins and return on capital look for their companies as consolidated entities. (A few companies win plaudits for voluntarily disclosing consolidated financials. Samsung SDI, for example, is able to produce consolidated quarterly earnings within three weeks of the quarter end).

Annual financial results take too long to be published

2. Annual financials are not required within two months, as is international best practice, but only within three months. The annual consolidated numbers only come out after five months.
3. It has become the norm to vote on AGM resolutions by poll (rather than a show of hands). However, this has not been made mandatory.

Audit and nominating committees are only required for the biggest companies

4. Korea only requires independent audit and nominating committees for companies with assets of more than 2tr won. Remuneration committees are not required by any company (although some have introduced them on a voluntary basis).

Class-action lawsuits – a threat or tool?

One positive development is the passage of a law allowing investors to bring class-action lawsuits from January 2005. This is a possible route by which minority shareholders will be able to discipline wayward stewardship. However the final version of this legislation was diluted by the addition of so many conditions that it may remain more of a threat rather than a frequently utilised tool.

Class-action law riddled with restrictive conditions

Conditions attached to class-action lawsuits

Korea's class-action law, which will go into effect in 2005, is a bold undertaking to try to enhance management accountability. Although novel, it nevertheless remains riddled with restrictive conditions.

To prevent abusive and frivolous litigation, restrictions include:

1. More than 50 shareholders whose combined shareholdings exceed 0.01% must bring the action. (This requirement, however, only has to be met at the initiation of the lawsuit).
2. Actions can only be brought for false disclosure, insider trading, stock manipulation, or accounting fraud by listed companies.
3. Legal counsel may not undertake more than three class actions in a three-year period.

Accounting fraud, insider trading and false disclosure claims can only be brought against companies with more than 2tr won in assets. Smaller companies with assets of under 2tr won will be subject to class actions starting from January 2007. Stock-manipulation claims, however, can be brought starting from next year, regardless of size.

CG stars

Actions can be brought only for insider trading, stock manipulation and accounting fraud

Companies with assets of <2tr won will only be subject to class actions from January 2007

The highest ranked CG companies fall into one of four categories. The clearest theme is financial services, with three of the top-five companies in the banks and insurance category (Kookmin, Hana and Samsung Fire & Marine). The fact that so many financial-services companies score well reflects improved disclosure and transparency that resulted from various crises (likewise, former Daewoo entity DSME makes the top tier having been forced to become squeaky clean after the crisis workout). The banks also score highly as high levels of foreign ownership have led to strong shareholder pressure to respect minorities. Foreign ownership is 77.5% at Kookmin, 64.7% at Hana and 61.4% at Samsung F&M. Shinhan, which also makes the first quartile in governance, has foreign ownership of 63.4%.

KT remains one of few companies in Asia that has both an independent chairman and allows cumulative voting for directors

A second theme among the top companies is former state ownership. Posco, KT&G, Kogas and KT all make the top quartile. This is an uncontroversial observation in Korea, where former state-owned enterprises (SOEs) are typically considered as having strong minority protection, at least by local standards. This is simply because they have no 'owner', there is no legacy of chaebol membership and during privatisation the companies were able to implement relatively strong minority protection without conflict of interest. Thus, KT remains one of the few companies in Asia that has both an independent chairman and allows cumulative voting for directors.

Daum Communications also makes it into the top quartile. It has five independent directors, including several foreigners, of the total board of nine. Daum is a good example of how smaller, newer and more entrepreneurial companies have the opportunity to approach governance best practice much more easily than their chaebol/'old Korea' counterparts. This is because the

Webzen, NHN, NC Soft and Daum all make it into the top 50% of the survey. Without a chaebol legacy to complicate matters, these companies can structure their AOIs and BODs starting with a blank slate

corporate structures are relatively clean, with few minority owned affiliates/subsidiaries and an alignment of incentives between the management and minority shareholders. (Daum has arguably made some very poor investment decisions recently and perhaps its outside directors are guilty of providing poor business advice. However, there are no governance controversies at the company). Daum was also noted for its strong corporate governance by the Korea Corporate Governance Service (KCGS) and is the highest-ranked Kosdaq company in our survey. We would expect Korea's other internet blue chips, NHN and NC Soft, to also move up the ranks as they mature and professionalise their governance structures.

Figure 56

Stocks in the top-two quartiles for CLSA Korea coverage
(in alphabetical order within each quarter, not ranked according to score)

Top quartile	Second quartile
Daum	Ace Digitech
DSME	Daishin Securities
Hana Bank	DHIM
Hankook Tire	Hanjin Shipping
Kogas	KTF
Kookmin Bank	LG Chemical
KT	LG Telecom
KT&G	NC Soft
Posco	NHN
Samsung Electronics	Samsung SDI
Samsung Fire & Marine	SKT
Shinhan Financial Group	Webzen
	Woori Financial Group

Source: CLSA Asia-Pacific Markets

Note: The top and bottom quartiles have 12 companies while second and third quartiles have 13 companies.

Financials checklist

The companies that performed best in the financials checklist were those that showed cyclically strong performance in 2003. Thus, steel companies Posco and INI Steel do well whereas Kookmin Bank, which lost money in 2003, is in the bottom quartile. Companies with strong balance sheets and healthy free cashflow also scored well. Companies with earnings a significant percentage of earnings from affiliates, and those that have shown an appetite to raise equity, were penalised in the scoring system and generally scored poorly.

Figure 57

Companies in the top quartile of the financials checklist

Company
KT&G
Samsung Fire & Marine
Samsung Electronics
Hankook Tire
Mobis
LG Engineering & Construction
Posco
Hana Bank
Daelim Industrial
Kepco
INI Steel
Dongkuk

Source: CLSA Asia-Pacific Markets

Hana Bank, DSME, Samsung F&M, Posco, Hankook Tire and Samsung Electronics score best on both the CG and A&R scores

The companies that scored best on both the CG and A&R scores are Hana Bank, DSME, Samsung Fire & Marine, Posco, Hankook Tire and Samsung Electronics. Of these, we have BUYs on Hankook Tire and Samsung Electronics. Hana Bank and KT&G are rated Outperform.

Relative performance of stocks sorted by CG

The stock performance by quartile is the exact opposite of what a governance activist would hope to find. Not only did the first quartile underperform, but it was the fourth quartile that performed best!

Figure 58

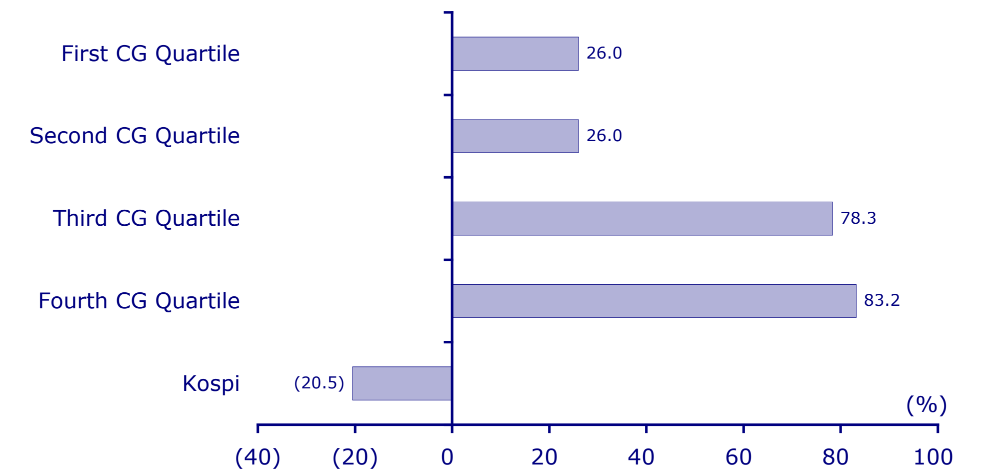
Stock performance of CG quartiles

(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	11.7	78.0	26.0
Second CG quartile	1.0	119.9	26.0
Third CG quartile	28.2	152.0	78.3
Fourth CG quartile	59.7	189.7	83.2
Average of all quartiles	25.2	134.9	53.4
Kospi	4.7	36.5	(20.5)

Fourth quartile the worst performing sector, yet all four sectors outperformed the Kospi when measured with a simple average

Figure 59

Stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

As counter-intuitive as this looks however, a more detailed inspection shows several encouraging factors at play.

It is at the worst-governed companies where the most activism takes place

First, while the lower quartiles showed better stock performance, this is because it is at the worst-governed companies that the most activism takes place. The prime example, of course, is at SK Corp, a stock that is in the bottom quartile of our survey. The factors that caused SK Corp to score badly though, are exactly the same ones that caused Sovereign to launch its campaign and drive the stock price up 270% over the last 12 months. Clearly improving fundamentals and refining margins were also a big factor, but the stock would certainly have performed more poorly without the governance story. Likewise with Hanwha Corp - another holding company to perform well on the back the SK Corp/Sovereign story on the expectation that increased activism would permanently narrow the holding-company discount.

Most of the best-governed companies are relatively mature enterprises

Second, some of the best-governed companies are former SOEs, such as KT, Posco and KT&G. The nature of SOEs is that they are very mature and less likely to show strong performance than mid-cap Korea over an extended period.

Some high-scoring companies are clean because of value-destroying crises in their pasts

Third, some of the best-governed companies are those that have been through major crises and had to be re-invented into squeaky clean form. (DSME and the banks fall into this category). Performance over three and five years for these companies would tend to capture periods of crisis and so stock appreciation would have been small or in some cases negative.

Best-governed companies tend to pay higher dividends

Fourth, the first quartile in the governance list tends to pay more dividends. This is partly because they are much more mature companies but also because governance is better and/or shareholder pressure is higher. If the reinvested dividends were included in the performance chart above, rather than just including capital gains, the performance gap would not be so stark.

Our coverage universe tends to be biased towards stocks we think investors can make money on in the long run. All four quartiles therefore outperformed the Kospi

Fifth, there is a natural bias within our coverage universe to cover stocks we believe investors can make money in. In some cases these companies can perform incredibly strongly despite poor governance. Hence, Kumho Electric is in the bottom quartile in terms of corporate governance, but the stock price is up 660% over three years. (Note that Kumho and SK Corp significantly swing the three-year average performance for our bottom quartile, with each quartile having only 13 stocks). This positive coverage bias is best illustrated by the fact that all four quartiles outperformed the Kospi over the past one, three and five years. The small sample size means that data points that would be outliers from the perspective of the whole market have an outsized influence with respect to their particular quartile. Thus, the fourth quartile shows such strong performance mostly because of four stocks: Kumho Electric, SK Corp, Hyundai Mobis and Hanwha. The positive coverage bias is exacerbated by the fact that the quartile performance is based on a simple average rather than weighted market cap. (The logic of using simple averages, however, is to determine the average performance of stocks of companies at different CG levels, without the result being skewed by the performance of the bigger caps in particular quartiles).

There are instances when being part of a chaebol is more positive for structural growth than it is negative for CG

Sixth, the survey this year places a lot of emphasis of affiliate party transactions and companies with chaebol-type relationships are scored down. This is as it should be from the perspective of assessing CG. However, there are instances when being part of a chaebol is nevertheless positive for structural growth and the financials of the company in question. Such is the case for Mobis, which has been long-term leveraged into Hyundai Motor's volumes and has earned a secular expansion in margins.

Seventh, highly cyclical companies are more likely to have been through crises and therefore been forced to clean themselves up with improved governance. These cyclical companies may be performing badly currently as the market begins to discount a potential softening in economic growth in 2H04.

There is nothing here to suggest investors should give up on governance. However, an equally important lesson is not to overemphasise governance where a strong fundamental story exists

With these seven factors in mind, the relative performance of each quartile makes a lot of sense. There is nothing here to suggest investors should give up on governance and there is nothing to undermine the long-term positive relationship between stock performance and governance that is well established in dozens of academic papers and seven of the other ten markets examined in this report. For investors in Korea, however, an equally important lesson is not to *over*emphasise governance where a strong fundamental story exists (Mobis, Kumho Electric). It is also important to recognise that improvements in corporate governance can have a very strong impact on stock prices even if the company does not move anywhere near to best practice (SK Corp).

CG differentiators

Figure 60

Negative CG differentiators

Q5 Dilute EPS through options, etc	Q25 W/out perceived safeguards in audit committees	Q43 Material related-party transactions	Q44 Controlling shareholders believed to be highly geared	Q54b Directors' remuneration rose faster than NP in the past five years
Shinhan Financial Group	Kogas	KT	SKT	Hanwha Corp
Daum	Webzen	Samsung Electronics	Hanwha	
NHN	NC Soft	KTF		
Webzen	Halla Climate	SKT		
NC Soft	LG Ad	Samsung SDI		
S-Oil	Kepco	LG Telecom		
LG Ad	Cheil Communications	Ace Digitech		
CJ	ReignCom	CJ		
Kangwon Land	Kangwon Land	Samsung Corp		
Kumho Electric		Cheil Communications		
SK Corp		Hyundai Heavy		
		ReignCom		
		Mobis		
		LG E&C		
		Kumho Electric		
		SK Corporation		
		Hyundai Motor		
		Kia Motors		

Figure 61

Positive CG differentiators

Q23 Independent non-executive chairman	Q31 Independent directors nominated by minorities	Q32 INEDs make up more than half the board	Q33 Increased no. of independent directors since 2000	Q48 Cumulative voting for board representation
KT	SK Telecom	Kookmin Bank	KT	Ace Digitech
S-Oil	SK Corp	KT	DSME	CJ
SK Corp	Samsung Electronics	Hana Bank	KT&G	Daishin Securities
		DSME	Posco	DHIM
		Samsung Fire & Marine	Samsung Electronics	DSME
		KT&G	Daum	Halla Climate
		Posco	KTF	Hana Bank
		Kogas	DHIM	Hanjin Shipping
		Samsung Electronics	NHN	Hyundai Heavy
		Shinhan Financial Group	SKT	Kangwon Land
		KTF	Hanjin Shipping	Kepco
		DHIM	LG Telecom	Kogas
		Samsung SDI	Ace Digitech	Kookmin Bank
		Daishin Securities	Webzen	KT
		Hanjin Shipping	NC Soft	KT&G
		LG Chemical	S-Oil	KTF
		Ace Digitech	Mobis	LG E&C
		Woori Financial Group	LG E&C	LG Petrochemical
		S-Oil	Kangwon Land	NC Soft
		Kepco	SK Corp	Posco
		Dongkuk		ReignCom
		Hyundai Heavy		Samsung Electronics
		Interflex		Shinhan Financial Group
		Kumho Electric		Shinsegae
		SK Corp		SKT
				Webzen
				Woori Financial Group

Source: CLSA Asia-Pacific Markets

Figure 62

Q54a – Directors' remuneration

Directors' remuneration/company net profit average for Korea - 2.8%

Company	**CG quartile**	**Remuneration (%)**
Companies with highest directors' remuneration/net profit in 2003		
Hyundai Heavy	4	16
LG Ad	3	15
SK Corporation	4	15
Samsung Corp	3	9
Cheil Communications	4	6
Kumho Electric	4	5
LG Home Shopping	3	5
Webzen	2	4
Daishin Securities	2	3
Daelim Industrial	3	3
Companies with lowest directors' remuneration/net profit in 2003		
Kepco	3	0.1
Posco	1	0.2
KT&G	1	0.2
SKT	2	0.2
Dongkuk	3	0.2
Ace Digitech	2	0.2
Hankook Tire	1	0.2
KTF	2	0.2
KT	1	0.2
Hyundai Motor	4	0.3

Source: CLSA Asia-Pacific Markets

CG picks

Top-five picks are Posco, Hankook Tire, Samsung Electronics, KT&G and Hana Bank

The companies that scored best on both the CG and A&R scores are Hana Bank, DSME, Samsung Fire & Marine, Posco, Hankook Tire and Samsung Electronics. Of these, we have BUYs on Hankook Tire and Samsung Electronics. Hana Bank and KT&G are rated Outperform.

The five stocks are cheap, have strong corporate governance and solid fundamentals

Figure 63

Top-10 CG companies – Financials and valuations

	CG quartile	**A+R score**	**Implied earnings gwth (%)**	**Rec**
Hankook Tire	1	75.0	(2.7)	BUY
Samsung Electronics	1	76.5	(10.2)	BUY
Hana Bank	1	69.4	(5.6)	O-PF
KT&G	1	83.8	(4.8)	O-PF

Source: CLSA Asia-Pacific Markets

Companies that are in the bottom quartile of our governance survey and we do not like fundamentally are Cheil Communications (U-PF), ReignCom (U-PF), Kangwon Land (U-PF) and Kia Motors (U-PF).

Companies in the bottom quartile in terms of A&R scores that we have negative recommendations on are Kangwon Land, NHN, Kookmin Bank, ReignCom, KT Freetel and LG Chemical (SELL).

Shan Choo
shan.choo@clsa.com
(603) 20724288 x213

Malaysia – Building momentum

Building on the foundations laid in 2001

Building upon the accelerated rate of reforms introduced in 2001 and implemented in 2002, the Malaysian CG environment in 2003 saw further improvement. Given the progress already made in 2003, momentum has slowed in CG2004, with fewer measures introduced. Notable changes over the past year include implementation of a Disclosure Based Regulatory (DBR) system by the Securities Commission to encourage better disclosure, and enhanced protection for corporate 'whistle blowers'.

Regulatory environment and CLSA/ACGA country CG score

By end-2003, 42.5% of the recommendations in the Finance Committee Report on Corporate Governance published in 1999 have been implemented, through regulatory reforms (eg, the revamp of Listing Requirements of the Kuala Lumpur Stock Exchange and amendments to securities laws), institutional reforms (eg, the establishment of Minority Shareholder Watchdog Group (MSWG), the institution of ongoing training and education initiatives) as well as setting out relevant industry best practices.

Figure 64

Malaysia ratings for macro-determinants of CG

	Rating (1-10)	2003 rating	Comment
Rules & regulations	7.1	9.0	Improvement in regulations, including a tighter definition of independent directors, but no allowance for class action suits, mandatory voting by poll or disclosure of individual director compensation. Rules on board committees and minorities nomination of directors somewhat weak.
Enforcement	5.0	3.5	Stricter implementation and enforcement of good CG practices.
Political & regulatory environment	5.0	4.0	Stronger political will to improve accountability and transparency, but still doubts over effectiveness of the regulatory/legal systems.
Adoption of IGAAP	9.0	7.0	Efforts continuing to keep reporting standards in line with international practices, including Employee Benefits and Retirement Benefit Plans.
Institutional mechanisms & CG culture	4.6	6.5	A lot of form over substance among companies and weak involvement of institutional investors.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Key measures

The regulatory environment in Malaysia continues to evolve, with the implementation of initiatives from the government, the Securities Commission (SC), the KLSE and the Malaysian Accounting Standards Board (MASB). Among the key initiatives are:

Introducing a Disclosure Based Regulatory system to encourage better disclosure

- The SC changed from merit to Disclosure Based Regulatory (DBR) system, which will encourage and focus on higher quality information disclosure by companies. There will be speedier approval by the SC for companies with good CG records, while those with poor records may find themselves restricted by the SC from seeking funds from the public.

Steps to protect whistle blowers

- The SC also took steps to enhance protection for corporate 'whistle blowers', increased the SC's range of sanctions and enhanced investors' rights for judicial redress through class-action suits.

Improving accounting standards

- MASB introduced a number of key standards with regards to the accounting & disclosure of Employee Benefits (MASB 29), Retirement Benefit Plans (MASB 30) and Discontinuing Operations (MASB 28).

Our country ranking for Malaysia has moved up from equal fifth last year to fourth, and the overall score for macro-CG determinants raised from 5.5 to 6.0. This came largely from a higher score on enforcement (which has a 25% weighting in the overall score). Under the new scoring system introduced this year, Malaysia gets a higher score for the political/regulatory environment and adoption of international standards of accounting. However, its score has moved down for rules and regulation as well as on the CG culture based on the criteria being used in this year's scoring.

CG stars

Still dominated by Public Bank, Tanjong and BAT

Overall scores improved in key areas such as transparency and accountability. The average CG score improved from 65.6% to 65.7% in CG2004 – 66.1% excluding IOI Corp's large fall. Key CG heavy weights such as Public Bank, Tanjong, BAT and Road Builder continued to dominate the top five, while the biggest improvements were recorded by government-linked companies (GLCs), most notably Telekom Malaysia and Tenaga.

Over the past five years, the top quartile appreciated by 45%, with the bottom quartile managing only 25% over the same period. The top scorers will continue to outperform the market, underpinned by quality management and superior track record. We expect these companies to continue to outperform in the medium term.

Figure 65

Stocks in the top two quartiles for Malaysia (CLSA coverage)

Top quartile	Second quartile
Public Bank	Guinness
BAT	Courts Mammoth
Tanjong	IJM
Maybank	JTI
Carlsberg	Commerce Asset
RBH	Malakoff
Nestle	SP Setia
KL Kepong	Transmile Group
Gamuda	Naim Cendera
Maxis	Media Prima
CIMB	AMMB
Unisem	Sime Darby

Source: CLSA Asia-Pacific Markets

Telekom - Better accountability and transparency

In 2002, the biggest CG improvements were made by Malaysia Airlines and the now delisted Celcom (formerly known as TRI). This momentum was carried forward in 2003 by changes in key GLCs, most notably by **Telekom Malaysia** (parent of Celcom). Management revamped its key business practices and took concrete efforts to cut costs, which boosted its CG Discipline scores. Together with improving transparency and accountability, Telekom was rerated, rising 31% in the 12 months until end June 2003.

Tenaga - Increasing transparency

Tenaga Nasional though has yet to significantly improve efficiency, but increasing efforts are being channelled towards enhancing returns. Management has largely kept to its targets of disposing minority stakes in the IPPs and containing capex to better manage its cashflow and debt level. Transparency has improved with more efforts to provide the investment community with first-hand information and access to key management.

Tanjong – Good guidance on new growth initiatives

Tanjong continues to show improvement in its governance profile. After a slight communication hiccup with the investment community regarding its surprise leisure investment in Germany, management has gone all out in terms of being as transparent as possible regarding the scope and potential of the investment. Guidance on new growth initiatives for the gaming division is good, while the delisting of Powertek has not resulted in reduced access to operating information.

CG disappointments

IOI - Pricey land acquisition from majority shareholder

Plantation giant **IOI Corp** saw the biggest downgrade in our most recent CG score, down 16.5ppts. The disappointments came in the discipline, responsibility and independence scores. This was the result of the sale of plantation land owned by the major shareholder to IOI Corp. The land was acquired at RM32,000 per hectare, which at a 13% premium to comparable values and deemed by the market to be overpriced.

HL Bank - Poor operational guidance

Hong Leong Bank had a bad CG2004. The departure of several senior management figures resulted in a period of uncertainty and reduced transparency. A negative provisioning surprise in 3QFY04 also raised concerns. New management will need time to familiarise itself with operations and articulate group strategy following two years of stagnant loan growth.

Gamuda - Needs to be more frank about double-tracking

Gamuda is a victim of the new administration's decision to indefinitely postpone the RM14.5bn double-tracking project. But this controversial project could have been better managed if management adopted a more open and frank discussion on potential risk, following the change in government.

Potential movers and shakers

GLCs will see the best CG improvement going forward

We expect to see improvement in CG scores, primarily among the GLCs. CG star Telekom Malaysia is ahead of the curve in this respect. However, with the GLC-restructuring fever sweeping the corporate landscape, we expect other GLC heavyweights such as Sime Darby and Tenaga Nasional (both already making progress) to report significant improvement in their next CG scores for progress over 2004.

Financials checklist

Strongest financials are with Gamuda . . .

The warning signs of potential corporate disasters also lie within the accounts, thus we have introduced a financial checklist for Accounting & Returns (A&R). The top-three stocks in the financial checklist are Gamuda, BToto and Magnum. All three are cash rich, with improving working-capital management, rising dividends and payout ratios. They have seen a steady improvement in ROE, which is set to rise further in the near future.

. . . while MAS has the lowest

At the other end of the spectrum, MAS, AMMB and Media Prima suffer from a poor ROE outlook. Both Media Prima (associate NSTP) and MAS (cash) have been penalised for high non-operating income, which contribute more than 30% to pretax.

Gamuda has the best of both worlds

For the best of both worlds, long-time favourite Gamuda fits the bill as it lies in the First Quartile for both our financials checklist and CG. Other companies that are in the top quartile for Malaysia on both CG and the financials checklist are construction company IJM, banking giant Public Bank and investment bank CIMB.

Relative performance of stocks sorted by CG

The top-CG quartile underperformed the country sample over the one and three year periods to June 2004, with better performance coming from stocks in the middle-CG quartiles. Over the last five years, the top-CG quartile outperformed very slightly against the country sample. However, the top half of the sample for CG outperformed the overall sample by 10ppts, or 19ppts against the bottom-half CG companies, over the past five years.

Figure 66

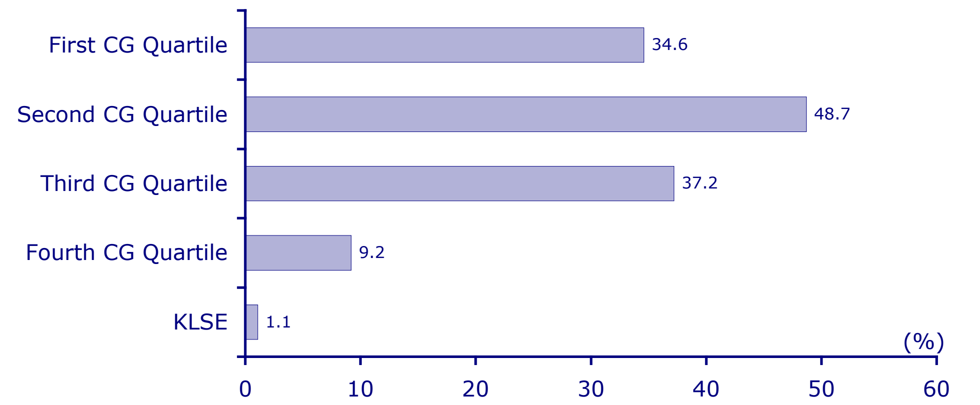
Stock performance of CG quartiles

(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	22.0	46.0	34.6
Second CG quartile	38.8	62.3	48.9
Third CG quartile	17.0	63.9	37.2
Fourth CG quartile	14.5	51.7	9.2
Average of all quartiles	23.1	56.0	32.4
KL Composite Index	18.5	38.3	1.1

If Transmile is excluded, the 2Q 5-year perf falls to 35%

Figure 67

Five-year stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

GLCs leading the way in CG improvements . . .

The top three stocks reporting the highest CG improvements enjoyed a period of outperformance. Top improver Telekom Malaysia saw the 7.94 improvement in its CG score coincide with a 31% increase to its share price in the past 12 months (versus 18% for the KLCI). Gaming and power giant, Tanjong also saw a 23% appreciation in its share price, together with the 6.2 rise in its CG score. National utility company Tenaga Nasional saw a 3 CG point rise and an 11% rise in its share price – although lower than the market's 18%, it was higher than the average 9.5% increase enjoyed by other Fourth Quartile stocks.

. . . with Telekom at the head of the pack

Figure 68

Companies with CG changes over 2003-04

	Change in score by 2004 questionnaire	2004 quartile ranking
Telekom Malaysia	7.94	3rd
Tanjong	4.53	1st
Tenaga	3.17	4th
PLUS	1.88	4th
BAT	1.67	1st
Maybank	1.67	1st
BToto	1.67	4th
SP Setia	1.50	2nd

Source: CLSA Asia-Pacific Markets

Figure 69

Negative CG differentiators

Q5 Dilute EPS through options etc	Q25 W/out perceived safeguards in audit committees	Q43 Material related-party transactions	Q44 Controlling shareholders believed to be highly geared	Q54b Directors' remuneration rose faster than NP in past five years
IOI Corporation	na	Digi.com	DiGi.com	IOI Corporation
Resorts World		Genting	AMMB	MISC
		Resorts	EON	EON
		MPI	Magnum	Proton
		Magnum	BToto	Unisem
		BToto		Telekom Malaysia
				SP Setia
				Genting
				Tan Chong Motors
				JT International
				YTL Power
				MAS
				KLK
				Resorts World

Figure 70

Positive CG differentiators

Q23 Independent non-executive chairman	Q31 Independent directors nominated by minorities	Q32 INEDs make up more than half the board	Q33 Increased number of independent directors since 2000	Q48 Cumulative voting for board representation
BAT	na	Public Bank	Public Bank	na
Public Bank		Road Builder	Carlsberg	
Nestle		Maybank	Gamuda	
Maxis		MISC	IOI Corporation	
Maybank		Commerce Asset	UMW Holdings	
IJM		Sime Darby	MISC	
Commerce Asset		Malaysia Airlines	EON	
Guinness Anchor		Magnum	AMMB	
JT International			Malakoff	
BToto			Unisem	
Media Prima			Courts Mammoth	
Transmile			Sime Darby	
			SP Setia	
			Petronas Gas	
			YTL Corp	
			JT International	
			YTL Power	
			MAS	
			KL Kepong	
			BToto	
			Transmile	

Source: CLSA Asia-Pacific Markets

Courts Mammoth and Genting have the costliest directors

Figure 71

Q54a – Directors' remuneration

Directors' remuneration/company net-profit average for Malaysia sample - 2.3%

Companies with highest directors' remuneration/net profit in 2003 (%)			
Courts Mammoth	8.9	JTI	5.7
Genting	8.1	Proton	5.6
ASTRO	7.2	Resorts	5.5
Naim Cendera	6.2	Maybank	5.0
JTI	5.7	BToto	4.9
Companies with lowest directors' remuneration/net profit in 2003 (%)			
PLUS	0.1	Media Prima	0.2
UMW	0.1	Digi.com	0.2
PGas	0.1	Tan Chong	0.2
MISC	0.1	Telekom Malaysia	0.2
Tenaga	0.1	Maxis	0.2

Note: Unisem was loss making, thus excluded from the table. Source: CLSA Asia-Pacific Markets

CG picks

Top pick is Public Bank

Out top CG pick is Public Bank. Not only does the stock have the highest CG score for Malaysia, but it is also at the very top for our rankings in the Asia ex-Japan universe. It scores highly on our financials checklist as well, with the highest implied earnings growth. With these credentials, Public Bank's stock will Outperform, being a magnet for investors as long the country's economic outlook is supportive. Other stocks with a good combination of CG and financial scores with earnings growth include CIMB, Gamuda and IJM.

But CIMB, Gamuda and IJM looks interesting too

Figure 72

The top-10 CG companies – Financials and valuations

	CG quartile	A+R score	Implied earnings gwth (%)	Rec
Gamuda	1st	83.8	2.1	O-PF
IJM	1st	75.0	2.6	O-PF
Public Bank	**1st**	**72.1**	**4.9**	**O-PF**
CIMB	1st	70.6	3.7	O-PF
KL Kepong	1st	69.1	0.8	na
BAT	1st	67.6	5.3	U-PF
Maybank	1st	67.6	4.4	O-PF
SP Setia	2nd	67.6	2.5	O-PF
Courts Mammoth	2nd	66.2	(1.6)	U/Rev
JTI	2nd	63.2	3.9	na

Note: Stocks ranked by A+R scores, excluding those in 3rd and 4th Quartile.
Source: CLSA Asia-Pacific Markets

Get out of IOI, Tan Chong, HL Bank, Plus, MAS and EON

Companies in the bottom CG quartile with key SELL recommendations include IOI Corp, Tan Chong Motors and Hong Leong Bank. At the end of the A&R spectrum, we believe investors should exit stocks like PLUS Expressway, national airline MAS and car distributor EON.

Philippines Research
mitzi.dedios@clsa.com
(63) 2886563746

Philippines – Measured steps

Some improvements noted, but more still needs to be done

The Philippines has taken marked steps to improve corporate governance (CG) with the implementation of the Securities Regulation Code (SRC) and Code of Corporate Governance (CCG). Still, a lot needs to be done to instil the right culture and commitment to CG. The Bangko Sentral ng Pilipinas (BSP), by virtue of its regulatory powers, has been at the forefront in mandating CG briefings for banks. However, this is not a requirement for listed non-bank firms. Additional legislation to prevent corporate fraud and abuse, in the form of the Corporate Reform Act of 2004, is likewise still to be taken up by Congress.

Top CG pick is Globe while Meralco has the worst CG ranking

Our top CG pick is Globe Telecom (Globe), as it is in the top CG quartile and in the second financial checklist quartile and trades at reasonable valuations where current valuations imply only 0.6% growth. Our least-liked firm is Meralco, which is at the bottom quartile for CG rankings and financial performance. While considered cheap, Meralco will likely stay cheap until CG and financial issues improve.

Regulatory environment and CLSA/ACGA country CG score

Country score improves to 5.0 from last year's 3.7

The Philippines shows a marked improvement in country score to 5.0 this year from last year's 3.7. It overtook China and is now ranked eighth of the ten countries tracked by CLSA. Progress has been made on the political and regulatory front with the implementation of the SRC and CCG. The executive and legislative branches of government are also striving to improve corporate and public governance. Some advances were also made in the enforcement and accounting fields, though there was some deterioration in the scores for rules and regulations and institutional mechanisms and CG culture categories. This was mainly because our scoring methodology became more rigorous this year and took into account a broader range of factors.

Figure 73

Philippine ratings for macro-determinants of CG

	Rating (1-10)	2003 rating	Comment
Rules & regulations	5.8	6.5	The Securities Regulation Code (SRC) and Code on Corporate Governance are now in place for listed firms. However, the Corporate Reform Act (CRA) of 2004 has just been re-filed in Congress. The CRA is similar to the Sarbanes-Oxley Act of the US and is meant to prevent corporate fraud and abuse.
Enforcement	3.1	2.0	Some improvement noted with tighter oversight by the Securities and Exchange Commission (SEC) and the Philippine Stock Exchange's (PSE) Compliance and Surveillance Group over listed firms and the Bangko Sentral ng Pilipinas (BSP) over banks.
Political & regulatory environment	5.0	2.0	Major advances observed with the executive and legislative branches of government striving to improve corporate and public governance. The higher score is also the result of our new methodology. However, the regulatory structure and legal systems still quite weak.
Adoption of IGAAP	8.5	6.0	Local accounting standards in line towards adoption of IAS. Expanded disclosure in 2003 annual reports.
Institutional mechanisms & CG culture	3.1	4.0	CG culture still to be institutionalised with mandatory CG briefings limited to banking institutions only.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Additional legislation needed to prevent corporate fraud

Much needs to be done to instil the right culture and commitment and further improve CG rules and regulations. The BSP, by virtue of its regulatory powers, has been at the forefront in mandating CG briefings for banks. However, this is not a requirement for listed non-bank firms.

The salient points of the SRC and CCG are the following:

- Publicly listed companies are required to have at least two independent directors or at least 20% of its board size in its board.
- Higher qualifications and ethical standards have been set for board directors.
- A tender offer to all shareholders is mandatory should any person or group acquire 35% or more of the existing shares of a public company.
- External auditors are required to be rotated or replaced every five years.
- Companies are required to form committees for audit and compliance, nomination and compensation, and risk management.
- Corporations must have an independent auditor and audit committee reporting to an independent director.
- Disclosures must be made within five business days on the acquisition of more than 5% of the stock of a company.
- It is unlawful for any person to manipulate the share price of a company and for brokers/dealers to execute orders for such share price manipulation.

Additional legislation to prevent corporate fraud and abuse, in the form of the Corporate Reform Act of 2004 is likewise still to be taken up by Congress. The CRA is patterned after the Sarbanes-Oxley Act of the US. The political campaign season for the May 2004 elections that kicked off early in late 2003 held up Congress deliberations on the CRA. It did not help that the primary sponsor of the bill, Sen. Lapus, is a member of the opposition party. With Congress prioritizing economic bills, the CRA may take some time to get enacted.

The salient points of the CRA are as follows:

- Require CEOs to certify the accuracy of financial reports under threat of punishment.
- Make punishable the shredding or altering of records while a company is under investigation with up to 20 years imprisonment.
- Make punishable securities fraud with up to 20 years imprisonment.
- Make illegal the granting of loans to executives of publicly listed firms or companies imbued with public interest such as pension and educational pre-need companies.

The CRA also seeks to enforce tougher provisions on existing Securities and Exchange (SEC) circulars on accounting firms providing consultancy services as well as on the rotation of accounting partner overseeing the audit of a specific firm every five years.

CG stars

CG stars led by Ayala Group

The Ayala Group, spearheaded by Ayala Corp (AC) and including Ayala Land (ALI), Globe Telecom (Globe) and Bank of the Philippine Islands (BPI), are at the top of our CG rankings, given the group's excellent reputation and deep commitment to CG practices. Philippine Long Distance Telephone (PLDT) also bounced back from last year's fiasco, triggered by the aborted takeover by the JG Summit group, with a more transparent and accountable management that has restored its credibility.

Figure 74

Stocks in the top two quartiles for the Philippines (CLSA coverage)

Top quartile	Second quartile
Ayala Corp	Bank of the Philippine Islands
Ayala Land	Philippine Long Distance Telephone
Equitable PCI Bank	Banco de Oro
Globe Telecom	First Philippine Holdings

Source: CLSA Asia-Pacific Markets

CG disappointments

Meralco is a CG disappointment

Meralco is at the bottom of our CG rankings due to late disclosure of material events and unclear related-party transactions. Meralco had failed to adequately warn investors of issues related to the refund of overcharged amounts and retraction of provisional rate increases. Meralco is also liable for the opaque business relationship with the power generation business of its controlling shareholders, the Lopez group.

Jollibee Foods Corp (JFC) fell dramatically in our CG rankings this year due to management decision not to hold quarterly analyst briefings and non-disclosure of its same-store-sales, which were previously provided on a regular basis. The entry of Henry Sy to the board of directors at San Miguel Corp (SMC) likewise did not improve SMC's CG score given that the 2003 annual report did not provide enough financial information on non-listed strategic business units including Coca-Cola Philippines and packaging group. Petron also remained at the bottom of the CG quartile due to late disclosure in submitting financial statements.

Financials checklist

BPI tops the financial rankings while Meralco comes out at the bottom

BPI topped the list of financial rankings while Meralco came out at the bottom. Other companies joining BPI include ALI, Banco de Oro (BDO) and SMC. Those joining Meralco are Filinvest Land (FLI), PLDT and AC. For PLDT and AC, their lacklustre financial scorecards should be a thing of the past thanks to the surging earnings of their mobile subsidiaries.

ALI made it to the top quartile for both the financials checklist and CG. Meralco was at the bottom quartile for the financials checklist as well as the bottom quartile for CG.

Relative performance of stocks sorted by CG

High-CG stocks outperformed on three- and five-year bases

High–CG stocks outperformed the Phisix on three- and five-year bases, but slightly underperformed on a one-year period ending 30 June 2004. **Globe**, our top CG pick, enjoyed an absolute return of 36% over one year, 48% over three years and 71% over five years. The average performance of the bottom quartile of CG stocks underperformed the Phisix on a three-year basis but outperformed on a five- and one-year basis.

Top-quartile CG stocks outperformed over last three and five years

Figure 75

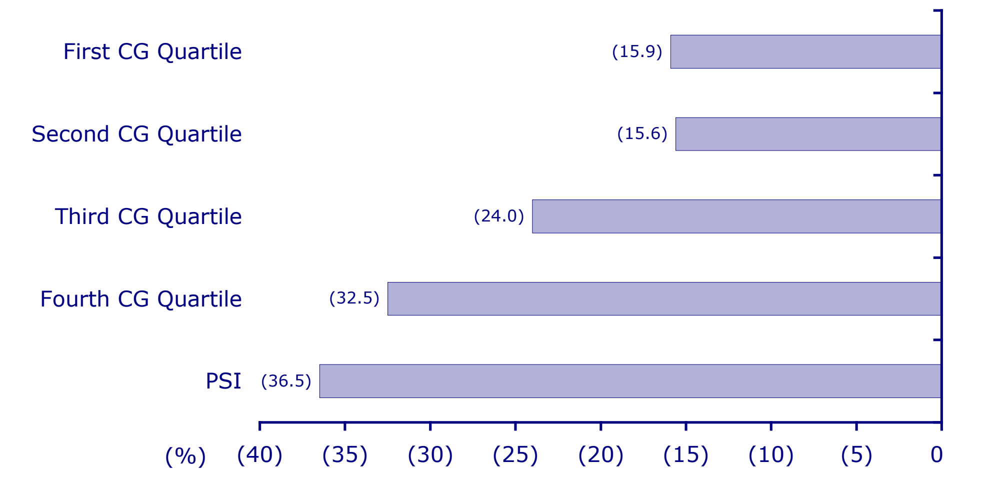
Stock performance of CG quartiles

(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	28.7	17.1	(15.9)
Second CG quartile	60.0	15.9	(15.6)
Third CG quartile	13.6	(3.9)	(24.0)
Fourth CG quartile	44.4	10.8	(32.5)
Average of all quartiles	36.7	10.0	(22.0)
PSE Index (Phisix)	29.2	12.0	(36.5)

Better CG stocks have fallen over last five years

Figure 76

Five-year stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

PLDT, which has seen its CG rank improve significantly since last year, had an absolute return of 104% over one year, 59% over three years and negative 0.9% over five years. JFC, which fell dramatically in our CG rankings this year, recorded absolute gains of 41% over one year, 78% over three years and 20% over five years.

PLDT, Metropolitan Bank and First Philippines each added 4 independent directors

Companies that have increased independent directors

As we have changed the scoring methodology this year, it is difficult to determine which companies have truly improved their CG. However, taking an increase in independent directors as a gauge of resources going into improving CG, the following table shows the companies that have made some effort in this direction. PLDT, Metropolitan Bank and Trust and First Philippine Holdings have each increased the number of independent directors by four in the last three years. However for none of the companies do independent directors make up more than half of the board.

12 companies have increased independent directors in the last three years

Figure 77

Companies that have increased independent directors

	Increase in indep directors in last 3 years	Indep dir's more than 50% of board?
First Philippine Holdings	4	N
Metropolitan Bank and Trust Co	4	N
Philippine Long Distance Telephone Co	4	N
Bank of the Philippine Islands	3	N
Equitable PCI Bank	2	N
Filinvest Land	2	N
Globe Telecom	2	N
ABS-CBN	1	N
Ayala Corp	1	N
Ayala Land	1	N
Banco de Oro	1	N
Jollibee Foods Corp	1	N

Figure 78

Negative CG differentiators

Q5 Dilute EPS through options etc	Q25 W/out perceived safeguards in audit committees	Q43 Material related-party transactions	Q44 Controlling shareholders believed to be highly geared	Q54b Directors' remuneration rose faster than NP in past five years
ABS-CBN Broadcasting	Jollibee Foods	Meralco		
Filinvest Land	Meralco	Petron		
First Philippine Holdings	Petron	San Miguel		
Meralco	SM Prime Holdings	SM Prime Holdings		
Petron				
San Miguel				

Figure 79

Positive CG differentiators

Q23 Independent non-executive chairman	Q31 Independent directors nominated by minorities	Q32 INEDs make up more than half the board	Q33 Increased no. of independent directors since 2000	Q48 Cumulative voting for board representation
Jollibee Foods	Petron	Meralco	ABS-CBN Broadcasting	ABS-CBN Broadcasting
San Miguel		Petron	Ayala Corp	Ayala Corp
		San Miguel	Ayala Land	Ayala Land
		SM Prime Holdings	Banco de Oro	Banco de Oro
			Bank of the Phil Islands	Bank of the Phil Islands
			Equitable PCI Bank	Equitable PCI Bank
			First Philippine Holdings	First Philippine Holdings
			Filinvest Land	Filinvest Land
			Globe Telecom	Globe Telecom
			Jollibee Foods	Jollibee Foods
			Metrobank	Meralco
			PLDT	Metrobank
				Petron
				San Miguel
				PLDT

Source: CLSA Asia-Pacific Markets

Average directors fees just 0.15% of net profit

Figure 80

Q54a – Directors' remuneration

Directors' remuneration/company net-profit avg for Philippine sample - 0.15%	
Companies with highest directors' remuneration/net profit in 2003 (%)	
Bank of the Phil Islands	0.26
Equitable PCI Bank	0.23
Filinvest Land	0.17
First Philippine Holdings	0.17
PLDT	0.17
Companies with lowest directors' remuneration/net profit in 2003 (%)	
Banco de Oro	0.07
Ayala Corp	0.08
Metrobank	0.09
Globe Telecom	0.11
ABS-CBN Broadcasting	0.15

Source: CLSA Asia-Pacific Markets

CG picks

Top CG picks are Globe and Ayala Land

Our top CG pick is Globe as it is in the top CG quartile and in the second financial checklist quartile and trades at reasonable valuations where current valuations imply only 0.6% growth. Without taking into account valuations, our other preferred CG play is ALI, which is in both the top CG quartile and top financials quartile.

Figure 81

Top-10 CG companies – Financials and valuations

	CG quartile	A+R score	Implied earnings gwth (%)	Rec
Ayala Corp	1	50.0	9.5	SELL
Ayala Land	1	79.4	9.5	O-PF
Equitable PCI Bank	1	58.3	6.3	U-PF
Globe Telecom	1	61.8	(0.6)	BUY
Bank of the Philippine Islands	2	80.6	7.4	O-PF
PLDT	2	48.5	7.7	BUY
Banco de Oro	2	69.4	0.8	O-PF
First Philippine Holdings	2	54.4	-	BUY

Source: CLSA Asia-Pacific Markets

Low CG-ranked firms are Meralco, Petron and San Miguel Corp

Our least-liked firm is Meralco, which is at the bottom quartile for CG rankings and financial performance. While considered cheap, Meralco will likely stay cheap until CG and financial issues improve. Other companies in the bottom CG quartile include Petron and SMC, even though the latter is ranked among the top quartile in terms of financials.

Prabodh Agarwal
prabodh.agarwal@clsa.com
(65) 69167816

Singapore – Soldiering on

Singapore has made good progress to CG-related issues

Singapore has been making good progress in CG-related issues, further reinforcing its pole position in the region. It is now required of all listed companies to comply with the Code of Corporate Governance effective for financial year beginning 1 January 2003. The code encompasses key elements of transparency and independence (eg, existence of independent audit, remuneration committees, split the roles of CEO and Chairman).

The Code of Corporate Governance was issued in 2001 and was a critical milestone in strengthening Singapore's disclosure-based regime. The Code sets out principles and best practices in four main areas of governance: board matters, remuneration, accountability and audit, and communications with shareholders.

Subsequently in August 2002, the Council on Corporate Disclosure and Governance (CCDG) was formed to review corporate standards, corporate governance and disclosure issues. The CCDG comprises members from businesses, professional organisations, academic institutions and the government. Discussions are now underway to revise and update the code.

BUY/SELL summary

ST Eng, Keppel Corp and SPH have high CG scores and feature among our top picks

Figure 82

BUY/SELL summary

High/improving CG BUYs	Country CG quartile	Rerating drivers
ST Engineering	1	Disciplined approach towards acquisition and transparent dividend policy.
Keppel Corp	1	Divesting non-core assets and returning capital to shareholders.
SPH	1	Divested non-core (Belgacom stake) and improved capital efficiency through capital reduction.
Low/uncertain CG SELLs		
SCI	4	Loose internal control and risk management systems resulting in frequent mishaps.

Source: CLSA Asia-Pacific Markets

Regulatory environment and CLSA/ACGA country CG score

Figure 83

Singapore ratings for macro-determinants of CG

	Rating (1-10)	2003 rating	Comments
Rules & regulations	7.9	8.5	More stringent criteria in new scoring methodology on nomination of independent directors, permission of class-action law suits etc.
Enforcement	6.5	7.5	More stringent criteria on protection of minority shareholders, which now also includes "private enforcement by the market".
Political & regulatory environment	8.1	6.0	Clear and consistent government policy in support of corporate-governance reform.
Adoption of IGAAP	9.5	9.0	Singapore's rules are now largely synchronous with international accounting and auditing practices. Efforts being made to regulate accounting profession.
Institutional mechanisms & CG culture	5.8	8.0	More stringent criteria on level of investor relations and companies strengthening their internal control and risk-management systems.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Besides the regulatory framework, Singapore has also institutionalised other practices to encourage better corporate governance. The NUS Business School, in January 2003, set up the Corporate Governance and Financial Reporting Centre to promote best practices in these areas. Similarly the Securities Investors Association of Singapore (SIAS) introduced for the first time last year an annual award for a Singapore company that meets the letter and spirit of the Singapore Code of Corporate Governance.

SGX listing manual requires all listed companies to disclose their CG practices in their annual reports

Guiding principles of the Code of Corporate Governance

The Singapore Exchange (SGX) listing manual requires all listed companies to disclose in their annual reports their corporate governance practices with reference to the Code. Companies are also required to disclose and explain areas of deviation from the Code.

Principle 1: Effective board to lead and control the company.

Principle 2: Strong and independent element on the Board.

Principle 3: Chairman and CEO to be separate to ensure appropriate balance of power, increased accountability and greater capacity of the Board for independent decision making.

Principle 4: Formal and transparent process for appointment of new Directors.

Principle 5: Formal assessment of the effectiveness of the board as a whole and the performance of individual Directors.

Principle 6: Board members to have complete, adequate and timely information.

Principle 7: Formal and transparent procedure for fixing remuneration packages of Directors.

Principle 8: Remuneration of Directors should be adequate but not excessive.

Principle 9: Disclosure on remuneration policy, level and mix of remuneration, and procedure for setting remuneration.

Principle 10: The board is accountable to shareholders; management is accountable to the board.

Principle 11: Establishment of Audit Committee with written terms of reference.

Principle 12: Sound system of internal controls.

Principle 13: Independent internal and audit function.

Principle 14: Regular, effective and fair communication with shareholders.

Principle 15: Greater shareholder participation at Annual General Meetings.

Corporate developments

TLCs earlier penalised in our CG rankings as they suffered from a perception of making overseas acquisitions at the behest of Temasek

Temasek-linked-companies (TLCs) earlier suffered from a perception of having made overseas acquisitions at the behest of Temasek, which resulted in some of the TLCs paying a very high acquisition price. Consequently, the concerned TLCs were penalised in our CG rankings. This perception has now somewhat abated for the following two reasons.

Firstly, in hindsight many of these acquisitions do not appear as value-destroying as they looked at the time of the acquisitions (eg, the SingTel-Optus and DBS-Dao Heng Bank deals). Secondly, Temasek is now on an acquisition spree by itself, without involving the TLCs and in some cases actually competing with fellow TLCs. This should result in further improvements to the CG scores of TLCs in future years.

Listed companies in Singapore appear to be generally making good progress in terms of corporate transparency. Studies conducted by The Business Times and the National University of Singapore seem to corroborate this.

CG Code here specifically requires split roles for CEO and chairman and about three-quarters of the companies already comply

About one third of the companies had more than half of the board comprised of independent directors. The CG Code here specifically requires split roles for CEO and Chairman and about three-quarters of the companies already comply (this was only 29% two years back). Similarly over 80% of the companies have established board committees for nominating, remuneration and audit. Clearly, the trend is towards greater compliance and companies seem to be steadily improving on all these counts.

CG stars

Figure 84

Stocks in the top two quartiles for Singapore (CLSA coverage)

Top quartile	Second quartile
Singapore Post	SembCorp Marine
ST Engineering	Accord CCS
Singapore Exchange	ComfortDelGro
MobileOne	Creative Technology
OCBC	Fraser and Neave
Keppel Corporation	Great Eastern Hdg.
DBS Group Holdings	SembCorp Logistics
SingTel	Venture Corp
Singapore Press	Keppel Land
SMRT Corp	

Source: CLSA Asia-Pacific Markets

Keppel Corp

Keppel Corp ranked as the "Best in Corporate Governance" in Asian capital goods sector in survey by *Asiamoney*

Keppel Corp is the recipient of numerous awards over the past year in recognition of the company's performance and governance practices. The group bagged the top award for 'Best Corporate Governance' practices at the latest annual report awards organised by The Institute of Certified Public Accountants of Singapore, Singapore Institute of Management, SGX, Singapore Institute of Directors, The Business Times and the Securities Investors Association (Singapore).

It was also ranked as the 'Best in Corporate Governance' among Asian Capital Goods Sector in survey by *Asiamoney* and as the 'Best Conglomerate in Asia' by *Euromoney*.

Between 2001 and 2003, Keppel divested over S$3bn of low-yielding businesses and non-core assets as part of the restructuring process and returned over S$600m of capital to shareholders

Three years ago, the company restructured to focus on three core businesses: offshore & marine, property development and infrastructure. From 2001 to 2003, Keppel divested over S$3bn of low-yielding businesses and non-core assets as part of the restructuring process and returned over S$600m of capital to shareholders, in addition to a normal dividend of S53¢ /share over this period.

Figure 85

CG track record of Keppel Corp

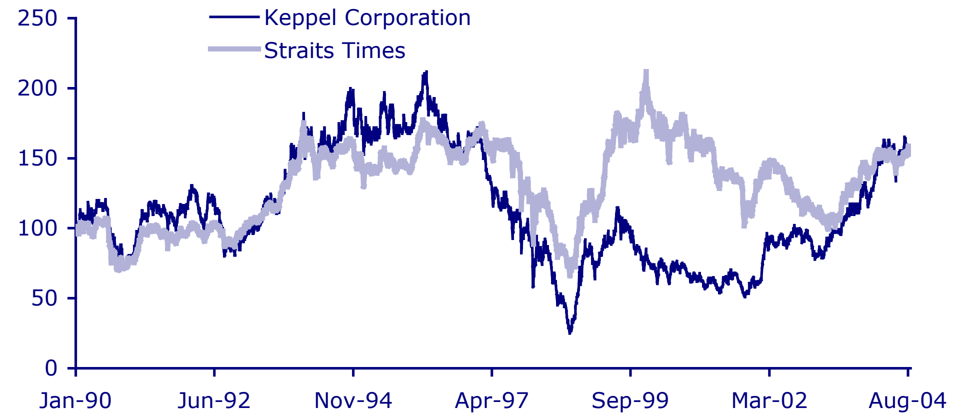
Date	Event	CG Comment
Jul-01	Sold Keppel Capital for S$1.7bn.	Non-core asset divested: start of Keppel's restructuring programme.
Aug-01	Proposed to privatise FELS.	Articulated clear strategy/benefits of privatisation move.
Nov-01	Capital return of S$0.50/share.	Returning excess cash, positive for shareholder value.
Dec-01	Proposed to privatise KHZ, Keppel T&T.	KHZ's privatisation synergistic with that of FELS'.
Mar-02	KTT privatisation/Friedman's fiasco.	A slight dent to overall improving CG.
Jul-02	Keppel delivers maiden interim cash dividend.	Still returning excess cash to shareholders.
Dec-02	Subsidiary Keppel Land divests its 70% equity interest in Capital Square for $85m.	Divestment of investment property as promised.
Dec-02	Subsidiary Keppel T&T reduced its stake in M1 from 35% to 14% through an IPO and realized proceeds of $287m.	Divestment of non core assets as promised.
During 02	Started quarterly reporting fin early 2002.	1 Year ahead of mandatory requirements.
	Starts performance appraisal for directors.	Increases accountability of board.
	Improves corporate access.	Improves transparency.
Feb-03	Sell its 20% stake in Keppel Insurance to HSBC Insurance for $31m.	Divestment of non core assets.
Dec-03	Sells 28% stake in Singapore Petroleum Company for $180m, reducing its stake in SPC to 49%.	Divestment of non core assets.

Source: CLSA Asia-Pacific Markets

The share price has performed extremely well, reflecting both the strong earnings outlook and a growing confidence in the credibility of top management.

Figure 86

Keppel Corp's market performance



Source: **CLSA evalu@tor®**

The company has initiated new measures to adequately educate and inform the non-executive directors so that they can debate and challenge management assumptions and proposals, thereby raising the effectiveness and robustness of the Board. The management conducts regular informal meetings and off-site strategy meetings with non-executive directors and continuous circulates relevant information.

Its nominating committee has commenced review of the Company's succession planning programme. It has also rolled out a Group-wide Enterprise Risk Management programme, which is annually reviewed by the Audit Committee.

SingTel started quarterly reporting three years before it become mandatory

Currently half of SingTel's 12-member board comprises non-Singaporean directors, including its chairman

Singapore Telecom

SingTel stands out among Singapore companies for its best practices in corporate governance and has progressively improved its level of corporate transparency over the years.

It started quarterly reporting of its financial results in June 2000, three years before it became mandatory. The company also has regular communications with investors and the media, providing access to senior management at briefings and news conferences.

The company's efforts to meet the substance of good corporate-governance and transparency, and not just the form are truly commendable. In its latest Annual Report for fiscal year ended 31 March 2004, its CEO and CFO have jointly certified the accounts. While already a legal requirement in the US under the Sarbanes-Oxley Act, it is not legally required in Singapore. The certification demands an onerous internal check and balance system to be in place, leaving little room for ignorance, negligence, inappropriate behaviour or fraud.

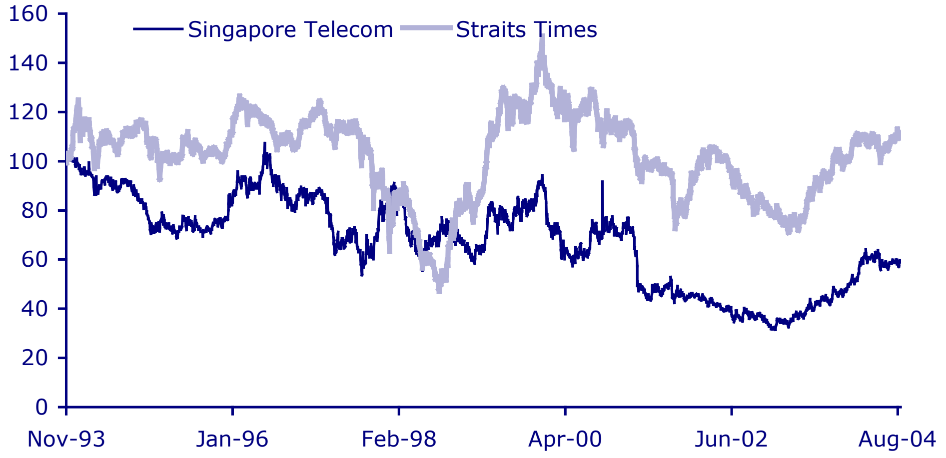
SingTel has also taken the lead among Singapore companies to diversify its board to include foreign directors to reflect the group's regional exposure. Currently half of SingTel's 12-member board comprises non-Singaporean directors, including its Chairman Chumpol NaLamlieng.

Not surprisingly, last year SingTel won the inaugural Corporate Governance Award, instituted by the Securities Investors Association of Singapore (SIAS). A panel of ten judges picked SingTel as the company that best meets the letter and spirit of the Singapore Code of Corporate Governance from the point of view of investors.

In the just released Corporate Transparency Index for 2004, SingTel placed third overall among all Singapore companies.

Figure 87

SingTel's market performance



Source: **CLSA evalu@tor®**

CG disappointments

SembCorp Industries

SembCorp Industries (SCI) has done well to remain focused on its five core businesses including utilities, logistics, marine engineering, environmental engineering and engineering & construction (E&C). The company has also divested about half a dozen non-core businesses over the past two years.

A series of mishaps over the past two years have prevented a serious rerating of SCI stocks

However, a series of mishaps over the past two years have prevented a serious re-rating of the stock, despite a strong business upturn and commendable divestment of non-core assets. In February 2002, SCI raised new equity, taking advantage of the buoyant share price, and without any clearly identified project/acquisition. The share price duly collapsed.

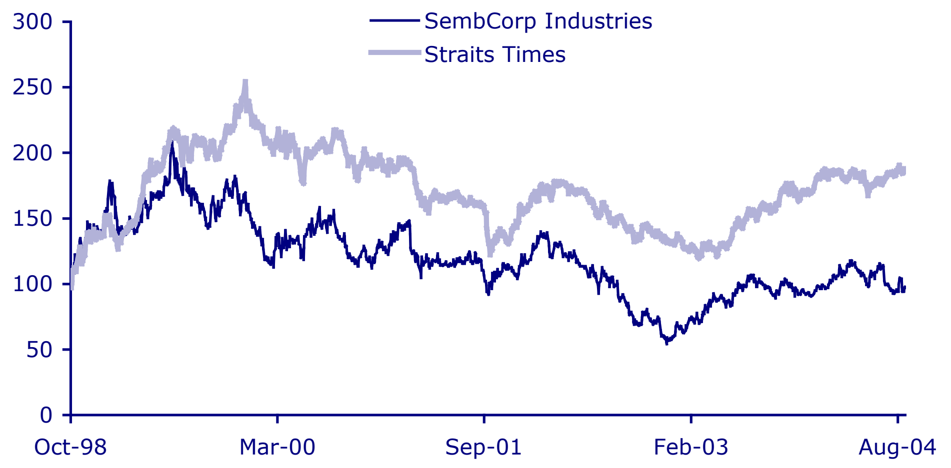
Thereafter, SCI blundered into five other episodes that have resulted in further derating. First, the privatisation attempt of SembCorp Marine was rejected by shareholders. Second, the announcement of an S$127m exceptional loss at the Engineering & Construction (E&C) division in 1H02. Third, the sale of their Singapore Food's stake to shareholders when the listed SFI shares fell below the offer price of S$0.70 to shareholders. Fourth, the accounting irregularities and the lack of internal control, in the Indian operations of their listed subsidiary, SembCorp Logistics.

Lastly, and most recently, SCI announced that it faces potential higher losses in its ongoing legal case related to 'Solitaire'. The case is pending with a London arbitration tribunal since 1997 and SCI made a provision of S$150m in 1998 towards potential liabilities. Although SCI has decided against raising the provision amount, it faces a potential additional liability of up to S$600m. Though management cannot be faulted for this legacy problem inherited when the Sembawang shipyard was acquired, still we are perplexed as to why more conservative provisioning is not being considered.

Consequent to these events, the group's credibility has suffered and institutional investors are likely to steer clear for some time.

Figure 88

SembCorp Industries' market performance



Source: CLSA Asia-Pacific Markets

High CG stocks have consistently outperformed

Relative performance of stocks sorted by CG

Over the long term, companies with high CG tend to outperform. Our top-quartile companies have consistently outperformed over one-year, three-year and five-year periods. Moreover, the bottom-quartile companies have consistently underperformed over these time periods.

Figure 89

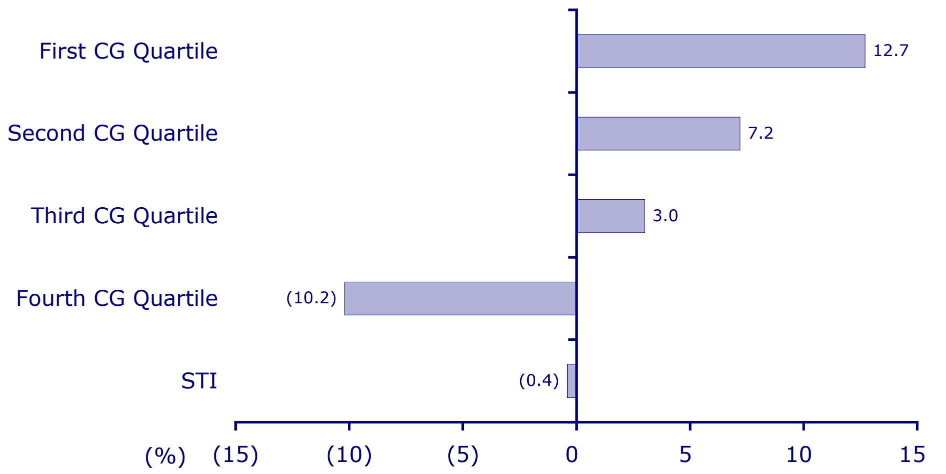
Stock performance of CG quartiles

(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	37.2	14.7	12.7
Second CG quartile	32.9	10.2	7.2
Third CG quartile	31.9	14.1	3.0
Fourth CG quartile	10.5	0.1	(10.2)
Average of all quartiles	28.4	9.6	1.4
Singapore STI Index	*26.9*	*8.0*	*0.4*

Better CG is reflected in the company's stock price performance

Figure 90

Five-year stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

SingTel and Keppel Corp have shown a disciplined approach towards divesting non-core assets and returning excess cash to shareholders

SingTel and Keppel Corp, our top picks as CG stars, saw significant upgrades to their CG scores last year. Both companies have shown a disciplined approach towards divesting non-core businesses and returning excess cash to shareholders. Keppel Corp has initiated new measures to inform and educate non-executive directors to strengthen the Board. SingTel has improved transparency in reporting and also improved access to management. Moreover, it has set in place a most transparent performance-linked remuneration package for senior management.

Keppel Corp and SingTel, our picks as CG stars, saw their CG scores upgraded last year

Figure 91

Companies with CG changes over 2003-04

	Chg in score by 2004 questionnaire	2004 quartile ranking
Keppel Corporation	7.4	1
SingTel	5.9	1
Datacraft Asia	2.0	4
Peoples Food Holdings	1.5	4
Singapore Exchange	1.3	1
OCBC	1.1	1
SembCorp Industries	(12.1)	3
STATS	(13.7)	3
SembCorp Logistics	(15.2)	2
SIA	(22.7)	4
Chartered Semi	(25.6)	4
Capitaland	(27.3)	4
NOL	(30.1)	4

Figure 92

Negative CG differentiators

Q5 Dilute EPS through options etc	Q25 W/out perceived safeguards in audit committees	Q43 Material related-party transactions	Q44 Controlling shareholders believed to be highly geared	Q54b Directors' remuneration rose faster than NP in past five years
Venture	None	SAT Services	Cosco Corp Singapore	DBS Group Holdings
		SIA	GP Batteries	OCBC
		NOL		United Overseas Bank
		SIA Engineer		Great Eastern Holdings
				Singapore Exchange
				Singapore Press
				Capitaland
				Creative Technology
				Venture Corp
				Chartered Semi

Figure 93

Positive CG differentiators

Q23 Independent non-executive chairman[1]	Q31 Independent directors nominated by minorities	Q23 Independent non-executive chairman	Q32 INEDs make up more than half the board	Q33 Increased no. of independent directors since 2000	Q48 Cumulative voting for board representation
SembCorp Industries	None	SembCorp Industries	SCI, Keppel	All except	None
DBS Group Holdings		DBS Group Holdings	F&N, SingPost	Informatics	
OCBC		OCBC	UOB, STATS	Allgreen	
Singapore Press		Singapore Press	SGX, SPH	City Developments	
SembCorp Marine		SembCorp Marine	SembMarine, SembLog	Creative	
Singapore Post		Singapore Post	Allgreen, Capitaland	GP Batteries	
Chartered Semi		Chartered Semi	City Dev, Marco Polo	SIA	
SingTel		SingTel	Keppel Land, MCL Land	NOL	
MobileOne		MobileOne	Creative, Chartered	SembLog	
NOL		NOL	Singtel, M1	SIA Engineering	

[1] Not necessarily independent of controlling shareholder; Source: CLSA Asia-Pacific Markets

Directors' remuneration accounts for <1% of net profits at most large companies

Figure 94

Q54a – Directors' remuneration

Directors' remuneration/company net-profit average for Singapore sample - 4.0%

Companies with highest directors' remuneration/net profit in 2003 (%)			
MCL Land	20.1	GP Batteries	8.8
Informatics Holdings	19.8	City Developments	8.1
Accord CCS	13.6	Venture Corp	5.5
Cosco Corp Singapore	13.6	Fraser and Neave	3.5
Singapore Exchange	10.6	Allgreen Properties	3.5
Companies with lowest directors' remuneration/net profit in 2003 (%)			
SingTel	0.2	Keppel Corporation	1.0
NOL	0.1	SembCorp Industries	0.8
SIA Engineer	0.0	ST Engineering	0.8
SAT Services	0.0	Singapore Press	0.7
SIA	0.0	Marco Polo Developments	0.2

Source: CLSA Asia-Pacific Markets

CG picks

Keppel Corp, SPH and ST Eng score highly on both CG and Accounting & Return (A&R) counts, and are where we have BUY/O-PF recommendations. Chartered has a low CG score, which further reinforces our SELL recommendation.

Keppel Corp, SPH and ST Eng are our preferred picks with high CG and A&R scores

Figure 95

The top-10 CG companies – Financials and valuations

	CG quartile	A+R score	Implied earnings gwth (%)	Rec
Singapore Post	1	0.79	(0.5)	U-PF
ST Eng	1	0.77	1.6	O-PF
M1	1	0.73	(0.9)	U-PF
Keppel Corp	1	0.70	(0.8)	BUY
DBS	1	0.56	3.2	O-PF
SingTel	1	0.77	4.7	U-PF
Singapore Press	1	0.69	3.9	O-PF
SMRT Corp	1	0.68	(0.1)	U-PF

Source: CLSA Asia-Pacific Markets

Peter Sutton
peter.sutton@clsa.com
(8862) 25479140

Taiwan – Dividends rising

Taiwan's CG score has not changed much over last year. However it has improved dramatically over the last five years

Much can be manipulated in the assessment of companies – whether it is audited financial statements, corporate governance scores or earnings guidance. However, in the world of finance there is one hard number – cash dividends. If this number is continually rising, then companies are clearly doing more for their shareholders. We can also assess the cash dividend number against capital raisings and total profits. The table below shows the payout ratio in Taiwan increased from 42% to 45% over the last year. This is not much of an increase, however the improvement over the last five years is dramatic.

A similar conclusion can be reached for overall corporate governance in Taiwan – not much change over the last year, but a lot of improvement over the last five. At some point the dividend payout ratio can not continue to increase, but in this slower growth, low gearing environment, we are probably not there yet.

Dividend payments to shareholders now dwarf employee bonus shares at market value

The table below shows data for all listed companies on the Taiwan Stock Exchange for the last ten years. For all listed companies, total cash dividends to be paid this year will be US$12.54bn, up 59% from US$7.88bn in 2003, which was up 52% from US$5.19bn 2002. Cash dividends are best assessed as a percentage of the profits of profit making companies (loss makers don't pay dividends) and we can see that this number has risen from a low of 7% in 1997 to 45% for accounting year 2003 (paid in 2004).

Figure 96

Taiwan cash dividends – Past 10 years

US$bn (at US$=NT$33.5)	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Cash dividend	1.55	1.68	2.17	1.05	3.97	2.16	4.84	4.86	7.93	12.54
Market value stock	0.55	0.63	1.32	1.23	4.16	3.57	3.35	2.30	2.17	2.61
Net cash flow to market	1.00	1.04	0.86	(0.18)	(0.19)	(1.41)	1.49	2.57	5.76	9.93
Aggregate profits	10.5	11.2	14.9	9.9	14.3	18.6	6.0	7.8	23.3	
Profit makers aggregate	11.1	11.6	15.3	13.3	16.7	21.6	14.2	18.9	27.9	
Payout ratio - (%)	15.1	18.8	6.8	29.8	12.9	22.4	34.3	42.0	45.0	

Source: CLSA Asia-Pacific Markets

Taiwanese companies pay bonuses to staff in the form of both cash and shares

Taiwanese companies pay bonuses to staff in the form of both cash and shares which are expensed in the reserves rather than the profit and loss account. In terms of market value over 95% of bonuses are in the form of shares. In the table above we can see that the market value of employee bonus shares has been in decline: from a high of US$4.2bn in 1999, the absolute number has nearly fallen by half. Across the market, firms propose to give their employees bonus shares with a current market value of US$2.6bn in 2004. However, that is dwarfed by the US$12.54bn in cash dividends, US$1.53bn in completed buybacks in 2004 and a further US$832m in approved buybacks. In our view these figures are the best ones to look at when assessing corporate governance in Taiwan. The next step is to determine if these changes are sustainable.

Free cashflow has improved and overinvestment is now much less of a problem

The following table shows data for the 50 largest non-financial companies listed in Taiwan as of the end of each calendar year for the past 10 years. The group of companies changes each year but is highly representative of the index. The ratios derived from this data show the transformation in the market's financial performance over that period. The most important change is in the ratio of free cashflow to profit over the period of this economic recovery. Previously Taiwanese companies would reinvest all their cash flow back into the business. However, the period from 2001 to 2003 shows a dramatic improvement in free cashflow. The ratios for capex/depreciation and capex/fixed assets show the 1995 to 2000 period to be one of overinvestment while 2001 to 2003, and our forecasts to 2005, look more normal with capex in the range of 1.0x to 1.5x depreciation.

Figure 97

Cashflow – Taiwan top 50

(US$bn)	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Net profit	3.0	4.1	4.0	4.9	4.2	6.6	12.2	4.3	7.8	12.9
Depreciation	1.7	1.9	2.0	2.3	2.7	2.9	6.0	7.2	8.3	9.1
Capex	(2.2)	(4.3)	(5.4)	(5.9)	(7.1)	(6.6)	(14.2)	(10.6)	(8.7)	(9.8)
Working capital change	(0.8)	(1.7)	0.2	(1.0)	(0.5)	(1.3)	(2.6)	1.2	(0.8)	(0.9)
Free cashflow	1.7	0.0	0.8	0.3	(0.8)	1.6	1.4	2.1	6.6	11.3
Financial ratios										
Free cashflow to net profit (%)	56	0	19	5	(18)	24	12	49	85	88
Capex/fixed assets - (%)	13	22	24	24	25	23	25	19	14	15
Capex/depreciation - (x)	1.3	2.3	2.7	2.6	2.7	2.3	2.4	1.5	1.0	1.1

Source: CLSA Asia-Pacific Markets

Over-investment appears a thing of the past and our forecasts see this continuing

The criticism heard from many is that capital intensive sectors never yield free cashflow for investors. Capex is now down to a similar level to depreciation. Over-investment appears a thing of the past and our forecasts see this continuing. Taiwan's new found status as a high cash payout market can be sustained as free cashflow is now so much higher as a percentage of profits.

Figure 98

Cashflow - CLSA coverage

(NT$bn)	2002	2003	2004	2005
Operating profit	274	388	684	799
Depreciation & amortisation	299	317	354	392
Working capital increase	(121)	(41)	(116)	(120)
Interest, taxes, other	(36)	(28)	(28)	(24)
Capital expenditure	(319)	(325)	(528)	(513)
Free cashflow	97	312	366	534
Net profit	265	391	695	804
Shareholders funds	2,616	2,935	3,343	3,864
Free cashflow to net profit (%)	36.5	79.7	52.7	66.5
Capex/depreciation (x)	1.1	1.0	1.5	1.3
ROE (%)	10.8	26.6	22.1	22.3

Source: CLSA Asia-Pacific Markets

The data in the table above is derived from aggregating the 62 non-financial companies which CLSA covers in Taiwan. This group shows a continued improvement in ROE this year and next over the level achieved in 2003. However, just as importantly, the ratio of free cashflow to net profit stays above 50% during the period. Our conclusion is that the excellent record of returning cash to shareholders that Taiwanese companies have developed from 2001 is sustainable.

High quality at low prices – TSMC near a record low valuation

In general the companies with the strongest ROE track records in each sector also have the highest corporate governance scores in each sector. We can derive implied growth rates by looking at sustainable ROE and the current price to book ratio. The best technology company in Taiwan is TSMC with a global leading position in its sector, a record of strong revenue and earnings growth over the cycle and the highest CG score in the tech sector. It is currently rated near its all time low price to book ratio and on less than 10.4x this year's earnings and 8.8x 05CL.

Similarly the strongest global position in the petrochemical sector is held by Formosa Plastics which has an ROE consistently above its cost of equity over the cycle and is trading below its long run average PB ratio. This stock is also cheap on an earnings basis, trading on only 9.9x this year's earnings.

Chinatrust is the top scorer in the financial sector

Finally the best CG score in the financial sector came from Chinatrust which has the strongest consumer franchise in Taiwan and an ROE which we believe can stay consistently above 20%. This stock is trading on 11x 04CL and 9.3x 05CL earnings.

Each of these three companies has an earnings yield for 05CL which is higher than their cost of equity and therefore the implied growth rate is negative. In our view this is too low a number for companies with such strong ROE track records and CG scores. All three companies also have strong financial positions and CLSA financial scores in the top 50% of our Taiwan coverage.

Low-scoring Hon Hai could do more for shareholders

A company on which we have a negative recommendation, which has a low CG score and which could do more for shareholders is Hon Hai. In our opinion its proposed diversification into TFT-LCD by buying into a venture controlled by the major shareholder's family will likely not add value. Certainly given the likely overcapacity in the industry in 2005 it will be viewed negatively by shareholders in the near term.

Another company with a low CG score is Mega Financial Holdings. This company has yet to integrate its banking subsidiaries and we worry that stakeholders other than shareholders will prevent it from maximising ROE.

Regulatory environment and CLSA/ACGA country CG score

The government has created a new regulatory body in Taiwan – the Financial Supervisory Board - which incorporates the Securities and Futures Commission, the Bureau of Monetary Affairs and the regulatory functions of the central bank. The head of the FSB reports directly to the Premier. The FSB has proposed new legislation to go before the Legislative Yuan (parliament) which will require all companies to have independent directors and for large companies to set up audit committees.

The "Investor protection centre" has been getting results, albeit with small companies

The government has sponsored the "Investor Protection Center" which investigates complaints from minority shareholders and initiates class action lawsuits against companies. So far only small companies have been taken on by this organisation but results have been achieved. You can read more about this organisation and the cases it has pursued at: http://www.sfipc.org.tw/english/main.asp

Figure 99

Ratings for macro-determinants of CG in Taiwan

	2004 rating (1-10)	2003 rating	Comment
Rules & regulations	6.3	7.0	Faster reporting and more rigorous consolidation standards would help as would stronger disclosure rules. New scoring methodology results in slightly lower score.
Enforcement	4.6	5.0	The SFI Investor Protection Center's ability to bring quasi-class action lawsuits on behalf of investors is unique in the region.
Political & regulatory environment	6.3	5.0	An improvement in the regulatory structure, free media and good government intentions help boost the score, but slow and weak enforcement from the judiciary loses points here.
Adoption of IGAAP	7.0	7.0	Still someway behind international standards, especially with regard to expensing share base compensation.
Institutional mechanisms & CG culture	3.5	6.0	In general still a short-term focus to investing by domestic investors in Taiwan; a much lower score on our 2004 country scoring. New methodology looks more rigorously at efforts made by companies on CG and activism by investors.
Overall	5.5	5.8	Not much change from last year.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Sector leaders on fundamentals are also the top scoring CG companies

CG stars

Sector leaders dominate the CG rankings. It is clear that good fundamentals go with good corporate governance. The biggest improvement in corporate governance in Taiwan in 2004 actually came from China Motor which we recently downgraded to underperform. However, the issue with this company is factors outside its control, namely the ongoing viability of Mitsubishi Motors following the surprise withdrawal of Daimler Chrysler from its financial restruturing plan.

Figure 100

Stocks in the top two quartiles for Taiwan (CLSA coverage)

Top quartile	Second quartile
TSMC	Vanguard
Formosa Plastics	Acer Inc
Nan Ya Plastics	CMO
Far Eastern Textile	Oriental Union
UMC	SPIL
Formosa Chem	Catcher
Sunplus	ZyXEL
SinoPac FHC	Quanta
China Motor	Nien Hsing
Formosa Petro	AUO
China General	MediaTek
Lan Fa Textile	Optimax
Chinatrust FHC	Tong Yang
Fubon FHC	Taishin FHC
	E Sun FHC

Source: CLSA Asia-Pacific Markets

Foundries lead CG in the tech sector

There are no downstream companies in the top quartile of CG scorers in Taiwan. The best company in this area is Acer which following the divestiture of most its manufacturing business and investment is now focussed purely on managing the Acer brand. This stock is also our top buy in downstream electronics.

Substance often Fails to follow form

CG disappointments

In the third quartile is King Yuan Electronics which is currently being pursued by the Securities and Futures Investor Protection Centre (see above) for compensation to minority shareholders. However, some of the companies with poor CG scores operate good businesses and in substance have good corporate governance. But they do not follow the form of good corporate governance. For instance, China Steel has a lower CG score than Posco because it has no audit committee and no independent directors. However, it prices its domestic steel sales much more in the interests of shareholders than Posco does. In addition it does not invest cash in unrelated businesses – such as biotechnology. It is not investing in a new steel mill in China at the top of the cycle either. It has a consistently higher ROE track record than Posco and an 80% cash dividend payout ratio compared with Posco's at around 25%.

Two companies from the same group but with very different scores

It is odd to see two companies from the same group with such dramatically different CG scores. Far Eastern Textile follows all the form for good corporate governance while Far Eastone does not. The former has independent directors, while the latter does not. Of course, Far Eastern Textile is the main group holding company. Perhaps the message is that you should have your money invested alongside the family's main holdings in Far Eastern Textile rather than in a subsidiary.

Financials checklist

Invest your money in the parent company not the subsidiary

There was not a strong correlation between the first three quartiles in the corporate governance scores and in the financial scores. The main reason for this is that companies in Taiwan generally have very strong financial positions. However, this did not apply to the fourth quartile where many companies had poor CG scores, poor ROE track records, high gearing and high future capex requirements.

The three DRAM companies in Taiwan – Nanya Tech, Powerchip and Promos were all in the fourth quartile for CG and financial scores. Also with poor recent financial performance were VIA and Accton and they both appeared in the fourth quartile on both scoring systems.

Relative performance of stocks sorted by CG

Bad CG really seems to matter for returns to shareholders

The table below shows that third and fourth quartile companies have performed poorly on the stockmarket over three and five year periods relative to other companies. The second quartile CG group actually outperformed the first quartile over one, three and five years. We can see that this second quartile group is on average much smaller than the first quartile. In addition it contains some companies which have shown exceptional growth over that period. Now these companies are larger, this feat will be more difficult to repeat. In our view the outperformance of the second CG quartile reflects a "small company effect" which will be difficult to repeat going forward, now that smaller companies are often more expensive than their large cap counterparts.

We stop covering the worst companies

The table below shows the high degree of survivorship bias in our coverage. The index is down 27% but over five years the average of all quartiles is positive 6.7%. We stop covering the worst companies in which investors have no interest. If we covered all companies then it is most likely that the third and fourth quartiles would have much worse performance numbers. The other issue here is the outperformance of small cap companies in Taiwan over the last five years.

"Small company effect" sees the second quartile outperform the first quartile

Figure 101

Stock performance of CG quartiles

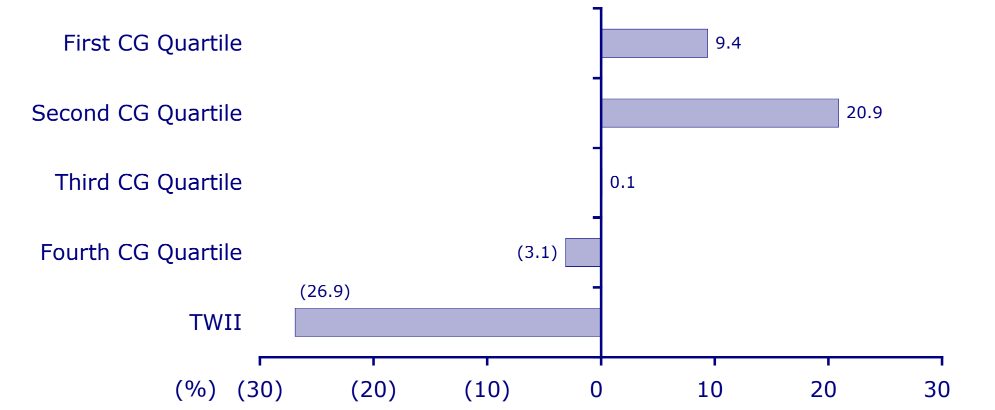
(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	8.7	98.5	9.4
Second CG quartile	14.9	131.3	20.9
Third CG quartile	4.1	56.7	0.1
Fourth CG quartile	4.2	30.0	(3.1)
Average of all quartiles	8.2	78.8	6.7
Taiex Index	2.1	25.5	(26.9)

Source: CLSA Asia-Pacific Markets

Companies with low CG scores have underperformed

Figure 102

Five-year stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

Acer is the CG winner in our universe

Acer is a noticeable outperformer in the tech sector following the implementation of its restructuring plan. This calls for the divestment of its manufacturing business and non-core investments and a focus on developing the Acer brand. The group is now much more transparent and easy for investors to understand. In addition the conflict of interest between its own brand and manufacturing for competitors has gone away.

The most obvious underperformance due to CG issues was the fall in Hon Hai's share price following the announcement at its AGM that it would invest in a related party TFT-LCD joint venture.

Formosa Plastic has introduced structural changes at board level

Acer has restructured its business to return capital to shareholders

Mediatek has substantially cut bonus share payments to employees

Figure 103

Companies with CG changes over 2003-04

	2004 quartile ranking
Improved	
Formosa Plastics	1
SPIL	2
ZyXEL	2
Acer	2
MediaTek	2
Declined	
Premier Image	4
Realtek	3
Novatek	3
Hannstar Display	3

Source: CLSA Asia-Pacific Markets

Figure 104

Negative CG differentiators

Q5 Dilute EPS through options etc	Q25 W/out perceived safeguards in audit committees	Q43 Material related-party transactions	Q44 Controlling shareholders believed to be highly geared	Q54b Directors' remuneration rose faster than NP in past five years
China General	Formosa Plastics	Acer Inc	CMO	Taiwan Cellular Company
Lan Fa Textile	Nan Ya Plastics	CMO	AUO	BenQ
Acer Inc	Far Eastern Textile	Catcher	Optimax	Delta
CMO	Formosa Chem	ZyXEL	Taiwan Cellular Company	Chunghwa Telecom
Oriental Union	SinoPac FHC	Quanta	Chunghwa Telecom	
Catcher	China Motor	AUO	Hannstar	
Quanta	Formosa Petro	BenQ	Compal	
AUO	China General	Hannstar	Compal Comm	
Optimax	Lan Fa Textile	Compal	Yageo	
Realtek	Chinatrust FHC	Compal Comm	Accton	
Delta	Fubon FHC	Gemtek	Far Eastone	
Hannstar	CMO	Hon Hai	Promos	
Advantech	Oriental Union	Accton		
Compal	Nien Hsing	Far Eastone		
Yageo	AUO			
Premier Image	Optimax			
Powerchip	Tong Yang			
Mega FHC	Taishin FHC			
Far Eastone	E Sun FHC			
Nanya Tech	Taiwan Cellular Company			
Promos	ASE			
China General	Wan Hai Line			
Lan Fa Textile	Hannstar			
Acer Inc	King Yuan Elec			
CMO	China Steel			
Oriental Union	Novatek			
Catcher	Taiwan Styrene			
Quanta	Compal Comm			
AUO	Yageo			
Optimax	Premier Image			
Realtek	Cosmos Bank			
Delta	Int'l Bank of Taipei			
Hannstar	Powerchip			
Advantech	Mega FHC			
Compal	Far Eastone			
Yageo	Nanya Tech			
Premier Image	Promos			
Powerchip				
Mega FHC				
Far Eastone				
Nanya Tech				
Promos				

Source: CLSA Asia-Pacific Markets

Figure 105

Positive CG differentiators

Q23 Independent non-executive chairman	Q31 Independent directors nominated by minorities	Q32 INEDs make up more than half the board	Q33 Increased no. of independent directors since 2000	Q48 Cumulative voting for board representation
Formosa Plastics	Acer Inc	Acer Inc	TSMC	None
Nan Ya Plastics	CMO	Catcher	Sunplus	
Formosa Chemical	AUO	ZyXEL	Fubon FHC	
Sinopac FHC	Hannstar	Realtek	Vanguard	
China Motor		Compal	Acer Inc	
Formosa Petrochemical			CMO	
China General			SPIL	
Lan Fa Textile			Catcher	
CMO			Quanta	
Oriental Union			AUO	
AUO			MediaTek	
Optimax			Optimax	
Taiwan Cellular			Taiwan Cellular Company	
Chunghwa Telecom			Realtek	
Hannstar			Delta	
Compal			Chunghwa Telecom	
Far Eastone			Hannstar	
			King Yuan Elec	
			Advantech	
			Premier Image	
			Gemtek	
			Hon Hai	
			Accton	

It is hard to see any relationship between director remuneration and CG score quartile

Figure 106

Q54a – Directors' remuneration

Directors' remuneration/company net-profit average for Taiwan sample - 1.5%

Companies with highest directors' remuneration/net profit in 2003 (%)			
ZyXEL	5.0	Gemtek	2.0
Far Eastone	5.0	Nien Hsing	2.0
Taishin FHC	3.0	China Motor	2.0
Int'l Bank of Taipei	2.0	AUO	2.0
SinoPac FHC	2.0	CMO	2.0
Companies with lowest directors' remuneration/net profit in 2003 (%)			
Powerchip	0.0	TSMC	0.5
Promos	0.0	Hon Hai	0.8
Cosmos Bank	0.0	E Sun FHC	0.8
China Steel	0.2	Fubon FHC	0.9
Quanta	0.3	BenQ	0.9

Source: CLSA Asia-Pacific Markets

Most companies in Taiwan have strong financial positions so the accounting score does not really help to pick good stocks

CG picks

Taiwan is a market characterised by strong financial positions for virtually all major listed companies. Our financial checklist puts two of Taiwan's telecom companies in the fourth quartile despite their strong cashflows and high dividend yields. In the fourth quartile are some companies with relatively weak financial positions and high reinvestment requirements. However, this is less than half the group. Therefore the stocks below are ones on which we have positive recommendations and are in the top three quartiles of the accounting/financial scores. Most stocks in Taiwan are cheap on an absolute basis. The cost of equity is around 10% yet we can find many companies with high returns on equity which have earnings yields over 10% and therefore negative implied growth rates. This is clearly too pessimistic a long term view on such a high quality group.

Strong sector leaders with low valuations

Figure 107

The top-10 CG companies – Financials and valuations

	CG quartile	A+R score	Implied earnings gwth (%)	Rec
Chinatrust	top	66.7	(0.1)	BUY
Formosa Chem	top	70.6	(0.5)	BUY
Formosa Plastics	top	64.7	(2.6)	BUY
Sunplus	top	69.1	(2.6)	BUY
TSMC	top	60.3	(2.1)	BUY

Source: CLSA Asia-Pacific Markets

Accton and VIA score poorly

In the fourth quartile of both the CG and Financial scoring tables are the DRAM companies which have never historically created much value for shareholders. However, we retain a positive outlook on this sector as prices remain high and capacity growth looks to remain below demand growth into 2005.

There are two companies which are fourth quartile for both the CG and Financial scores and on which we have negative recommendations. These are VIA and Accton. VIA recently had its proposed issue of employee bonus shares rejected by the SFC which will make it hard for it to continue to retain good employees. Accton trades on a high valuation and has poor earnings momentum.

Nick Cashmore
nick.cashmore@clsa.com
(66) 22574630

Thailand – Little change

Thai corporate governance largely unchanged

There has been little change on the CG front in Thailand over the past year. Disclosure and transparency rate well. However, enforcement remains subjective and the regulatory track record poor. The overall country score is largely unchanged from last year.

Banks high in CG ranking

Our top quartile CG companies include Siam Cement, Siam Commercial Bank, Kasikornbank, Bangkok Bank, Kiatnakin Finance and Banpu. Indeed, banks figure highly among the top CG rankings. At the bottom are the likes of True Corp, ITD, Central Pattana and TAC. Several companies score low in the CG ranks because of insufficient track record - CP 7-11 and Airports of Thailand count in this regard.

Regulatory environment and CLSA/ACGA country CG score

Accounting follows international standards, enforcement subjective

Thai GAAP closely follows policies set out by the International Accounting Standards Board (IASB). Within three years, Thai GAAP must concur with IASB policies, which will lead to better harmonisation with international best practice. However, enforcement remains subjective and piecemeal. For instance, Loxley saw extremely heavy trading in its shares in the two weeks before it was announced the government would pay Bt3bn in compensation for a court case. On the day of announcement the stock also dropped rather than rose, which would have been the case had this come as a surprise to the market. It was not felt this warranted an investigation, however.

Other high-profile cases are quietly forgotten or cases of questionable share manipulation not prosecuted for lack of evidence (TPI). The best that can be said is that CG mechanisms and culture is developing at a much faster pace than in many developed markets.

Figure 108

Thailand ratings for macro-determinants of CG

	Rating (1-10)	2003 rating	Comment
Rules & regulations	6.1	7.5	No major change, but lower score reflects our more rigorous methodology this year.
Enforcement	3.8	3.0	No major change, but slightly higher score this year as we broadened our scope to include “private enforcement”.
Political & regulatory environment	5.0	4.0	Regulators promoting good CG, but few major changes in past year.
Adoption of IGAAP	8.5	6.0	Accounting policies largely modelled on IASB guidelines. The survey this year also looks at adoption of international auditing standards, regulation of accounting profession, policies to make external auditors more independent; hence Thailand’s higher score.
Institutional mechanisms & CG culture	3.5	4.5	Training mechanisms established, but acceptance is nascent. Still a lot of form over substance among companies and a relatively weak response from investors on CG.

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

CG stars

The good . . .

Siam Cement ranks among the best of Thai companies in terms of CG and scores among the highest in our Asia ex-Japan universe. In recent years, the the group has bolstered transparency and communication with analysts and investors. Roadshows are regularly held around the world to meet with the investment community. Disclosure has been strengthened to show a clear breakdown between divisions. **Kasikornbank** and **Siam Commercial Bank** also rank highly on strengthened communication and disclosure with investors.

Figure 109

Thai stocks in the top two quartiles (CLSA coverage)

First quartile	Second quartile
Siam Cement	Land & Houses
Siam Commercial Bank	EGCO
KasikornBank	Siam City Cement
Kiatnakin Finance	Asian Property
Bangkok Bank	PTT
Banpu	Aromatics Thailand
Tisco Finance	Vinythai
PTTEP	National Finance
Thai Olefins	Aeon Thanasip
National Petrochemical	

Source: CLSA Asia-Pacific Markets

CG disappointments

. . . and the bad

Two new listings join the bottom-ranked fourth quartile this year: Airports of Thailand and CP 7-11. However, the position of these newcomers is because they do not yet have enough of a track record to be rated more highly. True Corp again scores last in our CG ranking due to weak disclosure.

Financials checklist

Financial health

We compiled an accounting and returns checklist to see whether a good CG score also comes with solid financials. Some higher-CG companies score in the bottom quartiles for the ranking on financials. Those scoring well in both CG and financials include Land & Houses, Aeon Thanasip, PTTEP and National Petrochemical.

Companies scoring badly on the financials checklist as well as CG include True Corp, Italian-Thai, National Finance and TAC.

Relative performance of stocks sorted by CG

Stock of better CG companies outperform lower-CGs *in the long run*

Ranked by CG, we examined the absolute price performance of each quartile. The findings suggest better CG companies outperform *in the long run* (ie, three-to-five years). Interestingly, on a one-year basis, fourth quartile CG stocks outperformed, rising by 152% against an average 140% for all stocks. However, on a three- and five-year basis, fourth quartile companies underperformed. Top quartile companies, though underperforming on a one-year view, outperformed on a three- and five-year time horizon. A fuller analysis can be seen in the following tables.

Performance-plus

Figure 110

Stock performance of CG quartiles

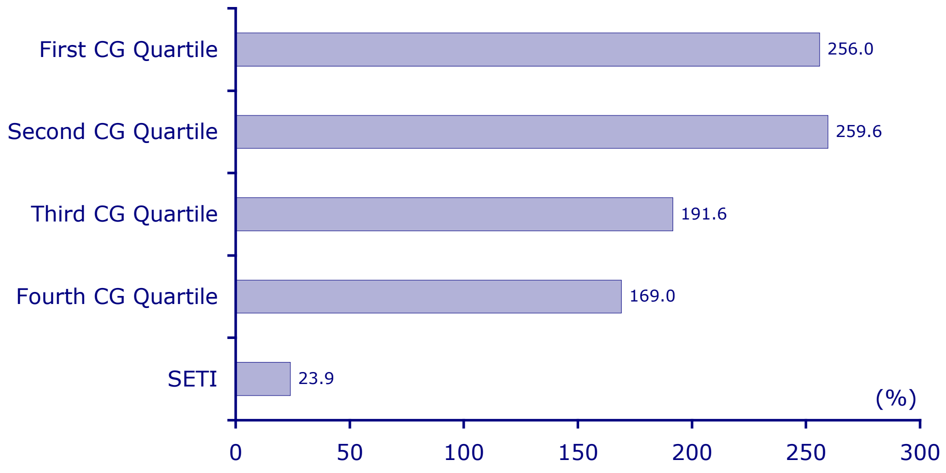
(%)	Performance to 30 June 2004		
	1Y	3Y	5Y
First CG quartile	120.2	325.7	256.0
Second CG quartile	206.9	543.0	259.6
Third CG quartile	79.3	109.2	191.6
Fourth CG quartile	151.8	294.7	169.0
Average of all quartiles	139.5	318.1	219.1

Source: CLSA Asia-Pacific Markets

Upper quartiles doing better than lower quartiles

Figure 111

Five-year stock performance of CG quartiles



Source: CLSA Asia-Pacific Markets

PTT is illustrative

One notable performer last year was PTT, which scored poorly in 2002, given the large off-balance sheet support the parent provided to subsidiaries. However, this was cleaned up and the stock was one of the better performing companies in 2H03. This year, CG concerns appear to be resurfacing with the company likely to purchase a large minority stake in TPI.

Figure 112

Negative CG differentiators

Q5 **Dilution of EPS through options etc**	**Q25** **Lacks perceived safeguards in audit committees**	**Q43** **Material related-party transactions**	**Q44** **Controlling shareholders believed to be highly geared**	**Q54b** **Directors' remuneration outpacing NP over past five years**
National Finance	Nil	CP 7-11	Bangkok Expressway	Home Pro
True Corp		AIS	TAC	Airports of Thailand
		PTTEP	True Corp	Thai Airways
		Shin Corp		Bangkok Expressway
		PTT		
		Asian Property		
		Aromatics Thailand		
		Italian-Thai		
		True Corp		
		BEC World		

Source: CLSA Asia-Pacific Markets

Figure 113

Positive CG differentiators

Q23	Q31	Q32	Q33	Q48
Independent non-executive chairman	**Independent directors nominated by minorities**	**Independent directors comprise more than half the board**	**More independent directors since 2000**	**Cumulative voting for board representation**
Tisco Finance	Nil	Siam Cement	Siam Cement	Nil
Siam Panich Leasing			Siam Panich Leasing	
Bangkok Expressway			PTTEP	
			Thai Union Frozen	
			Thai Airways	
			Airports of Thailand	
			PTT	
			Thai Olefins	
			Kiatnakin Finance	
			EGCO	

Aeon pays board 11% of net profit vs country sample average of 0.4%

Figure 114

Q54a – Directors' remuneration (2003)

Directors' remuneration/company net-profit average for Thailand sample - 0.4%			
Companies with highest directors' remuneration/net profit (%)			
Aeon	11.0	BEC World	0.7
Lalin	2.1	Banpu	0.6
Home Pro	1.5	Italian-Thai	0.6
Bangkok Expressway	1.3	CP 711	0.6
Thai Union Frozen	1.0	Vinythai	0.6
Companies with lowest directors' remuneration/net profit (%)			
TAC	0.02	Airports of Thailand	0.1
AIS	0.03	Tisco Finance	0.1
Thai Airways	0.03	Aromatics Thailand	0.1
PTT	0.05	Central Pattana	0.2
Shin Corp	0.10	Siam Panich Leasing	0.3

Source: CLSA Asia-Pacific Markets

AOT adds four independent directors

Companies with more independent directors

We have changed the scoring methodology this year, making it difficult to determine companies truly improving CG. However, taking an increase in independent directors as a gauge of improved CG, the table below shows those making some effort. AOT has introduced four new independent directors to its board in the past three years, while HMPRO, Kiatnakin and Thai Airways have added three independents. More than half the board seats at Siam Cement are filled by independent directors.

Siam Cement board more than half independent directors

Figure 115

Companies to increase number of independent directors

	Increase in number of independent directors in last 3 years	Independent directors comprise on more than 50% of board?
AOT	4	
HMPRO	3	
Kiatnakin	3	
THAI	3	
Siam Cement	2	✓
ATC	1	
Banpu	1	
SPL	1	
TUF	1	

Source: CLSA Asia-Pacific Markets

CG picks

In the table below we have listed out top picks according to CG score and AR score. Many of the names are blue chip companies with a proven track record in value creation for shareholders.

Our top CG companies, taking AR into account

Figure 116

Top-10 CG companies – Financials and valuations

	CG quartile	A+R score	Implied earnings gwth (%)	Rec
Siam Cement	1	63.2	1.9	BUY
Siam Commercial	1	88.9	3.3	SELL
KK Finance	1	61.8	(4.7)	BUY
Banpu	1	50.0	4.1	BUY
Tisco Finance	1	61.8	(3.0)	BUY
Thai Olefins	1	55.9	(0.3)	BUY
Land & Houses	2	75.0	2.8	BUY
Asia Property	2	67.6	(6.0)	BUY
PTT	2	53.0	(0.7)	BUY
Aeon Thanasip	2	70.6	1.1	BUY

Source: CLSA Asia-Pacific Markets

Worth watching

It is also noting a few companies at the bottom of the CG list that may improve. Italian-Thai is reputedly going to strengthen investors communication with an investor relation department. Thai Airways and Airports of Thailand are also showing promise at improving communication functions by holding regular analyst briefings.

Appendix 1: CLSA/ACGA country macro-CG determinants

1	RULES & REGULATIONS	China	HK	India	Indo	Korea	Malay	Ppines	Sing	Taiwan	Thai
i.	Do financial reporting standards for listed companies follow international best practices?	S	Y	Y	S	Y	Y	Y	Y	S	Y
ii.	Must companies report their annual results within two months?	N	N	N	Y	N	Y	N	Y	N	Y
iii.	Have reporting deadlines been shortened in the past three years?	N	N	Y	Y	N	Y	N	Y	N	S
iv.	Is quarterly reporting mandatory?	S	N	Y	Y	Y	Y	Y	Y	S	Y
v.	Has the government undertaken a review of company and securities laws in recent years to improve standards of corporate governance?	Y	Y	Y	S	Y	Y	Y	Y	Y	Y
vi.	Do securities laws require disclosure of ownership stakes above 5%?	Y	Y	Y	S	Y	Y	N	Y	N	Y
vii.	Do securities laws require prompt disclosure of share transactions by directors and controlling shareholders?	Y	Y	Y	N	Y	Y	Y	Y	S	Y
viii.	Do securities laws require continuous disclosure of material transactions?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
ix.	Do securities laws require prompt disclosure of major connected transactions?	S	Y	S	Y	Y	Y	Y	Y	Y	Y
x.	Are class-action lawsuits permitted?	S	N	N	N	Y	N	N	N	S	N
xi.	Is voting by poll mandatory for resolutions at AGMs?	N	S	N	N	N	N	N	N	S	N
xii.	Is there a national code of best practice largely based on international CG standards?	Y	Y	Y	S	Y	Y	Y	Y	Y	Y
xiii.	Has the code or related CG rules or guidelines been updated over the past year or two to take account of new international best practices? (eg, a requirement that at least one member of an audit committee have financial expertise)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
xiv.	Does the code or local listing rules contain a clear and robust definition of "independent director"? (ie, one that says independent directors should be clearly independent of both management and controlling shareholders)	S	S	Y	S	S	Y	Y	S	Y	S
xv.	Do the rules require disclosure of individual director compensation (by name, coming into effect at least by FY04)?	S	Y	Y	N	N	N	N	S	Y	N
xvi.	Do the rules require independent board committees to be formed (eg, audit, nomination, remuneration)?	S	S	S	S	S	S	S	S	S	S
xvii.	Can minority shareholders easily nominate independent directors?	N	S	N	N	S	S	N	S	S	N
xviii.	Can shareholders easily remove a director who has been convicted of fraud or other serious corporate crimes?	S	S	N	S	N	S	S	Y	Y	N
xix.	Will share-option expensing become mandatory over the next 12 months?	N	Y	S	S	N	N	Y	Y	S	N

Y = Yes; N = No; S = Somewhat; Continued on the next page

Appendix 1: CLSA/ACGA country macro-CG determinants

2	ENFORCEMENT	China	HK	India	Indo	Korea	Malay	Ppines	Sing	Taiwan	Thai
i.	Do securities regulators have a reputation for vigorously enforcing their own CG rules and regulations?	S	S	S	N	S	S	N	S	S	S
ii.	Do securities regulators treat all companies equally?	S	Y	Y	S	S	S	S	Y	S	S
iii.	Are the regulatory authorities sufficiently resourced—in terms of funding and skilled staff—to do their job properly?	S	S	S	N	S	S	N	S	S	S
iv.	Does the main regulator (ie, the securities commission) have sufficient powers of investigation and sanction?	Y	Y	Y	S	Y	Y	Y	Y	S	Y
v.	Is the main regulator investing more resources in investigation and enforcement? (eg, against cases of market misconduct such as insider trading, share-price manipulation, self dealing)	S	Y	Y	S	S	S	S	S	S	S
vi.	Does the stock exchange have sufficient powers to sanction breaches of its listing rules?	S	S	S	S	S	S	S	Y	S	S
vii.	Is the stock exchange investing more resources in investigation and enforcement?	S	S	S	S	S	S	S	S	S	S
viii.	Do institutional investors (domestic and foreign) exercise their voting rights?	S	S	S	S	S	S	S	S	S	S
ix.	Do institutional investors (domestic and foreign) attend annual general meetings?	S	S	S	N	S	S	S	S	Y	S
x.	Do minority shareholders (institutional or retail) often nominate independent directors?	N	N	N	N	N	N	N	S	N	N
xi.	Are minority shareholder activists willing to launch lawsuits against companies and/or their directors?	S	N	N	N	Y	S	N	S	S	N
xii.	Are minority shareholders adequately protected during takeovers, privatisations, connected transactions, and very substantial acquisitions or disposals?	N	S	Y	S	N	S	N	S	S	N
xiii.	Is there an independent commission against corruption (or its equivalent) that is seen to be effective in tackling public- and private-sector corruption?	N	Y	S	N	S	S	N	Y	N	N
3	**POLITICAL & REGULATORY ENVIRONMENT**										
i.	Does the government have a clear and consistent policy in support of corporate governance reform?	S	S	Y	S	S	S	S	Y	S	S
ii.	Is there a coherent and effective structure to the regulatory system governing the securities market? (ie, one without clear conflicts of interest involving either the securities commission or the stock exchange)	S	S	S	S	S	S	S	S	S	S
iii.	Is the statutory regulator (ie, the securities commission) autonomous of government (ie, not part of the ministry of finance)?	S	Y	S	N	S	S	S	S	S	S
iv.	Has the regulator recently amended securities laws to enhance protection of minority shareholders?	Y	Y	Y	S	S	Y	Y	Y	Y	S
v.	Has the stock exchange recently amended its listing rules to enhance protection of minority shareholders?	S	Y	S	S	S	S	S	Y	Y	S
vi.	Does the legal system allow minority shareholders cost-effective access to courts in order to settle disputes?	S	N	N	N	S	N	N	S	S	S
vii.	Is the judiciary capable of handling such disputes?	N	Y	S	N	S	S	S	Y	N	S
viii.	Is the media free to report on corporate governance abuses among listed companies?	S	Y	Y	Y	S	S	S	Y	Y	S

Y = Yes; N = No; S = Somewhat; Continued on the next page

Appendix 1: CLSA/ACGA country macro-CG determinants

4	IGAAP (or "ACCOUNTING & AUDITING")	China	HK	India	Indo	Korea	Malay	Ppines	Sing	Taiwan	Thai
i.	Does the government or the accounting regulator have a policy of following IAS (or US GAAP) accounting standards?	Y	Y	S	Y	Y	Y	Y	Y	Y	Y
ii.	Are local accounting standards largely in line with international standards?	S	Y	Y	S	Y	Y	Y	Y	S	Y
iii.	Do the rules require disclosure of consolidated accounts?	Y	Y	Y	Y	Y	Y	Y	Y	S	Y
iv.	Do the rules require segment reporting?	Y	Y	Y	S	Y	Y	Y	Y	S	Y
v.	Do the rules require disclosure of audit and non-audit fees paid to the external auditor?	Y	Y	Y	N	Y	Y	S	S	Y	S
vi.	Do the rules require disclosure of connected transactions?	Y	Y	Y	Y	Y	Y	S	Y	Y	Y
vii.	Does the government or the accounting regulator have a policy of following international standards on auditing (ie, the standards promulgated by the International Federation of Accountants in New York)?	Y	Y	S	S	S	Y	Y	Y	S	Y
viii.	Are local auditing standards in line with international standards?	N	Y	S	S	S	Y	Y	Y	Y	Y
ix.	Is the government or the accounting regulator taking account of new international best practices on the independence of external auditors? (eg, limits on the non-audit work that external auditors can do; requirements for audit-partner rotation)	S	S	S	S	S	S	Y	Y	S	S
x.	Is the government strengthening the regulation of the accounting profession? (eg, by setting up an independent oversight board)	S	S	S	S	S	S	S	Y	S	S
5	**INSTITUTIONAL MECHANISMS & CG CULTURE**										
i.	Are most listed companies increasingly following the spirit, not merely the letter, of corporate governance rules?	S	S	S	S	S	S	N	S	S	S
ii.	Do "non-financial" reporting practices (ie, those parts of the annual report relating to the MD&A, Report of the Directors, Statement on Corporate Governance, etc) follow international standards?	S	S	S	S	S	S	S	Y	S	S
iii.	Have listed companies improved their investor relations in recent years? (eg, through more regular meetings and communication; detailed online disclosure; better reports)	S	S	Y	S	S	S	S	S	S	S
iv.	Are listed companies increasing the pay of independent directors in line with the latter's growing responsibilities and liabilities?	N	S	S	S	S	S	S	S	N	N
v.	Are listed companies increasingly strengthening their internal controls and risk management?	S	S	S	S	S	S	S	S	S	S
vi.	Do "reputation intermediaries" (ie, investment banks, accountants, lawyers) promote high standards of corporate governance in clients about to undergo an IPO?	N	N	N	N	N	N	N	N	N	N
vii.	Are institutional investors engaged in promoting better corporate governance practices?	N	S	S	N	S	S	N	S	S	S
viii.	Have institutional investors formed their own private CG activist organisations? (Note: Industry associations do not count, nor do investor bodies established by the government or regulator.)	N	N	N	N	N	N	N	N	N	N
ix.	Have institutional investors set up any corporate governance "focus funds"?	N	N	N	N	N	N	N	N	N	N
x.	Are any retail investors engaged in promoting better corporate governance practices?	N	Y	S	N	Y	S	N	Y	N	N
xi.	Have retail investors formed their own shareholder activist organisations?	N	N	Y	S	Y	S	N	Y	N	N
xii.	Are professional associations—of accountants, directors, company secretaries, financial analysts and so on—promoting corporate governance training and awareness raising?	S	Y	Y	S	Y	Y	Y	Y	Y	Y
xiii.	Does the media actively report on corporate governance reforms and developments?	S	Y	S	N	S	Y	Y	Y	Y	Y

Y = Yes; N = No; S = Somewhat; Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Appendix 2: CLSA 2004 corporate governance questionnaire

Notes to the questionnaire:

1. Underlined questions, or parts of, are amended from last year or new questions in this year's report.
2. Bold questions are those that carry negative scoring.

Discipline (15% weight)

1. Has the company issued a "mission statement" that explicitly places a priority on good corporate governance, or has the company or management publicly articulated principles of good corporate governance that it is committed to maintaining? <u>Does the company's Annual Report include a section devoted to the company's performance in implementing corporate governance principles?</u>
2. <u>Do senior management or the controlling shareholders have a meaningful direct stake in the equity of the company?</u> (ie, not via other listed entities and not via options; a meaningful equity stake would be one of significant absolute value against the estimated net worth of the respective individuals.)
3. **Does management stick to clearly defined core businesses?**
4. A) What is management's estimate of its cost of equity?
   B) What is management's estimate of its weighted average cost of capital?
   C) Is management's estimate of its cost of capital and of cost of equity within 10% of our estimate based on its capital structure? (Answer "No" if either estimate is beyond 10% of our estimate.)
5. **Over the past five years, is it true that the company has not issued equity, or warrants/options for new equity, for acquisitions and/or financing new projects where there was controversy over whether the acquisition/project was financially sound, <u>or whether the issue of equity was necessary if gearing was not high by industry standards</u>, or whether equity financing was the best way of financing a project, or where the purpose for raising equity capital was not clear? Is it also true that the company has not issued options/equity to management/directors as compensation at a rate equivalent to more than a 5% increase in share capital over three years, and that there is no reason to be concerned on these grounds about the issue of equity/warrants for new equity in the foreseeable future?**
6. Does senior management use debt for investments/capex only where ROA (or average ROI) is clearly higher than cost of debt and where interest cover is no less than 2.5x? In using debt, has management always shown sensitivity to potential asset-liability duration and currency mismatches? ("Yes" if company has no gearing.)
7. Over the past five years, is it true that the company has not built up cash levels, through retained earnings or cash calls, that have brought down ROE?

New question

8. Is it true that the company does not have a history over the past five years of restructurings, mergers, demergers or spin-offs that reflect either mismanagement, abandonment of earlier strategies, booking exceptional gains when operating profits are weak, or an intention to hide losses?

New question

9. **Is the company able to make business decisions (eg, pricing/investments) within regulatory/legal constraints, but without government/political pressure that restricts its ability to maximise shareholder value?**

10. Has management disclosed three- or five-year ROA or ROE targets? If so, please state in (10b).

Transparency (15% weight)

11. Does the company publish its Annual Report within three and a half months of the end of the financial year?

12. Does the company publish/announce semi-annual results within two months of the end of the half-year?

13. Does the company publish/announce quarterly results within two months of the end of the quarter?

14. A) In the past 12 months, what is the longest time period between the Board meeting to accept results for a period (quarterly/half-year/finals), and the announcement of the results?

    B) Has the public announcement of results been no longer than two working days after the Board meeting? Is it true that there has not been any case in the past five years when the share price moved noticeably just before the release of results and in a direction that anticipated the results?

15. **Are the reports clear and informative?** ("No" if consolidated accounts are not presented; or if over the past five years there has been occasion when the results announced lacked disclosure subsequently revealed as relevant; if key footnotes to the accounts are unintelligible; if negative factors were downplayed when presenting the company's results that were important in assessing the business value; or if there is inadequate information on the revenue/profit split for different businesses, or regions/countries and product lines; or inadequate disclosure and/or provisions for contingent liabilities, NPLs and/or likely future losses; or inadequate details of group/related company transactions and their rationale.)

16. **Are accounts presented according to internationally accepted accounting standards (IGAAP)? Are the accounts free of substantial non-IGAAP compliant qualifications and of any controversial accounting policies?** (If the company provides two or more sets of accounts and at least one that is readily accessible is according to IGAAP, answer "Yes". If the company has changed accounting policies, or adopted a controversial accounting practice which has boosted stated earnings, answer "No".)

17. Does the company consistently disclose major and market-sensitive information punctually? Is it true that the company has not in the past five years failed to disclose information that investors deemed relevant in a timely fashion? ("No", eg, if there is any instance over the past five years of share price movement ahead of and anticipating an announcement which was believed to be insider buying.)

18. Do analysts have good access to senior management? Good access implies accessibility soon after results are announced and timely meetings where analysts are given all relevant information and are not misled.

19. Does the company have an English-language website where results and other announcements are updated promptly (no later than one business day)?

New question

20. <u>Does the company provide sufficient disclosure on dilutive instruments? (Eg if there are outstanding options, does the annual report provide clear information on the number of such options outstanding, their tenure and exercise price?)</u>

New question

21. **<u>Is it true that the company has not applied for a waiver on disclosure rules for the market?</u>**

Independence (15% weight)

22. **Is it true that there has been no controversy or questions raised over whether the Board and senior management have made decisions in the past five years that benefit them, at the expense of shareholders?** (Any questionable inter-company transactions would mean "No").

23. Is the chairman an independent, non-executive director?

24. Does the company have an executive or management committee that makes most of the executive decisions, which is substantially different from members of the Board and not believed to be dominated by major shareholders? (ie, no more than half are also Board members, and major shareholder not perceived as dominating executive decision making.)

25. **Does the company have an audit committee? Is it chaired by a perceived genuine independent director and are more than half the members of the audit committee independent directors? <u>Is there an independent director with financial expertise named on the committee?</u>**

26. Does the company have a remuneration committee? Is it chaired by a perceived genuine independent director?

27. Does the company have a nominating committee? Is it chaired by a perceived genuine independent director?

28. Are the external auditors of the company in other respects seen to be completely unrelated to the company? Does the company provide a breakdown of audit and non-audit fees paid to auditors, and if so are the non-audit fees not more than one-third of the audit fees? <u>Does the company disclose that the audit partner, or auditing firm, is rotated every five years? [No if any of the above is scored negatively.]</u>

29. Is it true that the Board has no direct representatives of banks or other large creditors of the company who are likely to direct corporate policy in favour of creditors rather than shareholders?

Accountability (15% weight)

30. Are the Board members and members of the executive/management committee substantially different such that the Board is clearly seen to be playing a primarily supervisory as opposed to an executive role? (ie, no more than half of one committee sits on the other?

New question

31. Does the company have independent, non-executive directors who are nominated by minority shareholders? (Directors nominated by investors or who represent other shareholders apart from the largest controlling shareholder would qualify; otherwise answer "No".)

32. Do independent, non-executive directors account for more than 50% of the Board?

33. A) What was the number of independent directors at the end of 2000?
    B) And at the end of 2003?
    C) Has the company increased the number of independent directors over the past three years? (Plans to increase independent directors will count as a negative answer.) **If the company has reduced the number of directors, answer "No";** if number of independent directors are the same insert "0".

34. Are full Board meetings held at least once a quarter?

35. Are Board members well briefed before Board meetings? Are they provided, as far as the analyst can tell, with the necessary information for effective scrutiny of the company, prior to the meeting, in a clear and informative manner? (Answers 35-37 must be based on direct communication with an independent Board member. If no access is provided, and no verification of an independent director is provided, answer "No" to each question.)

36. Does the audit committee nominate external auditors and conduct a proper review of their work as far as the analyst can tell?

37. Does the audit committee supervise internal audit and accounting procedures as far as the analyst can tell?

Responsibility (15% weight)

38. If the Board/senior management have made decisions in recent years seen to benefit them at the expense of shareholders (cf Q22 above), has the company been seen as acting effectively against individuals responsible and corrected such behaviour promptly, ie, within six months? (If no such case, answer this question as "Yes".)

39. Does the company have a known record of taking effective measures in the event of mismanagement? Over the past five years, if there were flagrant business failures or misdemeanours, were the persons responsible appropriately and voluntarily punished? (If no cases, the company does not have such a record, then answer this question as "No.")

40. **Is it true that there is no controversy or questions over whether the Board and/or senior management take measures to safeguard the interests of all and not just the dominant shareholders?** (eg, if EGMs with genuine independent advice for related-party transactions were not held, or independent verification of appropriate pricing for recurrent related-party transactions was not obtained, answer "No".)

41. Is it true that there have been no controversies/questions over whether share trading by Board members has been fair, fully transparent and well intentioned? (Are announcements made to the exchange within three working days, and do the major shareholders reveal all transactions including those under nominee names? Any case where it is believed by some that parties related to major shareholder were involved in transactions not disclosed to the exchange, or allegations of insider trading, would mean "No".)

42. A) How many members are on the Board?
    B) Is the Board small enough to be efficient and effective? (If more than 12, answer "No".)

New question

43. **Is it true that the company does not engage in material related-party transactions?** (eg, sourcing key materials from a related party, or using a related party that is not part of the listed group as a distribution channel, or placing funds in deposit or for investments in a related party that is not part of the listed group, or where the annual report discussion of related party transactions runs over two short paragraphs, or where the listed company has invested in businesses where the controlling shareholder has interests in the past three years, would count as a negative answer. Note that a related party that is not part of the listed group would include a unit under the parent which may be separately listed.)

New question

44. Is it true that the controlling shareholder (whether an individual or company) is not known or widely believed to be highly geared?

New question

45. **Is the controlling shareholder's primary financial interest the listed company?** (ie, not a government-controlled entity, or a listed company where the ultimate shareholder has various other business interests. Answer "No" if the company is a subsidiary of a separately listed parent.)

Fairness (15% weight)

46. **Is it true that there has not been any controversy or questions raised over any decisions by senior management in the past five years where majority shareholders are believed to have gained at the expense of minority shareholders?** (Management fees paid from the listed group to a parent company, or to a private company controlled by the major shareholders on the basis of revenues or profits would be deemed a negative.)

47. Do all equity holders have the right to call General Meetings? (Any classes of shares that disenfranchise their holders would mean a "No" answer.)

New question

48. Does the company have cumulative voting for Board representation? (ie, where minority shareholders with say a 20% interest will be able to appoint directors representing one-fifth of the Board.)

49. Are all necessary (ie, not just obligatory, but also relevant in the view of the analyst regarding accounting etc) information for General Meetings made available prior to the General Meeting?

50. Is senior management unquestionably seen as trying to ensure fair value is reflected in the market price of the stock, by guiding market expectations about fundamentals in the right direction through frank discussion on risk/returns, actions like share buybacks and investor meetings, etc?

51. Is it true there have been no questions or perceived controversy over whether the company has issued depositary receipts that benefited primarily major shareholders, nor has the company issued new shares to investors near peak prices, nor have the major shareholders sold shares near peak prices without prior guidance to the market on why shares are seen as fully valued? Also, the company has not issued shares to friendly parties just prior to AGM/EGMs where there are controversial matters being voted on at the shareholder meeting?

52. A) Does the controlling shareholder group own less than 40% of the company?

B) Please provide the stake owned by the controlling shareholder.

53. Does the head of Investor Relations report to either the CEO or a Board member?

54. A) What is total remuneration of the Board as a percentage of net profit after exceptionals?

B) **Over the past five years, is it true that total directors' remuneration has not increased faster than net profit after exceptionals as far as an analyst can tell?** (Answer "No" if directors' remuneration has increased faster than profits or if company does not make any declaration to clarify.)

Social responsibility (10% weight)

55. Does the company have an explicit (clearly worded) public policy statement that emphasises strict ethical behaviour: ie, one that looks at the spirit and not just the letter of the law, and the company is not run by senior executives who have been convicted of crimes that reflect negatively on their integrity? (Internal employee-conduct manual that emphasises ethical behaviour and no grounds to believe otherwise in the company's corporate culture would count as "Yes".)

56. Does the company have a policy/culture that prohibits the employment of the under-aged as far as the analyst can tell?

57. Does the company have an explicit equal employment policy: ie, no discrimination on the basis of sex, race, religion etc?

58. Does the company adhere to specified industry guidelines on sourcing of materials as far as the analyst can tell?

59. Is the company explicitly environmentally conscious? Does it promote the use of environmentally efficient products, or takes steps to reduce pollution, or participate in environment-related campaigns? (If there are no concrete examples of this, answer "No".)

60. Is it true that the company has made no investments/acquisitions and not entered into deals that raised questions of propriety (eg, any allegations of bribery or dealing with regimes that do not have legitimate authority like Myanmar) and there is no known litigation against the company and/or associates/subsidiaries that reflects negatively on the integrity of management?

Appendix 3: Companies with scores marked down 15-ppts by negative scoring questions

China	Reduction in score from negative scoring questions (%)	Country CG quartile ranking
Sina.com	15.0	2
Hainan Meilan Airport	15.0	2
UTStarcom	18.8	2
Weichai Power	15.0	2
Lenovo Group	18.8	3
China Res Power	15.0	3
Huaneng Power	15.0	3
China Mobile (HK)	15.0	3
China Eastern Airlines	15.8	3
Jiangxi Copper	17.9	3
Baoshan I&S	17.9	4
China Resources Ent	20.6	4
China Shipping Development	15.0	4
China Southern Airlines	15.8	4
Shanghai Industrial	16.9	4
Huadian Power	18.8	4
Jiangsu Expressway	16.9	4
Maanshan Iron and Steel	21.7	4
Angang New Steel	21.7	4
Tong Ren Tang	22.5	4
Brilliance China	16.9	4
TravelSky	23.5	4
First Tractor	16.1	4
Hong Kong		
Noble Group	15.0	2
First Pacific	15.0	3
MTRC	15.0	4
KMB	18.8	4
Hutchison Whampoa	15.0	4
PCCW	16.9	4
India		
ICICI Bank	18.8	3
Polaris	15.0	3
BPCL	15.0	3
HPCL	15.0	3
L & T	15.0	3
Tata Tea	18.8	3
Nestle India	15.0	3
Tata Motors	15.0	3
IOC	15.0	3
MTNL	15.0	3
IPCL	20.8	3
Reliance Industries	22.5	3
Tata Power	20.6	4
Ashok Leyland	18.8	4
Reliance Energy	18.8	4
M & M	18.8	4
Zee Telefilms	22.5	4
VSNL	18.8	4
Corporation Bank	18.8	4
Bank of Baroda	18.8	4
State Bank of India	18.8	4
Bharat Forge	16.9	4
ONGC	18.8	4
Maruti	16.9	4
PNB	20.0	4
ACC	22.5	4
GAIL	22.5	4
Canara	26.3	4
Oriental	26.3	4

Continued on the next page

Appendix 3 (Continued)

Indonesia	Reduction in score from negative scoring questions (%)	Country CG quartile ranking
INCO	15.0	1
United Tractors	15.0	1
Bank Central Asia	15.0	1
Bank NISP	15.0	2
Gudang Garam	15.0	2
Bank Rakyat Indonesia	18.8	2
Bank Danamon	18.8	2
Aneka Tambang	15.0	2
Indocement	22.5	2
Telkom	18.8	3
Perusahaan Gas Negara	15.0	3
Bank Niaga	22.5	3
Astra Autoparts	22.5	3
Bimantara	26.3	3
Trimegah	17.9	3
Indosiar	18.8	3
Semen Cibinong	20.2	3
BFI Finance	21.7	4
Surya Citra Media	22.5	4
Bank Mandiri	20.6	4
Ciputra Surya	18.8	4
Bentoel	20.6	4
Bumi Resources	15.0	4
Bank Panin	21.7	4
Lippo Bank	19.3	4
Korea		
Samsung Electronics	15.0	1
KTF	15.0	1
SKT	18.8	2
LG Telecom	15.0	2
AceDigitech	18.8	2
LG Chemical	15.0	2
Woori Financial Group	15.0	2
LG Petrochemical	15.0	3
LG Ad	15.0	3
KEPCO	15.0	3
S-Oil Corporation	15.8	3
INI Steel	15.0	3
Shinsegae	15.0	3
CJ	18.8	3
Hyundai Heavy	15.0	3
Samsung Corp	15.0	4
Cheil Communications	18.8	4
Reigncom	18.8	4
LG Engineering & Construction	22.5	4
Mobis	18.8	4
Kangwon Land	21.0	4
Hanwha Corp	18.8	4
Interflex	22.5	4
SK Corporation	23.3	4
Kumho Electric	22.9	4
Hyundai Motor	26.3	4
Kia Motor	26.3	4
Malaysia		
MISC	15.0	3
Telekom Malaysia	15.0	4
BToto	15.0	4
Tenaga	18.8	4
IOI Corporation	22.5	4
Magnum	18.8	4
Proton	17.9	4
Tan Chong	16.3	4

Continued on the next page

Appendix 3 (Continued)

Philippines	Reduction in score from negative scoring questions (%)	Country CG quartile ranking
Jollibee Foods Copr	18.1	3
San Miguel Corp.	18.0	4
SM Prime Holdings	27.4	4
Petron Corporation	25.0	4
Meralco	29.1	4
Singapore		
United Overseas Bank	15.0	2
Capitaland	15.0	4
NOL	15.0	4
Taiwan		
Acer Inc	15.0	2
Delta	18.8	3
Advantech	15.0	3
Hannstar	15.0	3
Premier Image	15.0	3
Compal	15.0	4
Compal Comm	16.9	4
Cosmos Bank	15.0	4
Powerchip	15.0	4
Mega FHC	22.5	4
Nanya Tech	15.0	4
Promos	18.1	4
Thailand		
TAC	16.9	4

Source: CLSA Asia-Pacific Markets

Appendix 4: Average CG scores of companies by country

Average of CG Score (%)	Overall	Quartile 1	Quartile 2	Quartile 3	Quartile 4
Country					
China	51.0	64.3	54.6	47.3	36.7
Hong Kong	64.2	75.2	68.1	61.0	52.1
India	54.9	70.3	60.1	49.7	39.3
Indonesia	44.3	59.6	47.1	39.7	30.9
Korea	56.8	73.8	62.5	51.7	38.2
Malaysia	62.5	75.4	65.3	60.3	48.9
Philippines	56.3	80.4	69.1	55.6	20.2
Singapore	61.1	70.6	64.1	58.5	49.9
Taiwan	54.9	68.4	59.0	51.4	40.8
Thailand	62.0	73.2	66.2	61.1	48.8
Top 100 by mkt cap	61.0	77.1	67.0	57.7	42.1

Source: CLSA Asia-Pacific Markets

Jamie Allen

Secretary General

jamie@acga-asia.org

3403 Citibank Tower
3 Garden Road Central, HK
Tel: (852) 28724048
Fax: (852) 28727288

Appendix 5: About ACGA

The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership organisation working on behalf of all investors and other interested parties for the improvement of corporate governance in Asia. ACGA is funded by a network of sponsors and corporate members, including many of the region's leading investment funds, financial institutions and intermediaries (see below for a full list).

ACGA advocates the competitive benefits of better corporate governance and works closely with institutional investors, regulators and companies to achieve concrete improvements. It is one of the few organisations systematically researching corporate governance developments around Asia, tracking 11 markets and producing independent analyses of new laws and regulations, investor action and corporate initiatives. ACGA has also launched a special service for institutional investors—a confidential "Investor Discussion Group" on corporate governance in Asia. It meets quarterly and discusses issues of practical importance to investors.

ACGA is incorporated under the laws of Hong Kong and is managed by a secretariat based there. Its governing Council comprises directors from around Asia.

Website

For further information about ACGA and comprehensive coverage of corporate governance developments in Asia, go to: ***www.acga-asia.org***

Members

Members include (in alphabetical order):

1.	Aberdeen Asset Management Asia	22.	Li & Fung
2.	AIG Investment Corporation (Asia)	23.	LIM Advisors
3.	British Columbia Investment Management Corporation	24.	Lloyd George Management
4.	California Public Employees' Retirement System (CalPERS)	**25.**	**Lombard Asian Private Investment Company[1]**
5.	California State Teachers' Retirement System (CalSTRS)	26.	Marsh
6.	**Chubb Insurance[1]**	27.	Milbank, Tweed, Hadley & McCloy
7.	Citigroup Asset Management - Asia	28.	Mirant Asia-Pacific
8.	**CLSA Asia-Pacific Markets[1]**	29.	Neptune Orient Lines
9.	Coudert Brothers	30.	Oracle Corporation Asia Pacific
10.	Credit Agricole Asset Management	31.	Prudential Asset Management
11.	Deloitte Touche Tohmatsu	32	Standard and Poor's
12.	Dibb Lupton Alsop	33.	Standard Life Investments
13	Fidelity Investments Management	34.	State Street Global Advisors (Asia)
14.	GIC Special Investments	**35.**	**Sun Life Financial Asia[1]**
15.	Hermes Pensions Management	36.	SUNDAY Communications
16.	Hewitt Associates	37.	Swire Pacific
17.	Hong Kong University of Science and Technology	38.	Templeton Asset Management
18.	IMC Pan Asia Alliance	39.	Value Partners
19.	ING Asia-Pacific	40.	VTech Holdings
20.	Jardine Lloyd Thompson Asia	41.	Watson Wyatt
21.	Kookmin Bank		

[1]Also a Founding Corporate Sponsor of ACGA. Source: CLSA Asia-Pacific Markets

CLSA ASIA-PACIFIC MARKETS

Research & sales offices

www.clsa.com

Operational hubs

Hong Kong
CLSA Hong Kong
18/F, One Pacific Place
88 Queensway
Hong Kong
Tel : (852) 2600 8888
Fax : (852) 2868 0189

Singapore
CLSA Singapore
9 Raffles Place #19-20/21
Republic Plaza II
Singapore 048619
Tel : (65) 6416 7888
Fax : (65) 6533 8922

USA
Calyon Securities (USA) Inc
Calyon Building
1301 Avenue of The Americas
New York, New York 10019
Tel : (1) 212 408 5888
Fax : (1) 212 261 2502

United Kingdom
Credit Lyonnais Securities
Broadwalk House
5 Appold Street, Broadgate
London EC2A 2DA
Tel : (44) 207 696 9190
Fax : (44) 207 214 5401

Asia-Pacific Markets

China – Beijing
CLSA Beijing
Unit 10-12, Level 25
China World Tower 2
China World Trade Centre
1 Jian Guo Men Wai Ave
Beijing 100004, P.R.C.
Tel : (86 10) 6505 0248
Fax : (86 10) 6505 2209

India
CLSA India
8/F Dalamal House
Nariman Point
Bombay 400 021
Tel : (91) 22 2284 1348
Fax : (91) 22 2284 0271

Korea
CLSA Korea
15th Floor Sean Building
116, 1-Ka, Shinmun-Ro
Chongro-Ku
Seoul, 110-061
Tel : (82) 2 397 8400
Fax : (82) 2 771 8583

Taiwan
CLSA Taiwan
6/F, No. 117, Sec. 3
Min-sheng E. Road
Taipei
Tel : (886) 2 2717 0737
Fax : (886) 2 2717 0738

China – Shanghai
CLSA Shanghai
Room 03, 16th Floor
Jin Mao Tower
88 Century Boulevard
Pudong, Shanghai 200121
Tel : (8621) 5047 1118
Fax : (8621) 5047 3533/4

Indonesia
CLSA Indonesia
WISMA GKBI Suite 1501
Jl. Jendral Sudirman No.28
Jakarta 10210
Tel : (62) 21 574 2626/2323
Fax : (62) 21 574 6920

Malaysia
CLSA Malaysia
Suite 15-2 Level 15
Menara PanGlobal
8 Lorong P Ramlee
Off Jalan P Ramlee
50250 Kuala Lumpur
Tel : (603) 2072 4288
Fax : (603) 2078 4868

Thailand
CLSA Securities (Thailand) Ltd
16th Floor, M. Thai Tower
All Seasons Place
87 Wireless Road, Lumpini
Pathumwan, Bangkok 10330
Tel : (662) 257 4600
Fax : (662) 253 0532

China – Shenzhen
CLSA Shenzhen
Room 3111, Shun Hing Square
Di Wang Commercial Centre
333 Shennan Road East
Shenzhen 518008
Tel : (86) 755 8246 1755
Fax : (86) 755 8246 1754

Japan
Calyon Securities
Hibiya Kokusai Building 7th Floor
2-2-3 Uchisaiwai-cho
Chiyoda-ku, Tokyo 100 0011
Tel : (81) 3 5512 5533 (Research)
(81) 3 5510 8722 (Trading Floor)
Fax : (81) 3 5512 5896

Philippines
CLSA Philippines
18th Floor, Tower One
The Enterprise Center
6766 Ayala Avenue
Makati City
Tel : (63) 2 886 5637-46
Fax : (63) 2 886 5692

Key to investment rankings: BUY = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).