CG Watch 2007

Corporate governance in Asia

In collaboration with the Asian Corporate Governance Association

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Regional
Special report

Qarp picks (ranked by upside)

Nissan Motor
Korean Exchange Bank
Woori Financial
China Steel
Toyota Motor
Hana Financial
Formosa Plastics
KDDI
Nippon Elec Glass
Standard Chartered
Bumiputra-Commerce
Malayan Banking
Posco
ST Engineering
PTT
Hang Seng Bank
Keppel Corp

Higher-ranking CG markets

Hong Kong
Singapore
India
Taiwan
Japan

On a wing and a prayer

The greening of governance

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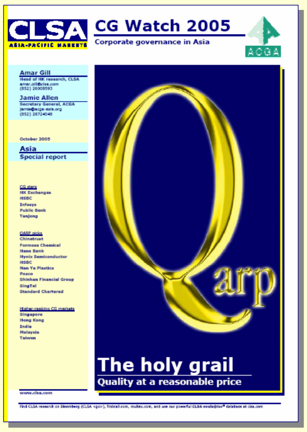


Acknowledgements and disclaimer

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 Asia-Pacific 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 1 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.

On a wing and a prayer

Climate change is as urgent an issue for Asia as elsewhere, if not more so. Global warming will have a huge impact on agriculture, which still dominates many of the economies, and on the Himalayas, which is the source of 10 major rivers for the region, while rising sea levels threaten densely populated coastal areas. Governments are beginning to respond but growth remains their first priority: they are not prepared to be bound by emission limits. Greater economic risk will come as customers in the developed world impose emission standards on companies to which they outsource manufacturing.

Green issues and governance

Asian corporations, by and large, seem unaware of the issues and risks; 42% did not respond to our Clean & Green (C&G) survey. In all 64% got a score of zero on our C&G criteria, which is introduced this year as part of our corporate-governance (CG) scoring. This replaces our previous category of social and environmental responsibility. We view environmental responsibility as part of good governance in a broader sense, ie, avoiding unnecessary risk and taking into account concerns of stakeholders.

The race changes: Rankings and results

As in our previous reports, country scores have been done with the Asian Corporate Governance Association (ACGA). This year, the ACGA team has taken a bigger role in the scoring, building up the country criteria to 87 issues under five categories: CG rules and practices, enforcement, political and regulatory environment, accounting and auditing standards, as well as overall CG culture. The measures have been tightened, the scores however are generally lower, reflecting that often with CG the more one looks the less one finds. Hong Kong and Singapore continue to lead the pack, although this year's scoring reverse their orders, with Hong Kong climbing up to the top position. ACGA's detailed analyses in the country sections show Indonesia, the Philippines and China as the bottom-three for macro CG determinants.

Qarp-driven performance

In our 2005 CG report, we introduced the concept of quality at a reasonable price (Qarp), ie, inclusion of PB and ROE in stock selection of better-CG companies. In the two years since that report, Qarp stocks outperformed in just half of the markets but with some big winners, on average, Qarp stocks outran country MSCI indices by an average of 31ppt, including stellar performances of some large-cap Qarp picks. Investors will have much better odds of picking strong performers among high-quality companies by the Qarp criteria, rather than just high CG alone to select stocks. At current valuations, our larger-cap Qarp picks include Nissan, Toyota, KDDI and Nippon Electric Glass from Japan; Asia ex-Japan financials viz Korean Exchange Bank, Standard Chartered, Hang Seng Bank, Bumiputra-Commerce; as well as China Steel, Formosa Plastics, Posco, ST Engineering, PTT and Keppel Corp.

CG progress slackened

We rated 582 companies for CG in the report. With the introduction of C&G criteria, company CG scores have fallen. On common questions between 2005 and 2007, however, the average score for our total sample has risen 1.2 points, a much slower rate than the improvement seen between 2001 and 2005. This reflects less pressure on companies on the CG front in a period when business environments and markets have been favourable. Of the larger-cap corporations, CG commitment appears the highest, reflected in CG scores over 80% for HSBC, Sharp, HK Exchanges, TSMC, Infosys and CLP. The true test for most companies will be maintaining CG standards in a downturn, when the level of real change will be demonstrated, rather than the incremental progress seen in an easier environment.

Green issues and governance

> For human society, as well as for the other organisms on the planet, the combination of the magnitude and the rapidity of the rise in global average temperature projected for the 21st Century is a major threat.
>
> - UN Scientific Expert Group Report on Climate Change and Sustainable Development, February 2007

> There is no tradeoff between business that is good for the environment and good business.
>
> - John Browne, former BP chairman

We have added Clean & Green to our CG criteria . . .

The issue of climate change is as urgent for Asia as it is elsewhere, if not more so. Global warming will have a huge impact on agriculture, which still dominates many of the economies, and on the Himalayas, which is the source of 10 major rivers for the region and of rising sea levels in densely populated coastal areas. Governments are beginning to respond but development remains their first priority: they are not to be held back by emission limits. Greater economic risk will come as customers in the developed world impose emission standards on companies to which they outsource manufacturing.

Asian corporations, by and large, seem unaware of the issues and risks; 42% did not respond to our Clean & Green (C&G) survey, and in all 64% got a score of zero on our C&G criteria, which is introduced this year as part of our corporate-governance (CG) scoring. This replaces our previous category of social and environmental responsibility. We view environmental responsibility as part of good governance in a broader sense, ie, avoiding unnecessary risk, especially with climate change now a major issue for all.

Inclusion of Clean & Green in CG scores

. . . with a 10% weight in the scoring of companies

A major change in this year's CG report is the inclusion in our CG scoring of companies their sensitivities to environmental issues. We have titled this subsection of the scores "Clean and Green", or C&G. This represents 10% of the total CG score and replaces the previous social and environmental responsibility component, which also had a 10% weighting.

In the past, there had been some controversy whether corporate governance should include social and environmental responsibilities. This comes down to whether one adopts a narrower or broader definition of corporate governance. A narrower definition would focus on the equitable treatment of minority shareholders. Most investors show interest in corporate governance because they want to make sure their returns are not undermined by controlling shareholders/management short-changing minority shareholders.

Intuitively, a socially and environmentally reckless firm is not a well run one

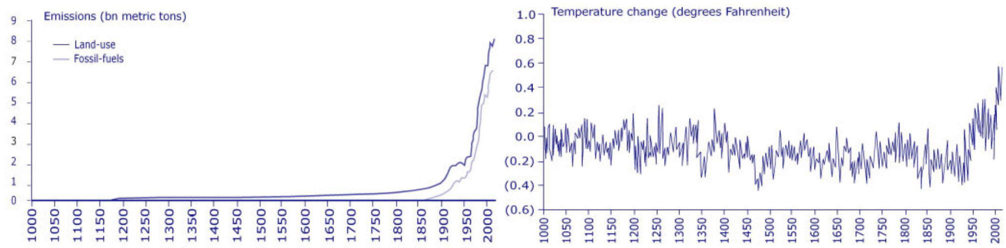
A broader definition of corporate governance, however, takes into account interests of other stakeholders as well. We had already been including scores for social and environmental responsibility in the past, as we have favoured a broader concept of corporate governance. We see CG as about how a firm is run beyond just its financial bottom-line. Equitable treatment of minorities is certainly a key part. But governance, in our view, goes far beyond that. It seems implausible to say that a company has good governance, that is, it is generally well run, just because it displays satisfactory financial data and shares the returns equitably with all investors, irrespective of whether the corporation is reckless with regard to social and environmental issues.

Intuitively, a company is not well run if it exploits underaged labour, if it does not give equal opportunities to all staff regardless of race or sex, and/or is an egregious polluter. Companies that pay little or no regard to these issues are taking risks, not just of condemnation by local authorities, but also of a backlash from their customers and the investment community. Good governance must include checks and balances to ensure profit maximisation is within the constraints of being a responsible corporate citizen.

Global temperatures not moving up coincidentally as green-house-gas emissions rise

Figure 1

Land and fossil-fuel use versus temperatures in the past 1,000 years



Source: World Meteorological Programme

Corporate responsibility to prevent irrevocable living-conditions change

Labour and environmental issues might have seemed like local, rather than global, issues in the past, in that the standards that should apply may be determined more by a country's situation and its laws, than by global practices. However, we are in an age when the viability of life on Earth generally, human life in particular, has become a live issue. Delaying the adjustment of our behaviour could soon make it too late to hold global temperatures from crossing the tipping point of catastrophe. Thus, it has become a responsibility for all, including corporate entities, to prevent an irrevocable change in living conditions on this planet.

This is partly a matter of responsibility and partly of mitigating risk. Twenty years ago, consumer activists in the developed West took up campaigns against companies that were seen as exploiting labour in the developing world. This led over the years to companies like Nike, etc, being extremely careful and going to lengths to ensure that their suppliers are not seen as exploitative in this regard.

Auditing the supply chain

Environmental audit of supply chain likely

Today, in Europe, Australia and some states of America, climate change has become one of the key topics of discussion. What multinationals do out in Africa, Asia or Latin America has already become a concern for consumers in the developed world. Interestingly, auditing the supply chain for responsibility regarding climate change has not yet become common. But just as the global brands were put to task to ensure acceptable labour practices, consumers in the West are likely to be insisting on audit of environmental responsibility of companies to which manufacturing is outsourced. It is inconsistent, if not hypocritical, for western companies to maintain that they are green with regard to their activities - design, brand-building, marketing - but to take a hands-off approach to processes outsourced to the developing world.

These companies are already enforcing higher environmental standards on suppliers in their home markets. For instance, power companies wanting to supply to Google must generate one-fifth of their electricity from renewable sources. Dell requires key suppliers to publish carbon-emissions data or risk-losing business. Wal-Mart is pushing its suppliers to minimise their packaging and reduce reliance on non-renewable fuels. The supermarket chain is promoting long-lasting compact-fluorescent lightbulbs and is the world's largest buyer of organic cotton. By the end of 2007, its new sourcing standards will stretch to its shrimp suppliers in Thailand.

Wal-Mart will start to audit shrimp exporters' environmental standards

The little shrimp is big business globally. Wal-Mart imports 20,000 tonnes of shrimp annually, just over 3% of US shrimp imports. In 2005, it announced by the end of 2007 it will buy all its shrimp from farms certified as meeting environmental and social standards drafted by the US-based Global Aquaculture Alliance. Among the requirements are that farmers must replace any mangroves cleared for their ponds by planting three times as many of the trees elsewhere. Thailand is the largest exporter of shrimp to the US, with the US$1.28bn worth of trade annually. Smaller shrimp farmers in the country, who are not able or willing to get accreditation, will lose out to larger producers, including US companies that are moving their shrimp farming to Asia. Shrimps are just the starter on the menu of likely actions by consumers and buyers in the West.

In the UK, meanwhile, consumer pressure has led to various environmental friendly choices. One can choose from a carbon-neutral taxi firm (Radio Taxis), bank at a carbon-neutral bank (HSBC), hire a carbon-neutral car (Avis), listen to a carbon-neutral band (Coldplay) and watch carbon-neutral TV (BSkyB). Similar alternatives are also presented to consumers in Europe.

Consumers in developed world likely to demand environmental audit

Consumers in the developed world are likely to request the global brands to audit the environmental responsibility of companies they outsource to beyond their own shores. This will quite likely become a trade issue. China is already being accused of unfair trade practices for its policy on the renminbi. Similarly, if mainland companies are perceived as being irresponsible with regard to pollution, emissions, health and safety standards, it will be argued that this is one of the reasons why their products are unfairly cheaper compared to local goods in the West. America's testy trade relationship with China will get an added twist relating to emissions, especially likely with the US Congress now be controlled by Democrats.

Climate change in Asia

> Warming is likely to be well above the global mean in central Asia, the Tibetan Plateau and northern Asia, above the global mean in eastern Asia and south Asia, and similar to the global mean in Southeast Asia . . . It is very likely that heat waves/hot spells in summer will be of longer duration, more intense and more frequent in East Asia . . . There is very likely to be an increase in the frequency of intense precipitation and winds associated with tropical cyclones are likely to increase in east Asia, Southeast Asia and south Asia.
>
> - *Climate Change 2007: The Physical Science Basis*, Working Group to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change

466 glaciers downsized 20% from 1962 to 2001

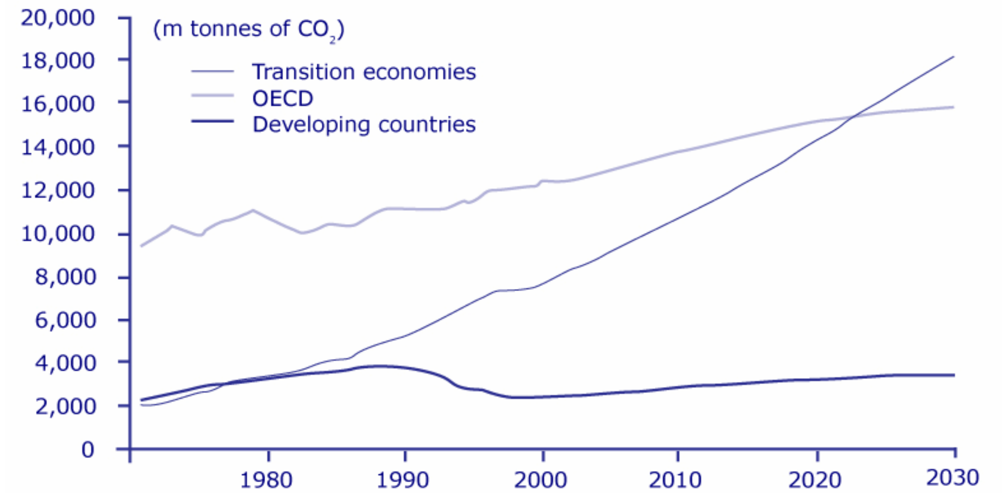
Climate change is a global issue and global warming will hit tropical/Asian regions as hard as anywhere else in the world. The Indian Space Research Organisation, using satellite imaging to gauge the changes to 466 glaciers, has found more than a 20% reduction in size from 1962 to 2001. A separate study found the Parbati glacier, one of the largest in the area, retreated by 52 metres a year in the 1990s. Temperature at the northwestern Himalayan range is estimated to have risen 2.2 degrees Celsius in the past two decades.

Developing countries' CO_2 emissions around two-thirds of OECD's . . .

. . . but to be greater by 2025

Figure 2

World energy-related CO_2 emissions by region



Source: International Energy Association, Rocky Mountain Institute, CLSA Asia-Pacific Markets

Figure 3

Global contribution to emissions (2003)

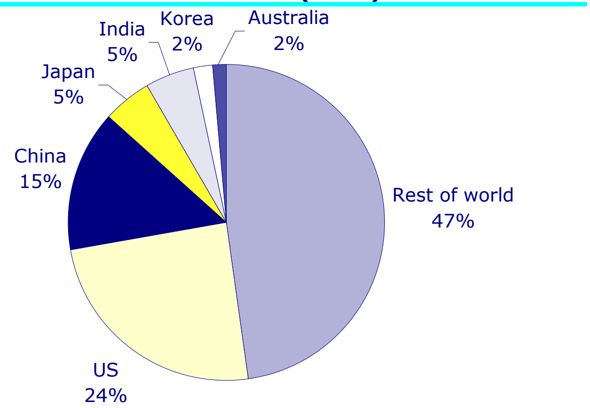
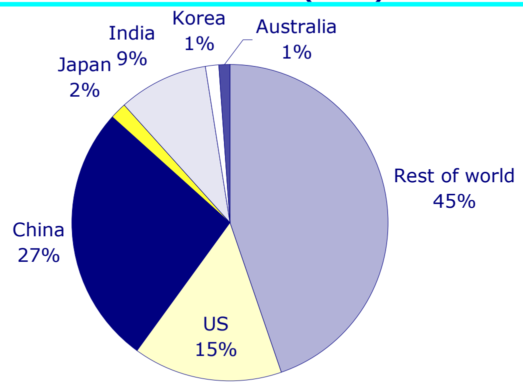


Figure 4

Global contribution to emissions (2050)



Source: UN, CLSA Asia-Pacific Markets

Tibet's glaciers have been melting, and temperature rising

An official study found the Tibetan region's glaciers were melting at an average rate of 131km^2 per year over the past 30 years. The Intergovernmental Panel on Climate Change (IPCC) estimates 80% of ice in Tibet would disappear within 30 years. The average annual temperature in the plateau region is rising at a rate of 0.3 degree Celsius every 10 years due to global warming, says the Tibet Meteorological Bureau. Four of Tibet's five warmest winters in the past 35 years have occurred since 2000; the average temperature last year was 1.6 degrees warmer than usual.

Ganges, Brahmaputra and Indus could become seasonal rivers

The Himalayas, stretching through Tibet and beyond, is the source of 10 of the great rivers that flow through China, India and Southeast Asia (including Yangtze, Ganges, Mekong, Brahmaputra and Indus). The IPCC has predicted that Ganges, Brahmaputra and Indus could become seasonal rivers by 2035. The impact of reduced flow in the rivers over the coming decades is scary for China and India, the two countries with the largest populations, with consequences for drinking-water supply, electricity generation, irrigation for agriculture, as well as the threat from alternating floods and drought on disease. This could also lead to tensions as China is already contemplating damming up in Tibet the flow of the Brahmaputra that meanders down to India and Bangladesh.

India just set up National Council on Climate Change

Leaders of the developing world are aware of the issues, even if their responses are somewhat tentative. In July 2007, Manmohan Singh, India's Prime Minister, chaired the first meeting of the nation's National Council on Climate Change. The committee's first act was to draft policy for the government. This should be approved in time for the United Nations climate conference in Bali in December, at which negotiations towards a successor to the Kyoto agreement on cutting carbon emissions, which expires in 2012, should begin.

China set out its emission targets

China is ahead of its neighbour in articulating its response to climate change and emissions. In June 2007, its National Development and Reform Commission (NDRC) published a report that set out Beijing's targets. By 2010, the PRC aims to reduce energy consumption per unit of GDP by 20%. It targets to lift the ratio of renewable power generation to total installed capacity from 7% in 2006 to 10% by 2010, and further boost it to 16% by 2020. Forest cover will expand from 18% of total land area in 2005 to 20% by 2010. China's planners emphasise that between 1981 and 2005, energy consumption per unit of GDP in China has fallen by 47%, while the OECD (Organisation for Economic Cooperation and Development) countries have dropped their energy intensity by 16% and the global average has come down by only 13%.

China has low per-capita emissions, but to rise despite better efficiency

China stresses that, per capita, its greenhouse gas emissions are just one-third of OECD's. The challenge, though, is that as long as its GDP is growing at around 10%, even a 20% reduction in energy intensity and allowing also for cleaner energy production, ie, lower emissions per unit of energy consumed, China's emissions would continue to rise by 5-6% pa. China is set to overtake the US as the largest producer of emissions about now, which will soon allow American politicians to deflect criticism on this issue by pointing to their trade partner as the main source of emissions.

The urgency for Beijing to come up with at least some short-term solutions was underscored by International Olympic Committee president, Jacques Rogge, who warned that the country's air pollution could force the postponement of endurance events at the Olympic Games, which are to start on 8 August 2008.

Some enforcement being seen in China

China's local authorities are beginning to take some actions against polluters. Last year, Guangdong officials shut down the main plant of textile manufacturer Fountain Set (listed in Hong Kong) because of its pollution into the river, which breached regulations. An Inner Mongolia branch of Mengniu Dairy was ordered to suspend operations because it did not have wastewater-processing facilities. The State Environmental Protection Administration (SEPA) also demanded the Zhongyuan chemical subsidiary of Sinopec to cease operations for failing to use effluent disposal facilities.

To close 10,000MW of capacity from smaller generators

Beijing has launched a nationwide campaign to close 50,000MW of small generating units (ie, below 135 MW) by 2010; 10,000MW of capacity is due to be closed by 2007. This is an opportunity for the independent power producers (IPPs) to increase capacity through larger plants and take market share away from smaller producers. However, some of the listed IPPs also have to shut down their existing smaller plants. Datang Group is reported to have closed 1,298MW of capacity, Huaneng 1,070MW, Huadian 750MW, China Power International 715MW, and Guodian 712MW.

Disregard of the environment is a risky strategy

As pollution and the environment become issues in other countries, there will be more enforcement. Disregard of the environmental cost of doing business is, thus, a risky strategy. Companies that are manufacturing for consumers in the West need to be aware of the risk, not just of enforcement by local authorities but also pressure from their customers. The urge of consumers will be increasingly felt, and probably become economically more significant than enforcement by local authorities. Logically, this pressure must go right up the chain, not just to manufacturers but also to the companies they use for power needs, transport, supplies, etc. The whole supply chain has to be green or it undermines some parts becoming clean.

Climate change will impact agriculture and habitable areas of Asia

Climate change is a global issue but it will affect, in particular, the viability of agriculture, which is still key to Asian economies. Over the longer term, the areas that are habitable are likely to be reduced, especially in low-lying areas with high concentration of urban population in south Asia and China.

Poor CG for companies not to pay attention to the environment

Companies that pay no attention to their impact on the environment are being reckless in at least three respects: local enforcement; customer pressure; and social responsibility. Not heeding this risk, when the impact of climate change is already obvious from steadily rising temperatures and more freakish weather patterns, means irresponsibility. In our view it is also poor corporate governance on a wider notion of CG. Hence, the inclusion of C&G questions in our survey from this year on.

Asian companies mostly appear oblivious

C&G questionnaire sent to the companies; only 57% replied

At this stage, awareness of and responses to climate-change issues are still lagging in Asia generally. Last year, we produced our first report on the issue, *C&G Audit 2006: Carbon management in corporate Asia*. We sent our Clean & Green survey questionnaires to 150 companies in the region, only 60 responded (40%). This year, as part of the corporate-governance scoring exercise, we sent the same survey to all companies under our core coverage. We made it explicit that scores from the C&G survey would be incorporated into the overall CG score. Of the 582 companies that we scored across the region, 336 (58%) filled and sent back the questionnaire this time.

Most firms do not see environmental issues as relevant

The response of many companies is that their businesses were not polluting and hence, the C&G survey did not apply to them. It has not yet sunk in for most corporate managers in Asia that whatever business one is in, it will have a carbon footprint. Every business consumes electricity, involves travel and will have other impacts on the environment, including paper usage, etc. With a carbon footprint comes the responsibility to minimise, if not actually negate the cost of carbon emissions. A change in mindset will happen. Just as 10 years ago the concept of corporate governance was not even discussed, but it has now become integral in corporate presentations and annual reports of most Asian companies, so will their responses to climate change.

Dirty industries and tech are at the forefront of C&G awareness in Asia

Presently, we find the companies more conscious of climate change and starting to tackle the issues are generally in industries where globally these sectors are being brought to task. In our survey this year, technology, materials, together with power and gas, are the three sectors with the most companies that scored 50% or higher for C&G. This is certainly not because these companies are cleaner than others. However, that they are already aware of the issues and beginning to address them gives these companies a positive score in our C&G survey. It makes more sense for the companies that are in more polluting industries to start first in seeking to control and offset their emissions. This will have greater impact than if the measures were kicked off by companies with a smaller carbon footprint. And technology companies not yet sensitive to the environment will find it hard to pretend to be at the forefront of current developments.

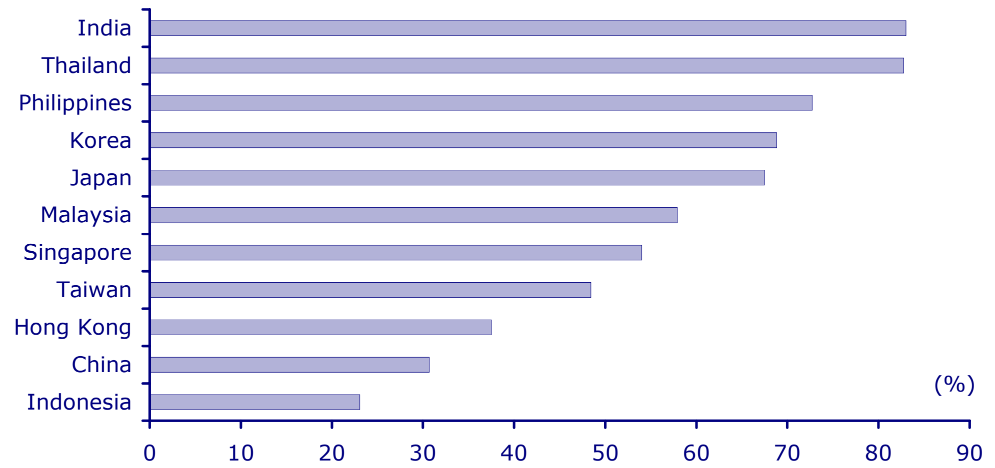
Our C&G survey received a 56% response rate from Asian corporations

Excluding Japan, we received 309 responses to our C&G survey, or 57% of our company sample. For Japan, the response rate was 68%. With only slightly more than half of our Asia ex-Japan sample responding, average and median analyses of C&G scores are misleading. More suggestive is analysis of respondents (ie, companies paying some attention to C&G issues), and how many of the total sample by countries/sectors managed to score at least 50% in the C&G survey (ie, already putting in place at least half of the level of commitment that we see as integral to being environmentally responsible).

Higher response rate from India, Thailand, Korea, the Philippines and Japan

Figure 5

Response rate to our C&G survey by country



Source: CLSA Asia-Pacific Markets

Higher response rates from Thailand, India, the Philippines and Korea

We have higher rates of response from companies in India, Thailand, the Philippines, Korea and Japan. The highest was Thailand and India, where 83%, of the companies responded. This is from a relatively small sample of 29 key companies under coverage for Thailand; most of these are in oil and petrochemicals, cement, etc, where there is already a high level of C&G awareness in the sectors globally. Similarly for the Philippines, the sample is not large with just 22 companies under our core coverage. However for India and Korea, each with a sample of over 70 companies surveyed, the response rates of 83% and 69%, respectively, were creditable.

The lowest response rate came from Indonesia . . .

The lowest response rate, 22% of a relatively small sample, was from Indonesia. As our country and research head, Nick Cashmore, writes in the country section of this report, 'Indonesia is ranked as one of the largest carbon polluters in the world through deforestation. There is also no tradition of communal responsibility for the environment.'

. . . followed by China and HK

The two other markets with the lowest rates of response are China (31%) and Hong Kong (38%). For Hong Kong, the main reason is a surprising lack of awareness, with companies commonly saying that they do not produce emissions and hence, should not be subject to C&G scrutiny. For the PRC, it was a combination of non-industrial firms with a similar view and most other mid- and smaller-sized industrial companies simply not focusing on pollution yet. Given China's rapid growth, driven by investments and industrial output, plus continued outsourcing to the mainland, the lack of awareness and measures to allow them to give any response to a C&G survey is alarming.

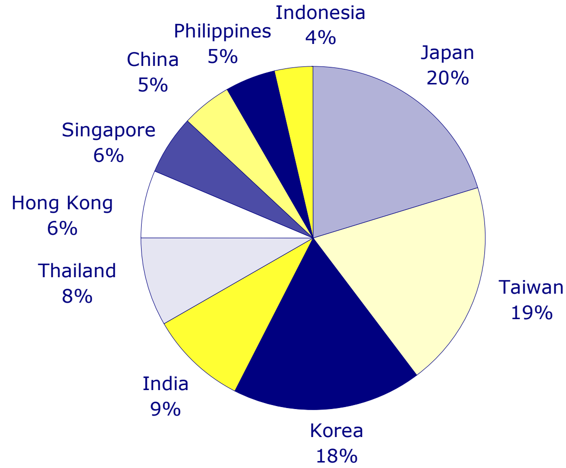
Just 16% of the Asia ex-Japan sample scored 50% or higher for C&G

Only 87 of the companies in Asia ex-Japan scored 50% or higher in our C&G survey, ie, just 16% of the overall sample (including those that did not respond, which are likely to have received low scores, if not zero). Of these, Taiwan and Korea together made up 37% of the companies that have C&G score of at least 50%. This can be explained by a higher representation of companies from sectors where there is greater awareness of C&G issues.

Almost half of the companies achieving 50% in C&G are from Taiwan, Korea and India

Figure 6

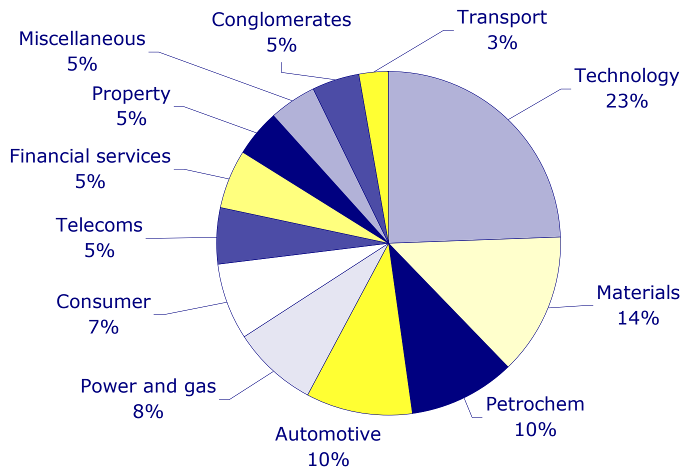
Composition of companies with C&G score of 50% or higher (by country)



Technology and materials companies make up 37% of firms scoring respectably on C&G

Figure 7

Composition of companies with C&G score of 50% or higher (by sector)



Source: CLSA Asia-Pacific Markets

Tech companies about one-quarter of those with high C&G scores

About one quarter of those with high C&G scores are in the technology sector, representing companies where internationally their clients are likely to be already emphasising the need for environmentally responsible operations. Other sectors that are facing pressures to be clean and green globally also have companies in Asia, which are getting more sensitive regarding emissions. Technology, together with materials, petroleum and chemicals, autos, and power and gas make up 65% of the companies in the Asia ex-Japan universe with a C&G score of 50%-plus.

Countries with smaller sample sizes tend to have higher average scores

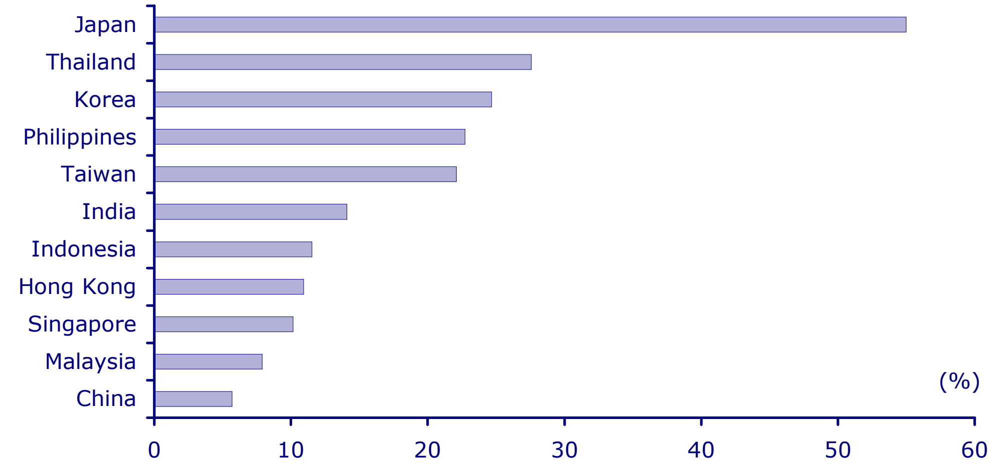
Countries with smaller sample sizes, where the bias of coverage would be the better companies, can be expected to have a higher percentage of their country sample getting a respectable score on these surveys. Thailand and the Philippines together had 13 companies that scored 50% or higher on C&G; but for each country, this represented only 7-8% of the firms from Asia ex-Japan with a 50% or higher C&G score. For Thailand, most of the companies scoring well are petrochemicals, which would be more sensitised to these issues.

Just over half in our Japan sample scored 50% or higher for C&G . . .

. . . less than a third in other markets

Figure 8

Percentage of responses by country scoring 50% or above on C&G



30 companies in our sample with C&G scores of 80% or higher

Nine from Japan, seven from Taiwan

10 are tech and six materials companies

Figure 9

Companies with C&G scores of 80% and above

	Country	Sector	C&G score (%)
Samsung SDI	Korea	Technology	100
HSBC	Hong Kong	Financial services	95
NEC	Japan	Technology	95
Posco	Korea	Materials	95
Sharp	Japan	Technology	95
Toyota Motor	Japan	Automotive	95
Zyxel	Taiwan	Technology	95
Cathay	Hong Kong	Financial services	90
China Steel	Taiwan	Materials	90
Fuji Film	Japan	Technology	90
Hynix Semiconductor	Korea	Technology	90
Nanya Plastics	Taiwan	Petrochems	90
StandChart	Hong Kong	Financial services	90
Taiwan Cement	Taiwan	Materials	90
United Microelectronics	Taiwan	Technology	90
Asahi Glass	Japan	Materials	85
Astra Intl	Indonesia	Conglomerates	85
CLP	Hong Kong	Power and gas	85
Kia Motors	Korea	Automotive	85
Kumho Tire	Korea	Automotive	85
NTT DoCoMo	Japan	Telecoms	85
Siam Cement	Thailand	Materials	85
Aromatics Thailand	Thailand	Petrochems	80
Ibiden	Japan	Technology	80
Millea	Japan	Financial services	80
Nanya Printed Circuit Board	Taiwan	Technology	80
PTTEP	Thailand	Petrochems	80
Shin-Etsu Chemi	Japan	Materials	80
Taiwan Semiconductor	Taiwan	Technology	80
Thai Oil	Thailand	Petrochems	80

Source: CLSA Asia-Pacific Markets

Fewest companies in China, Malaysia, Singapore, HK and Indonesia with a respectable C&G score

Generally for countries where we have better sample sizes, less than one in five of the companies had C&G scores of 50% or higher. Lowest by ratio is China with just 6% of the sample companies able to score at least 50% for C&G, followed by Malaysia with only 8% of the sample scoring 50% or higher. Singapore was surprisingly not much higher: only 10% of our coverage for the island state scored 50%-plus on C&G, with the ratio only slightly higher at 11% for Hong Kong, 12% for Indonesia and 14% for India.

Japan

55% of our Japanese firms scored at least 50% vs Asia ex-Japan's 16%

Our Japan sample is not large, as this is the first year that we are scoring Japanese companies for corporate governance. We surveyed 40 Japanese companies. Of these, 68% responded to the survey, and 55% scored at least 50% on C&G. Although the sample from Japan is only 7% of the overall Asia companies we scored for CG/C&G, 19% of those that scored 50% or higher on C&G are from Japan. Of the Japan sample, 55% at least hit the halfway mark on C&G compared to 16% for our Asia ex-Japan sample.

Environmental issues are taken much more seriously in Japan

While there is some sampling bias towards better companies within our relatively small sample of 40 Japanese companies, this still reflects that environmental issues are taken much more seriously in Japan, with emission regulations already in place. Within our Japan sample, Sharp, Toyota, NEC, Fuji Film, Asahi Glass , NTT DoCoMo, Ibiden, Shin-Etsu Chemical and Millea score 80%-plus on C&G and rank among the top within Japan, as well as in the region.

The C&G survey

We sent 20 C&G questions to companies

Our C&G questionnaire is very simple, requires only "yes" or "no" answers (as is the case with our overall CG questionnaire). It comprises 20 questions that can be divided into four sections:

- **Leadership** (three questions): Is there any recognition of climate-change issues at the highest levels of company management?
- **Recognition and reaction** (eight questions): Is the company aware of regulations and able to quantify its emission levels and exposure to climate-change risk, and have emission-reduction targets been set?
- **Disclosure** (four questions): How does the company communicate its policy to the public and investment community?
- **Looking to the future** (five questions): What business actions are being taken in response to climate change and/or investor and customer's views on climate change

We translated the questionnaire for Japanese and mainland Chinese companies from English to their languages, and their comments, if any, from their languages back to English. For the rest of Asia, we used an English-language questionnaire.

C&G score is a simple percentage of "yes" answers

We have not attempted to weight answers. Rather, we have taken a simple percentage of "yes" answers as each company's C&G score. This is due to the simplistic nature of the questionnaire and the embryonic state of development of this area in Asia. We have also not taken data, where it was supplied, to make any kind of comparison between companies. This is because, to date, there is no real standard on how emission measurements are taken or stated, or accounted for. Quantifying carbon emissions is itself fraught with difficulties, with much depending on the methodology adopted.

20 yes/no questions - still hard for nearly 200 companies to respond

Figure 10

CLSA C&G questionnaire

CLSA ASIA-PACIFIC MARKETS **Greenhouse gas emissions and climate change**

		Question	Yes	No	Comment
Leadership	**1**	**Is any individual or committee responsible for the company's GHG emissions and/or climate-change controls?**			
	2	Does this person/committee report directly to the board?			
	3	Does the remuneration of any board member/ executive or manager of the company depend wholly/in part on meeting emissions targets?			
Recognition and reaction	4	Is the company aware of any current government regulation that requires it to monitor or reduce emissions?			
	5	Does the company have any mechanisms in place to monitor and inventory GHG emissions?			
	6	Is this mechanism verified by a third party?			
	7	Has the company quantified annual emissions of CO_2 in either of the past two financial years? (If yes, please include the data in the comments field)			
	8	Has the company set voluntary or regulatory-mandated targets for emission reductions? (If yes, are targets absolute or a percentage of emissions)			
	9	Are emission savings quantified and used as part of the evaluation procedures for new capex projects?			
	10	Has the company made any formal assessment of the risk to its business of climate change?			
	11	Is the company ISO14000-accredited?			
Disclosure	12	Does the most recent annual report or chairman's statement carry details of emissions?			
	13	Does the most recent annual report or chairman's statement carry any comments on the risks or rewards to the business of climate change?			
	14	Does the most recent annual report or chairman's statement carry a statement of intent/objectives or targets regarding GHG emissions?			
	15	Have there been any other communications with the market or shareholders in this regard?			
Looking to the future	16	Does the company use any renewable energy sources?			
	17	Do any existing R&D projects involve innovative technology to reduce emissions or utilise renewable energy sources?			
	18	Will any business unit benefit from climate change or increased regulation and general acceptance of the need to reduce emissions?			
	19	Have any suppliers/vendors/contractors instituted GHG reduction measures or been selected in order to lower the company's indirect emissions footprint?			
	20	Has there been any evidence to date of interest in emissions policy by either key customers or investors?			

Source: CLSA Asia-Pacific Markets

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The race changes: Rankings and results

Big changes in the leader board at Asia's most grueling regulatory endurance race, the HypaBank Corporate Governance Challenge. Team Hong Kong has edged out in front of Team Singapore for the first time - though it seems more due to Singapore's loss of pace in the latest stage than any dramatic surge from Hong Kong. Team India retains its number-three ranking, but the gap is widening between second and third places. Team Taiwan has leapt into fourth place with a burst of energy. Can it sustain this? We'll have to see. Japan, a new entrant, is holding down the fifth place. And not far behind are Teams Korea and Malaysia in equal sixth - no change for Korea, but a disappointing drop of two places for Malaysia, which appears to be struggling. Team Thailand caused a shock when its members collided with themselves over some slippery obstacles, and has fallen back to the eighth spot. And among the last three, China has outrun its close competitors from the Philippines to occupy the ninth place, leaving Philippines second last and Indonesia still firmly at the back of the pack.

Aggregate total scores are lower than before

So might a sports commentator relate, with the required hyperbole, the results of the market rankings in our latest CG Watch survey, the first in two years and our fourth in collaboration with CLSA Asia-Pacific Markets. As the table below shows, not only has the ranking of markets changed since our last CG Watch survey in October 2005, the aggregate total scores are lower than before. What are the factors driving these changes? (See Appendix 2 for the survey in detail.)

Figure 11

Market rankings: CG quality

Rank	Market	Rules & practices (%)	Enforce (%)	Political & regulatory (%)	IGAAP (%)	Culture (%)	Total score (%)	2005 (%)
1	HK	60	56	73	83	61	67	69
2	Singapore	70	50	65	88	53	65	70
3	India	59	38	58	75	50	56	61
4	Taiwan	49	47	60	70	46	54	52
5	Japan	43	46	52	72	49	52	-
6	Korea	45	39	48	68	43	49	50
6	Malaysia	44	35	56	78	33	49	56
8	Thailand	58	36	31	70	39	47	50
9	China	43	33	52	73	25	45	44
10	Philippines	39	19	38	75	36	41	46
11	Indonesia	39	22	35	65	25	37	37

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

Lessening of pressure for reform across the region

On the issue of market rankings, the changes reflect the degree of emphasis that regulators, issuers, intermediaries and investors have placed on corporate governance in the booming economies and stock markets over the past two to three years. There has been a palpable lessening of the pressure for reform around the region, as one would expect during such a time, and many governments, regulators and market participants have taken their eye off the governance ball. Indeed, certain regulators are positively complacent about what they have achieved in the past decade, recounting with pride how much their stock markets have risen, and saying that all they need do now is to 'refine their rules' and 'improve implementation' of best practices. This implies a degree of regulatory perfection that does not yet exist in any Asian market. The ongoing process of company and corporate governance reform in the US, the UK and Europe suggests that even the developed markets do not yet think their own job is done.

HK regulators continue to grapple with difficult reform issues

Not all markets and governments have reacted in the same way. Hong Kong has moved into first place for a range of reasons, one of which is that it continues to grapple with some difficult reform issues and its regulatory officials are well aware of the distance between local norms and international standards. Singapore, in contrast, gives the impression that its reform process has reached an acceptable plateau - to be fair, many of its disclosure standards are higher than those of Hong Kong - while its officials seem less concerned that some key local rules and practices are not in line with global best practices. Even though the process of reform is continuing in Singapore, such as in proposed amendments to securities laws, there is a palpable sense that the pace of policymaking has slowed. Hong Kong may not be attacking its problems with vigour or urgency, but at least it continues to progress.

Singapore's reform seems to have reached an acceptable plateau

Hong Kong is also well ahead of Singapore in terms of shareholder rights and, in recent years, closed off several loopholes that undermined investor protection (eg, it disallowed discounted stock options, required an independent vote for any voluntary delisting, and mandated voting by poll for certain major and connected transactions). Singapore has yet to address these issues.

HK ahead of Singapore in private enforcement in a few categories

Another noticeable difference is Hong Kong's performance in the "Enforcement", "Political & Regulatory Environment" and "CG Culture" categories. While its scores are clearly far from perfect, we believe that it is ahead of Singapore in the following areas: "private" enforcement by the market (but not necessarily "public" enforcement by the regulators); regulatory transparency, meaning disclosure of enforcement activities by the securities commissions and stock exchanges; media freedom and discussion; and corporate responsiveness to the views of investors.

Taiwan and China have also improved their ranking

As for the other two markets that have both improved their rankings - Taiwan and China - rises are due to the fact that they have moved ahead with reform despite their booming markets. Taiwan's regulatory authorities have become increasingly open in recent years to engaging in a discussion about the strengths and weaknesses of their governance system, and have made real strides in improving not only their rules, but enforcement as well. Taiwan's listed companies have yet to show the same degree of enthusiasm - except in sectors like IT and telecoms that are subject to international competition - and it remains a frustrating place for investors trying to vote their shares. However, overall, there does seem to be genuine scope for further reform.

China's achievements over the past two years are mostly in the regulatory realm as well, including major amendments to both the Company Law and the Securities Law, a series of changes to the listing rules of the Shanghai and Shenzhen exchanges, and a wholesale revamping of the country's accounting and auditing standards in line with international norms. Public enforcement does not stand out for its excellence, though it does seem to be improving gradually. But one area where China has made a definite leap forward is in the quality and quantity of the English language material on its regulatory websites, especially that of the China Securities Regulatory Commission (CSRC).

Methodological changes = lower scores

Absolute scores fallen for most markets because of methodology changes

As in our last survey, absolute scores have fallen for most markets primarily because of various changes we made to our methodology. These changes include the following:

Number of questions raised from 76 to 87 to draw sharper distinctions

New questions

Our last survey had 76 questions across the five categories. We dropped one question in the CG Culture section (dealing with whether or not institutional investors had set up their own shareholder associations) and added 12 new questions for a total of 87. Five of these were incorporated into the CG Rules & Practices section, two were added to Political/Regulatory, four to IGAAP, and one to CG Culture (see Appendix 2 for the full questionnaire).

Most of the new questions seek to draw sharper distinctions between rules and practices, and between the governance practices of large listed companies (usually defined as those in the main market index of large caps) compared to small- and medium-sized companies (defined as the rest of the market). For example, our previous survey asked simply whether financial reporting standards of listed companies compared favourably against international best practices. The new survey breaks this into three questions: the first looking at whether local financial reporting standards (ie, rules) compare well against international standards; the second assessing whether the financial reporting practices of large caps are world-class; and the third asking the second question again but for small and mid-cap firms.

We draw similar distinctions in the IGAAP section between national policies on accounting and auditing, the extent of convergence between national and international standards, and the quality of both accounting and auditing practices at large caps and small/mid caps.

First category not just CG rules, but also practices

CG Rules & Practices

Related to the above, we have renamed our survey's first category from "CG Rules" to "CG Rules & Practices". Continuing the practice in our last report of looking at rules in context, as versus only what is on paper, we have broadened this approach to include more questions in the first section. While we recognise that changing rules is not always easy, and that regulators deserve credit for doing so, we believe it is equally important to judge a rule by its effect and success. Regulators sometimes bring in new rules without much thought as to how to enforce them (or in some cases, even the intention of doing so). Giving a full point (ie, "Yes") in such instances - as we did a few years ago - produces a misleading picture of the quality of corporate governance in a cerrtain market. The classic case is Malaysia, which used to score highly for its rules (around 90%), but now scores quite badly (44%) when one looks at corporate practices as well and drills deeper into the rules themselves.

In some cases practices ahead of rules, eg, Thailand

Focussing on practices in this category has another benefit: if market or corporate practices are ahead of the rules, then we will mark a country up a level or two. We did this, for example, in the case of Thailand on the question as to whether companies released their detailed AGM agendas 28 days before meetings. The law is still seven days, but many of the better Thai companies send out their materials two to four weeks early.

Finer distinctions also in the scoring

Scoring system

We have rounded out our scoring system by adding another layer - "Largely". The scores are now based on the following gradations: Yes (1 point); Largely (0.75 points); Somewhat (0.5 points); Marginally (0.25 points); and No (zero point). We have also, reluctantly, added a further score of "X" (zero point), where data is unavailable. The two questions affected come under Enforcement and relate to whether or not regulators are expanding their investigation and enforcement budgets (see "The X factor" below).

Wording of some questions are made more precise

Wording

We have made further changes to the wording of some questions where we think they could be more precise. For example, under Political/Regulatory, we ask whether statutory regulators (ie, securities commissions) are formally and practically autonomous of government, then give criteria as to what we mean. One item we have added is whether the commission relies on the government for its annual budget, a useful indicator of its degree of dependence (and commensurate lack of independence).

Commitment to CG reform seems to have waned

While the lower scores this year largely reflect changes in survey methodology, as opposed to a decline in corporate governance standards, there are some markets where the commitment to corporate governance reform seems to have waned at the political level (notably Korea, Malaysia, Thailand, and the Philippines) and the steady progress among corporations has stalled or fallen off (largely the same group of countries, plus Indonesia).

The more you look, the less you find

All regulatory systems, however, share a characteristic that we first noted in our 2005 report: 'the more you look, the less you find'. That is to say, the more one investigates the details of rules, the specifics of enforcement, and the nature of legal and regulatory institutions, the less robust they appear (in most cases). This is not necessarily the fault of regulators, we hasten to add, since almost all of them operate in difficult and uncooperative political environments. But it does help to explain the lower scores in this year's survey. In contrast, it is encouraging that most markets this time scored higher for "CG Culture", indicating that the level of CG-related activity among companies, investors, corporate governance associations, academics, director institutes and other professional bodies is increasing. This should provide a foundation for continued, albeit gradual, improvements in the years to come.

Please look beyond the rankings!

More significant differences at the top and the bottom

One plea we wish to make to readers of this survey, especially regulators, is that you look at the market rankings in the context of the scores. We have found readers expressing surprise that certain countries are ranked quite highly (India, which ranks third, being the usual example).

The "X" factor

Two questions in this survey have been rated as "X" for almost all markets, meaning that "no data is available". The questions are B6 and B9 under the "Enforcement" category and relate to whether securities commissions and stock exchanges, respectively, have been investing significantly more resources in investigation and enforcement over the past two years.

Initially, we attempted to answer these questions by extrapolating from the enforcement records of regulatory bodies. We found, however, that detailed enforcement data is not available in most markets, and where it is available one cannot easily draw any meaningful conclusions about budgets from the numbers. Does an increase in investigations and disciplinary cases, for example, reflect a bigger regulatory budget, a reallocation of existing resources and staff, or rather more complaints from investors?

Although we sought answers from securities commissions and stock exchanges, we found them to be unwilling or unable to share budgetary data. Some view their budgets as confidential, others simply did not have the data in the required form. We would like to propose, as a best practice, that regulatory bodies make public on an annual basis how their budgets are allocated to enforcement. Since they are public bodies, there is no strong reason why such information should be confidential. Greater transparency from regulators would not only give their efforts more credibility, it would require of them what they ask of listed companies.

India's score of 56% is not especially high

Our response is to point out that India's score of 56% is not especially high and that the rankings are relative: third place does not necessarily mean "good", it only means that India's corporate governance regime is, on balance, slightly better than the markets below it. Looking at the scores again, one can see that the percentage point differences between third, fourth, fifth and sixth places are not that great. The more significant differences are at the top (between first/second place and the rest) and, to a lesser extent, at the bottom (between the last two places and the rest).

We have also found regulators quoting (usually selectively!) the results of "CG Watch" to show their market in the most favourable light. While we expect this to some degree, we would urge regulators to focus not only on the ranking of their market, but also the scores accorded to the five different categories and what this says about the strengths and weaknesses of their corporate governance systems. As always, we stand ready to be corrected if a regulator feels we are being too harsh.

Market strengths and weaknesses

Drilling down more deeply into each market, we highlight below a few of their main strengths and weaknesses. Markets are ordered according to their ranking in our survey.

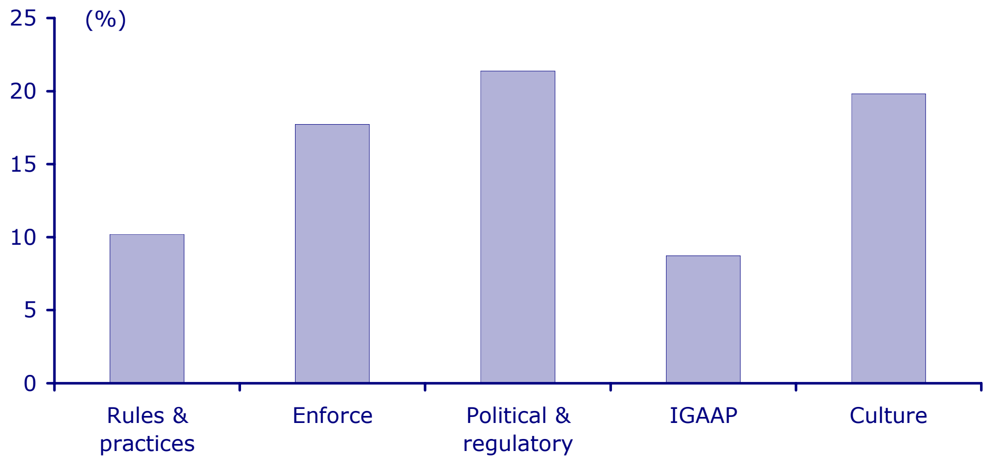
(1) Hong Kong

Higher than the Asia average . . .

. . . especially on political and regulatory, CG culture and enforcement

Figure 12

HK: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Voting by poll is widely practised in Hong Kong

Strengths. Relatively high (and improving) standards of financial and non-financial reporting. Accounting and auditing standards in line with international norms. Good disclosure of director share transactions, individual director remuneration, and reasonably good disclosure of material transactions. Voting by poll is mandatory for certain resolutions at EGMs (and is now regularly carried out for all resolutions at AGMs by most large caps). A core group of institutional and retail investors are actively voting against resolutions with which they disagree. Protection of minority shareholders in takeovers and "privatisations" is strong. Regulatory and stock exchange websites are a good source of information on laws, regulations, public enforcement activities, and company announcements/reports. Media freedom is relatively high and there is space for an independent activist, David Webb, to operate - something that not all governments would tolerate.

Reporting deadlines well below international best practice

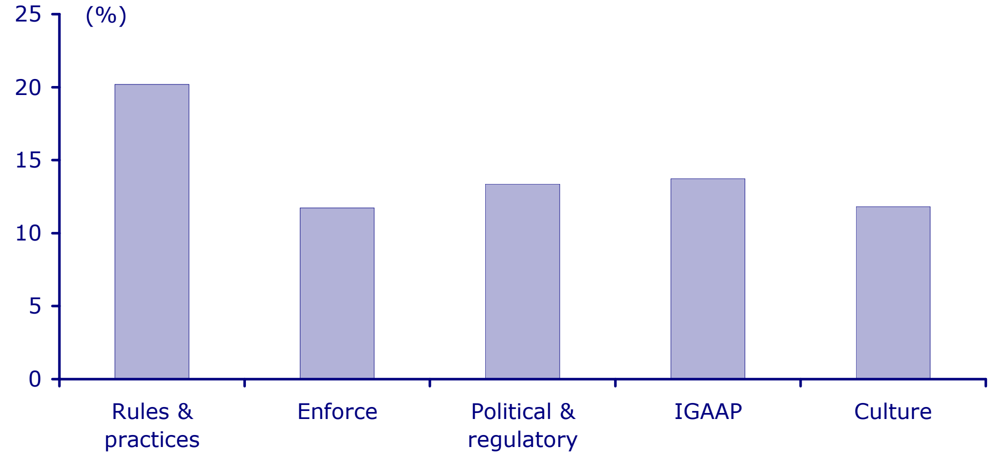
Weaknesses. Frequency of financial reports remains limited to annual and interims, while reporting deadlines (120 days for audited annuals) is well below international best practice. Continuous disclosure of price-sensitive information could be much improved. Legal remedies available to investors are extremely limited (and costly). Definition of "independent director" is artificially designed and weak, which undermines the value of this role. Enforcement powers of both the main securities commission and the stock exchange are insufficient. Enforcement and disciplinary proceedings drag on, literally, for years. Many, probably most, institutional investors are still not voting their shares or taking an active interest in corporate governance issues. Almost none attend AGMs. And Hong Kong still has no organised retail shareholder association.

(2) Singapore

Generally better scores but stronger on rules and practices

Figure 13

Singapore: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Regulatory deterrence against insider trading is improving

Strengths. Generally high standards of financial and non-financial reporting. Frequency and timeliness of financial reporting is world class, including high-quality quarterly reporting and audited annual results within 60 days. Companies also provide reasonably good disclosure of material transactions. Accounting and auditing standards in line with international norms, plus regulation of the auditing profession is being strengthened. Regulatory deterrence against insider trading is improving. Scope of information on regulatory websites, especially as regards public enforcement activities by the Monetary Authority, has grown. A small group of institutional investors are actively voting their shares and, in some cases, attending AGMs. Some dedicated retail shareholders are also attending AGMs and asking questions. Singapore has an organised retail shareholder association (SIAS).

Voting by poll is not mandatory and rarely practiced

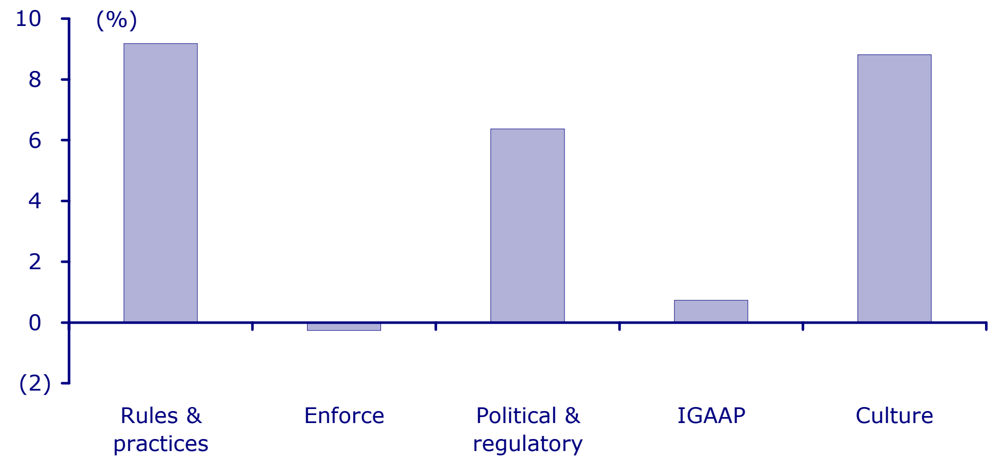
Weaknesses. There is limited disclosure of individual-director remuneration in Singapore. Independent directors in most listed companies need not be independent of the controlling shareholder. Legal remedies available to investors are extremely limited. Voting by poll is not mandatory and rarely practiced, even by major listed companies. Discounted stock options are still permitted. Rules governing takeovers and privatisations are quite strong, except that the approval process for voluntary delistings does not adequately protect minority shareholders (since all shareholders, including the controlling shareholder and directors, may vote). The deadline for releasing AGM notices and detailed agendas is still only 14 days, which is well below global best practice. Finding data on enforcement activities on the stock exchange website is not easy, while the organisation of company announcements could be greatly improved.

(3) India

Scored mostly higher than average

Figure 14

India: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Media extremely free to report on and debate CG issues

Strengths. Financial and non-financial reporting standards among the largest companies are high (in some cases, truly world class). Release of audited annual results by these companies is quick (within 60 days). Disclosure of individual director remuneration is required and companies release their detailed AGM agendas relatively early (at least 21 days). The main securities commission, SEBI, is independent of government (more so than in most Asian markets). Regulatory websites contain large amount of information on laws and regulations. The media is extremely free to report on and debate corporate-governance issues. India has some excellent examples of well-governed firms and a national industry body, CII, which spreads the word via reports, conferences and training courses.

Huge disparity between many large caps and rest of the market

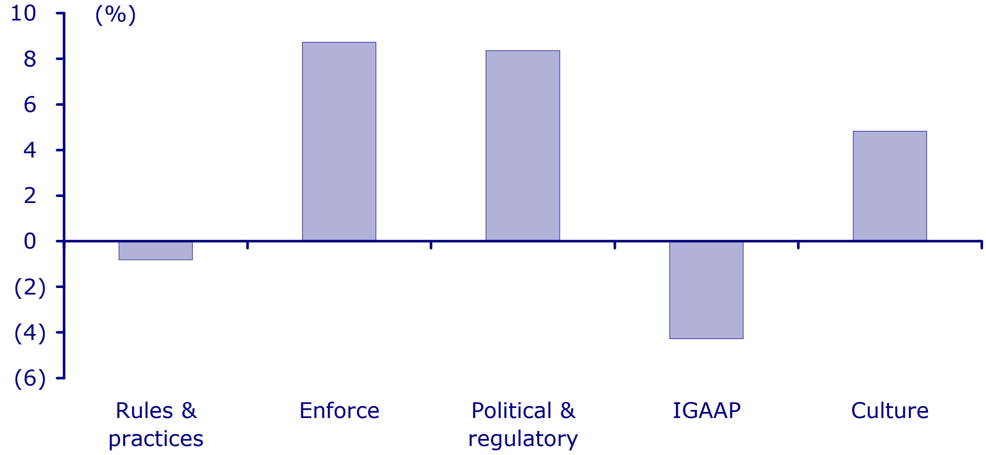
Weaknesses. There is a huge disparity between the high standards of many large caps and the rest of the market (made up of thousands of small listed firms). Despite the good reputation of Infosys, HDFC Bank and some others, the true level of commitment to good governance among India's large caps is less than advertised. Various disclosure rules have weaknesses (eg, those relating to quarterly reporting, material transactions, and share transactions by directors). Legal remedies for shareholders are in theory quite strong, but in practice extremely weak (due to an inefficient court system). Public corruption and disorganisation is rife. There is virtually no voting by poll at AGMs, even among the large caps, and meetings are often held in remote locations. Regulatory enforcement is improving, but resources and results still limited. There is also minimal involvement of institutional investors in corporate governance issues. Greater involvement by retail groups, but their efforts are piecemeal, fragmented and localised (no real national shareholder association).

(4) Taiwan

Weaker on accounting and auditing standards

Figure 15

Taiwan: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Major improvements to company and securities laws

Strengths. Financial reporting standards are reasonably close to international norms and are improving (eg, quarterly reports will be consolidated from 2008). The same for accounting and auditing standards (eg, employee bonus shares will have to be expensed from 2008). Major improvements have been made to company and securities laws, as well as ancillary regulations, over the past two years. Regulatory enforcement has taken a step forward, especially with regard to corporate fraud and insider trading. Taiwan is one of the few places in Asia that requires directors convicted of fraud to resign their positions on boards. The scope of regulatory and corporate information on regulatory websites is wide and improving. Finding English translations of major laws and rules is easy. The judiciary is fairly independent and generally clean, while media freedom is strong. There is active involvement of academics and certain non-profit organisations in corporate governance reform. And there is a quasi-government agency, the Securities and Futures Investor Protection Centre, undertaking law suits on behalf of minority shareholders.

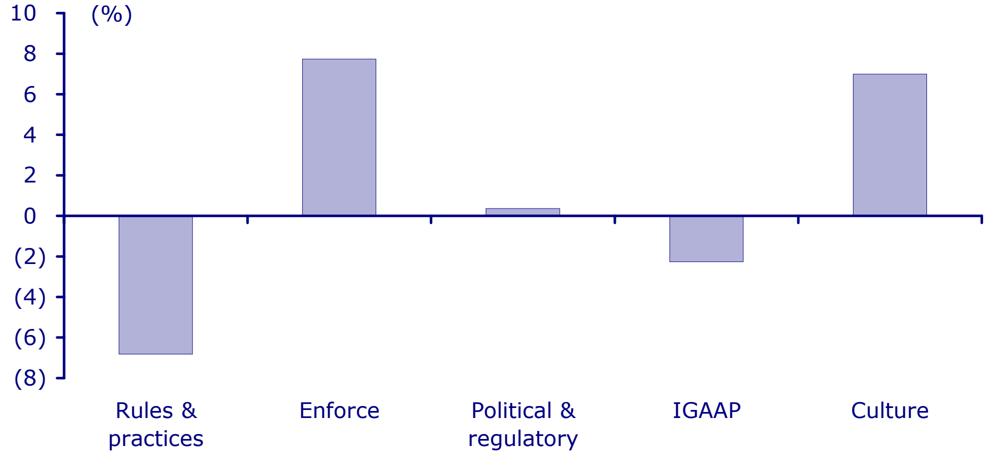
Entire apparatus of annual meetings needs an overhaul

Weaknesses. Non-financial reporting standards could improve, as could disclosure of substantial shareholding stakes and share transactions by directors. Voting by poll is normally carried out for the election of directors at AGMs, but not for all resolutions, and voting results are not made public. Indeed, the entire apparatus of annual meetings in Taiwan - from sending out notices, to finalising agendas, to voting and publishing results - needs an overhaul. Institutional investors routinely cite Taiwan as one of the most difficult markets in Asia to vote in. Regulatory enforcement has improved, but whether the current level of activity will be maintained is an open question. Regulatory agencies are still under-resourced and there is a lack of cross-fertilisation between the market and certain agencies, such as the Securities and Futures Bureau, in terms of recruitment. The main statutory regulator, the Financial Supervisory Commission, is not independent from the Taiwanese government and often exposed to strong parliamentary and political pressure. The judiciary is improving, but still lacks the depth of skill needed to deal with complex securities cases.

(5) Japan

Figure 16

Japan: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Stronger-than-average score on enforcement . . .

. . . but weaker on rules and practices, and accounting and auditing

Despite resistance to global norms in Japan, disclosure standards are high

Strengths. Despite much open criticism in Japan of global standards of corporate governance, financial and non-financial reporting practices are quite high, especially among the larger companies. Quarterly reports are fairly robust and detailed, while rules on disclosure of substantial shareholding stakes and share transactions by controlling shareholders have recently been improved. Indeed, the past two years have witnessed major legislative changes, including a new and modernised Company Law and a new omnibus securities law, the Financial Instruments and Exchange Law. The latter is often referred to as "J-SOX", because it borrows elements from the Sarbanes-Oxley Act dealing with internal controls. Regulatory enforcement has become more vigorous in recent years, but is not always consistent or fairly applied. However, disclosure of public enforcement activities is relatively good, while private enforcement by the market is on the rise (eg, through the voting of shares at AGMs and investor engagement with companies). Japan has an active Pension Fund Association and is the only country in Asia to have a working electronic voting system.

Less compelled to change organisational structures

Weaknesses. While listed companies have been willing to improve their disclosure practices and enhance communication with shareholders, they have felt less compelled to change their organisational structures and open themselves to outside scrutiny by, for example, independent directors and minority shareholders. Japan has no real concept of "independent director", nor does it have a proper national code on corporate governance (unlike other Asian markets). Rather, it promotes modern corporate governance ideas in a rather fragmented way through various parts of its company and securities laws, regulations and listing rules. This may be a necessary compromise, but it creates a fair degree of ambiguity around government policy. For example, the government has produced numerous rules for enhancing investor protection, but then issued guidelines on setting up "poison pills". At the same time, there are many areas where standards could be improved, but which appear to be neglected at present, including: cutting the deadline for releasing audited annual results from the current 90 days to 60 days; requiring all listed companies to publish their AGM agendas earlier (the rule is still 14 days); requiring the results of poll votes to be published; and so on.

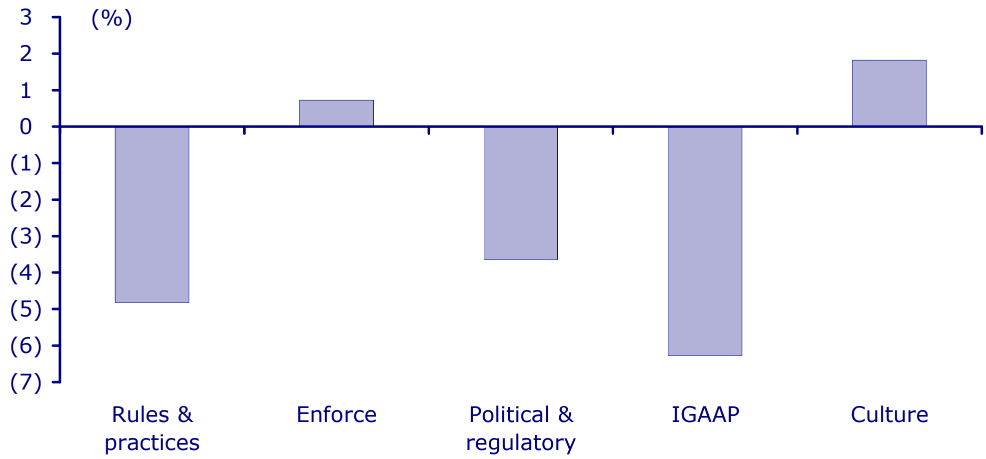
Slightly better than the regional on CG culture and enforcement . . .

. . . but lower on accounting/auditing, rules/practices, political/ regulatory environment

(6) Korea

Figure 17

Korea: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Public enforcement has also improved

Strengths. Financial and non-financial reporting practices among the larger listed companies have improved. Public enforcement has also improved, most noticeably in the activities of public prosecutors and the judiciary. Korea is unusual in having had a vigorous retail activist movement and minority shareholders willing to take companies to court. It is also one of the few countries to pass a law permitting class-action lawsuits for accounting fraud. The media is quite free to report on corporate governance issues (although not always impartial). Government has been taking notice of new international best practices on auditor independence and whistleblowing protections. And Korea now has a corporate governance focus fund.

Reporting and accounting standards still some way from international norms

Weaknesses. Financial reporting and accounting standards still some way from international norms (eg, lack of consolidation for interims and quarterly reports; deadline for audited annual results is still 90 days; valuation still based on cost rather than fair value). Rules on disclosure of share transactions by directors and individual director remuneration are well below global best practice. Class-action lawsuits may be permitted, but a range of restrictions have nullified the impact of this law. Directors convicted of fraud are not required to resign from boards, except in banking and financial firms. There is virtually no voting by poll at the AGMs of listed companies (even among the large ones). The position of independent directors remains weak (as in most markets). In light of the above, it is not surprising that the government's policy on corporate governance comes across as highly inconsistent.

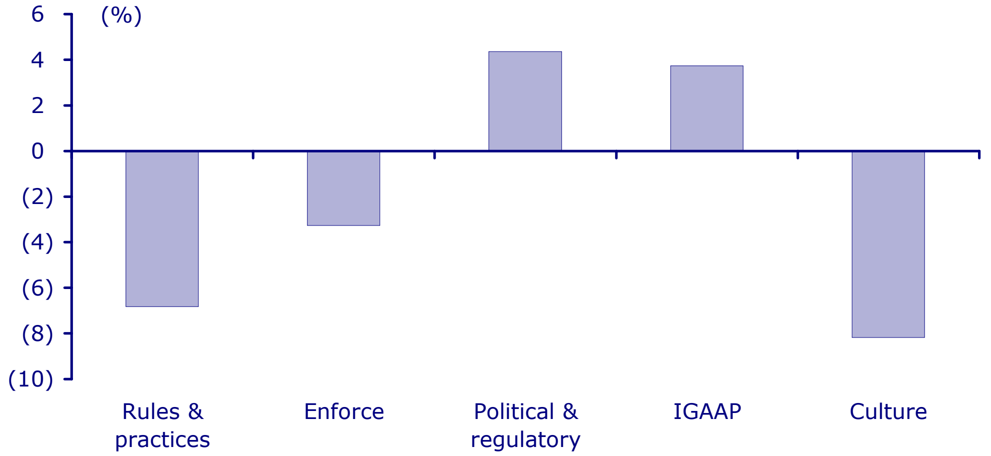
Better-than-average score for political /regulatory environment and accounting/auditing

Weaker on CG culture, rules & practices, as well as on enforcement

(6) Malaysia

Figure 18

Malaysia: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Regulatory bodies have strong investigation and enforcement powers

Strengths. Financial reporting and accounting standards have improved in recent years and the reporting practices of large caps are close to international best practices. Quarterly reporting is fairly sound. Regulatory bodies are well-staffed and have strong powers of investigation and enforcement. Disclosure of public enforcement activities is good, while regulatory and stock exchange websites are informative and provide access to all major laws, regulations, corporate announcements, and so on. The Malaysian government has been taking account of, and implementing, new international best practices on auditor independence and whistleblowing protections. Professional bodies are quite actively promoting corporate governance and related training, while the Minority Shareholder Watchdog Group, which is still government-funded, has been revamped and given a sharper focus.

Poor reporting standard among small companies

Weaknesses. The quality of financial reporting among small listed companies is poor, while the standards of non-financial reporting among all companies leaves a lot to be desired. Few companies report their audited annual results within 60 days. Securities laws do not appear to provide a credible deterrent against insider trading. Legal remedies for shareholders are limited. There is virtually no voting by poll at AGMs. There is little confidence in the market that independent directors are genuinely independent in Malaysia. While public enforcement efforts have improved, regulators do not have a reputation for treating all companies and individuals equally. Indeed, the consensus is that politics hampers the ability of regulators to do their job properly. Private enforcement by the market is limited (at both the institutional and retail level), with many investors having a low opinion of the ethical standard of the average listed company.

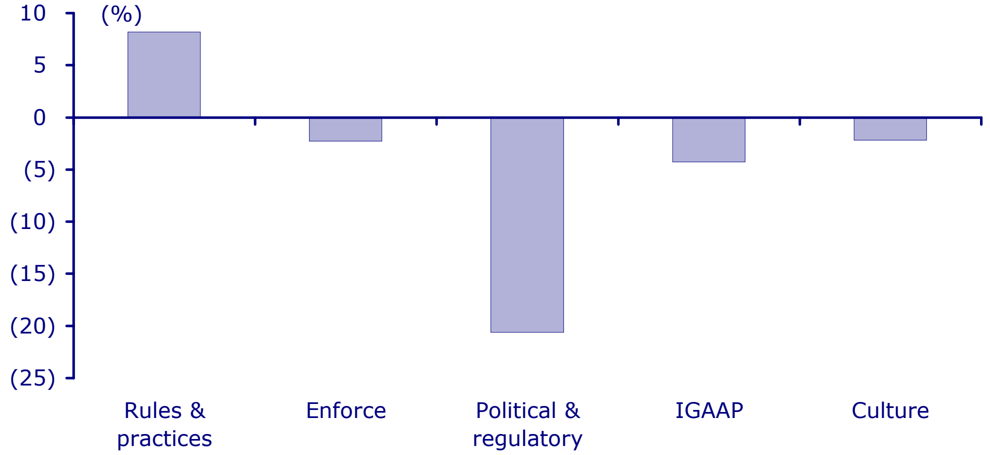
Higher-than-average on rules & practices . . .

. . . but weaker in other categories, particularly political and regulatory environment

(8) Thailand

Figure 19

Thailand: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Regulators have taken innovative measures to improve enforcement

Strengths. Financial reporting rules are in line with international norms and reporting practices among large companies are largely in line. Non-financial reporting rules (and practices by large caps) also compare quite favourably with global standards. Companies report audited annual results within 60 days, and quarterly reporting is quite robust. Regulators in Thailand have made greater efforts to improve enforcement in recent years (and disclose what they are doing) and have undertaken some quite innovative measures (eg, a director "white list"; an AGM assessment programme). Companies are starting to vote by poll voluntarily at their annual meetings (although in a slightly strange hybrid way: votes are not counted confidentially, but anyone who wants to vote against raises their hand and his/her vote is deducted from the total). There is an active director training programme organised by the Thai Institute of Directors.

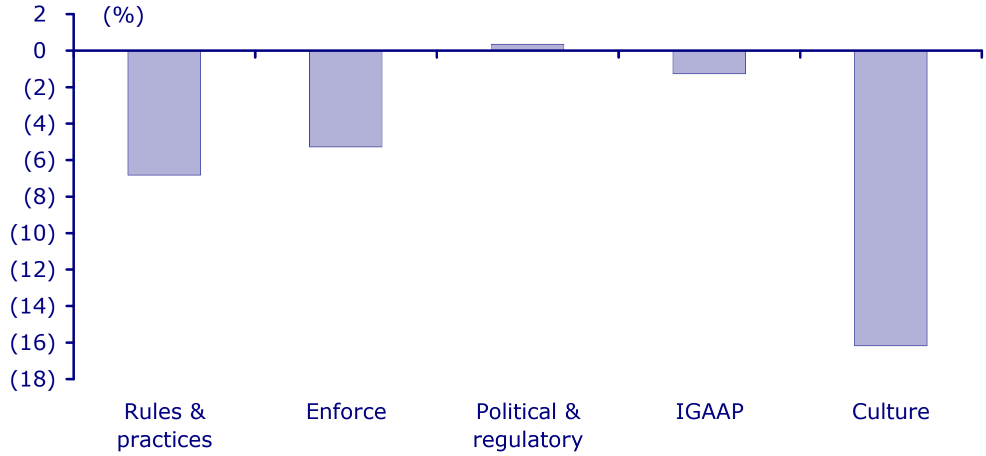
Current military government hasn't taken a big interest in CG reform

Weaknesses. While the political coup in 2006 removed a premier who was known for undermining corporate governance reform, and removed many of his cronies from parliament, the current military government has not taken a big interest in the equity market or corporate governance reforms. Major legislative amendments to both the Public Companies Act and the Securities and Exchange Act continue to languish in the system, as they have done for several years, and hold back the introduction of improvements to Thailand's corporate governance regime. Regulatory enforcement may be improving, but some of the innovative efforts, such as the "white list", are proving harder to implement than expected - since neither the securities commission nor the stock exchange has the power to remove a director not on the white list. Thailand has a history of innovative regulatory initiatives that proved less than successful over time. Meanwhile, investor confidence in the its corporate-governance regime seems to be at its lowest point for more than five years.

(9) China

Figure 20

China: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Lower-than-average on most categories . . .

. . . particularly overall CG culture, rules & practices and enforcement

China makes bold moves when you least expect it

Strengths. One of China's main strengths is an ability to make bold moves when you least expect it. Witness the announcement in early 2006 that it would bring its accounting and auditing standards rapidly into line with international norms. Although there are countless practical problems associated with this move - lack of trained accountants and experienced auditors, difficulties over measuring fair value, and so on - it should help to build confidence in the quality of listed company accounts in China over the long term. Major legislative amendments to both the Company Law and the Securities Law in 2005 should also lay a stronger foundation for corporate governance. In other areas: large listed companies in China often do vote by poll (although are not required to by law) and they release their detailed AGM agendas earlier than most companies in the region (20 days). Surprisingly, while few large A-shares report their audited annual results within 60 days, some of the mid caps do. Meanwhile, regulatory websites have improved hugely over the past two years, especially in the quantity and timeliness of English-language material.

"Form over substance" is prevalent among companies

Weaknesses. "Form over substance" is prevalent in the approach of many listed companies to the numerous rules imposed by the country's regulators. Although the quality of financial reporting among large caps is quite high, especially among those listed overseas, the value of non-financial reporting is much lower (eg, disclosure of director remuneration is often quite vague and misleading, not to mention inconsistent from company to company). Quarterly reports are more limited in scope than in many other markets. Rules governing disclosure of share transactions by directors and material transactions are not up to international standard, while securities laws appear to provide little deterrent effect against insider trading and market manipulation (which is generally considered rampant in China). Access to the legal system is also restricted and the competence of the judiciary to adjudicate difficult securities cases is an issue. There is little scope for minority shareholders to organise themselves into an independent association to protect their interests.

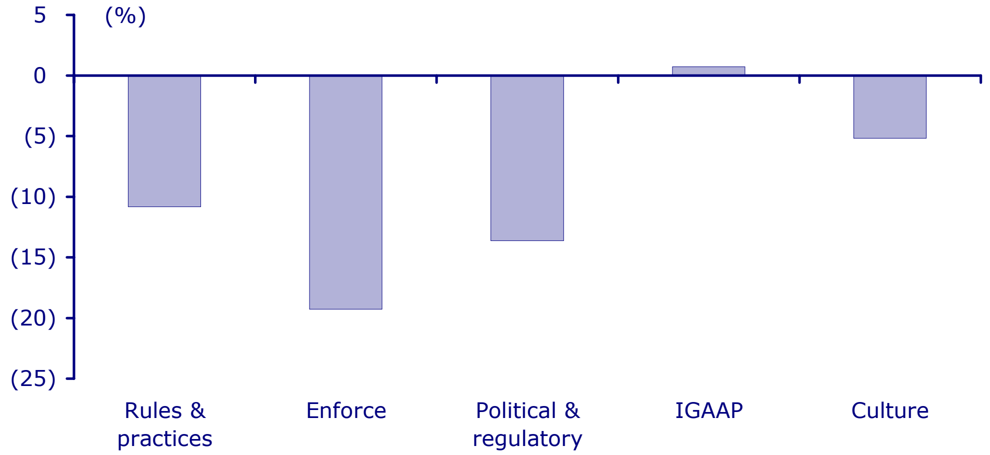
(10) Philippines

Average score for accounting and auditing standards . . .

. . . but lower-than-average on other macro CG categories

Figure 21

Philippines: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Philippine firms produce some of the most detailed AGM circulars

Strengths. Financial-reporting practices among large caps are common, including the quality of quarterly reports. Interestingly, listed Philippine companies produce some of the most detailed AGM circulars in the region, with some of the better ones releasing them quite early. Regulatory websites are informative and the media has considerable freedom to report on CG issues. In strict regulatory terms, probably the biggest area of strength has been the market's focus on bringing its accounting and auditing rules into line with international standards. Another area of strength is director training.

Regulatory system does not deter insider trading

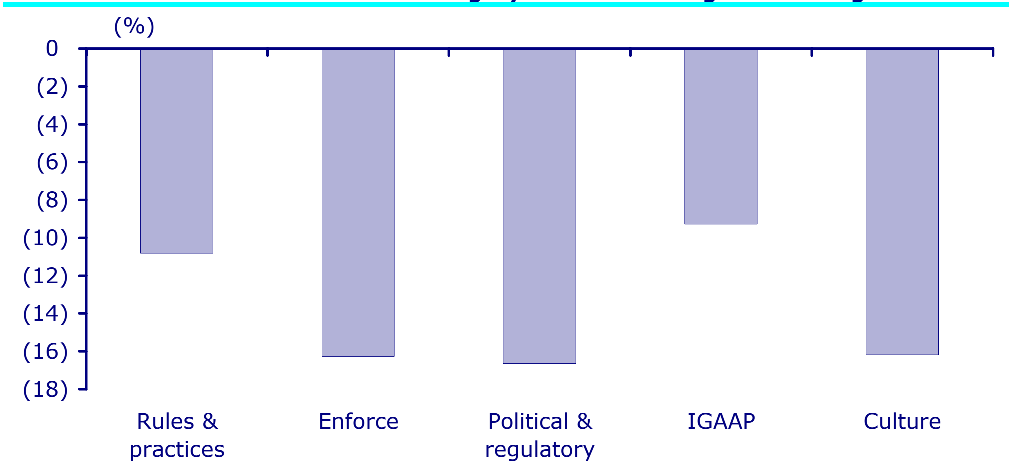
Weaknesses. The quality of non-financial reporting is not high, even among larger firms. They have 105 days to report audited annual results. Disclosure rules relating to material transactions could be improved. The regulatory system does not deter insider trading. Class-action lawsuits are permitted, but rarely initiated. Voting by poll is non-existent and is seen by companies (incorrectly) as difficult and time-consuming. After a strong start early this decade, the Securities Commission seems to have lost its focus regarding CG policy. Enforcement is seen as woeful and regulators lack resources to do a proper job. The influence of the market (ie, investors) is extremely limited.

(11) Indonesia

Lower-than-average on all categories

Figure 22

Indonesia: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Quality of many quarterly reports is actually good

Strengths. Surprisingly, given the poor to uneven state of financial reporting in Indonesia, the quality of many quarterly reports is actually good. Another surprise: Indonesia offers some of strictest protection for minority shareholder pre-emption rights in the region (indeed, its rules are probably too restrictive). A third surprise: the present government's anti-corruption drive is yielding some results. In contrast to the Philippines, meanwhile, Indonesia continues to try to improve its corporate governance regime through, for example, revising its national code of best practice and bringing in a new CG code for banks.

Few believe government is truly serious in amending CG codes

Weaknesses. While the government may be amending its corporate governance codes, few we have spoken to believe it is truly serious in its efforts. The anti-corruption drive aside, the Indonesian government has a deeply entrenched credibility problem. This malaise is echoed in market: in the low quality overall of financial reporting; weak disclosure of material events and share transactions by directors; the scope for insider trading; the lack of investor involvement; and the antipathy shown by many companies to corporate governance. None of this is helped by the extremely weak enforcement record of regulators and the lack of independence of the main securities regulator.

The half-way mark

Strengths to build on if able to muster necessary political support

Although the absolute scores in this year's CG Watch may not be high, the survey does highlight that each country has some genuine strengths on which it can build, if it chooses to do so and can muster the necessary political support. Some markets clearly have a higher ratio of strengths to weaknesses than others, with the Philippines and Indonesia leaning rather alarmingly towards the latter. But certainly all are in a much better shape, from a corporate governance perspective, than they were at the start of this decade. The challenge now is to keep going and avoid the temptation to sit back and relax. In view of the inherent volatility of Asian stock markets, the latter may not be an option in any case.

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Qarp-driven performance

In our 2005 CG report, we introduced the concept of quality at a reasonable price (Qarp), ie, inclusion of PB and ROE in stock selection among higher-than-average CG companies. In the two years since that report, we found that only in half of the markets did Qarp stocks outperform. However, the performance in those markets was generally very strong and thus Qarp stocks outran country MSCI indices by an average of 31ppt, including some stellar performances of large-cap Qarp picks. Investors will continue to have better odds of picking strong performers among high-quality companies using the Qarp criteria, rather than just high CG alone. At current valuations, our large-cap Qarp picks include, from Japan, Nissan, Toyota, KDDI and Nippon Electric Glass; Asia ex-Japan financials, including Korean Exchange Bank, Standard Chartered, Hang Seng Bank, Bumiputra-Commerce; and beyond these, China Steel, Formosa Plastics, Posco, ST Engineering, PTT and Keppel Corp are also among the larger caps currently meeting our Qarp criteria.

Definition of Qarp

Qarp definition

In our 2005 CG Watch, we introduced the concept of Qarp, and how we could identify such stocks. The definition we used is companies with higher-than-average CG scores in their respective markets, and ROE higher than cost of equity (COE), with at least 10% upside to theoretical value. COE was derived using the capital asset pricing model (CAPM). The theoretical value is derived from the Gordon growth model, which gives PB as a function of ROE, COE and long-term growth:

$$PB = (ROE - g) / (COE - g)$$

The ROE for the formula should be an estimate of long-term ROE, but we used the average of the two year forecast ROE for the current and following year as a proxy, except for companies in cyclical industries, where we believed the cycle may be topping out, in which case we used an ROE estimate across a cycle.

The other key variable in the equation is the long-term growth used. Each research head with the respective analysts determined the long-term nominal growth to be applied.

Qarp performance by country: 2005-07

In only half of the markets did Qarp stocks outperform

As we did not undertake a 2006 CG Watch, the Qarp list was not updated last year. We thus examined the performance of the Qarp stocks selected in mid-2005 for the two years to mid-2007. We find that in exactly half the markets, the Qarp stocks outperformed the MSCI Index for the country. However, the outperformance in three of the markets - China, Indonesia and Hong Kong - was extremely strong, between 77ppt to 163ppt. For the other seven markets, the out/underperformance was plus or minus 20ppt of the country index’s performance. The net effect is that on average, we find that the Qarp stocks outperformed the country MSCI indices by an average of 31ppt.

Qarp outperformance usually from a few big winners

This result reflects that in each of the countries, where Qarp stocks outperformed it is usually because of a handful that were stellar performers and the others performed roughly in line with the market. A few big winners make all the difference, as long as the rest of the portfolio does not fall apart. With higher-quality firms being selected, there were very few real disasters in terms of big share-price declines (although overall robust markets helped).

A few names made the difference in the 2005 Qarp picks

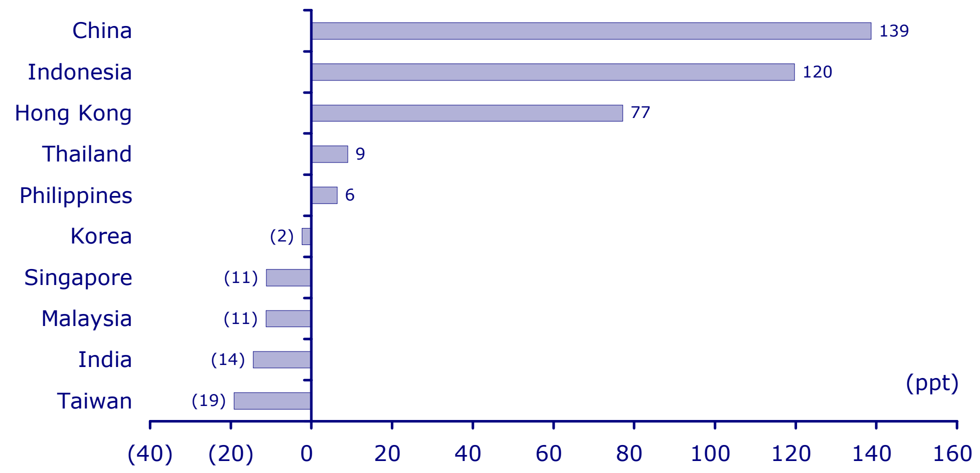
The stellar Qarp picks from the markets where these stocks outperformed strongly were a handful of names: China Vanke, Hopson Development and Zhenhua Port Machinery, up between 460% to 614% over the two years from China; Inco and Bank Niaga in Indonesia, up 292% and 110% respectively while Ports Design up 289% as well as OOIL rising 125% in Hong Kong. (Returns here in local currency terms and compared to the index performance in local currency.) The country sections in the latter part of this report provide the performance of the Qarp stocks identified in 2005 with commentary on key reasons for their performance.

Very strong performance of Qarp stocks in China, Indonesia and HK . . .

. . . and less deviations from regional MSCI in other markets

Figure 23

Qarp stocks' performance against country indices (mid-2005 to mid-2007)



Source: CLSA Asia-Pacific Markets

Qarp performance relative to CG

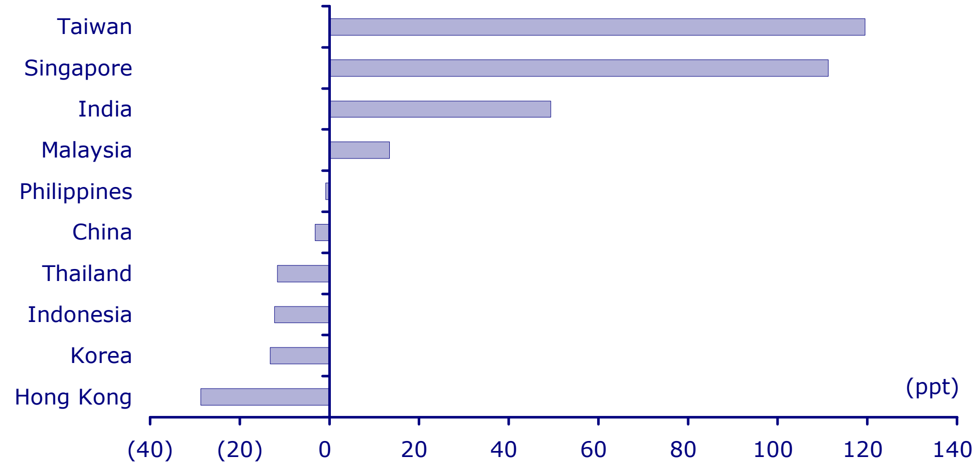
ROE and PB brought in to screen high CG stocks to derive Qarp

The reason we used the Qarp analysis is that we had found in rising markets, high-CG stocks tended to underperform. This is within expectation as these companies have lower risk and hence, lower beta. The idea was to bring in valuations, in particular ROE and PB, to see if it could select high-quality companies that appeared to be undervalued and could provide alpha thus outperform even in rising markets.

Qarp stocks outperformed top CG stocks in only four of the 10 markets

Figure 24

Qarp - Top CG quartile (Jun3 2005 to June 2007)



Source: CLSA Asia-Pacific Markets

In seven of the 10 markets, high-CG stocks outperformed

Curiously, we found that in seven of the markets, the top CG quartile stocks in themselves (without the valuation overlay of ROE and PB) outperformed the respective country MSCI indices. Top quartile CG stocks underperformed only in India, Malaysia and Taiwan. However, the extent of outperformance was not as great as that provided by Qarp. On average, the top CG quartile stocks only outperformed each country's MSCI index by 8ppt. Against the average 69.7% gain of the 10 country's MSCI indices, this is not significant.

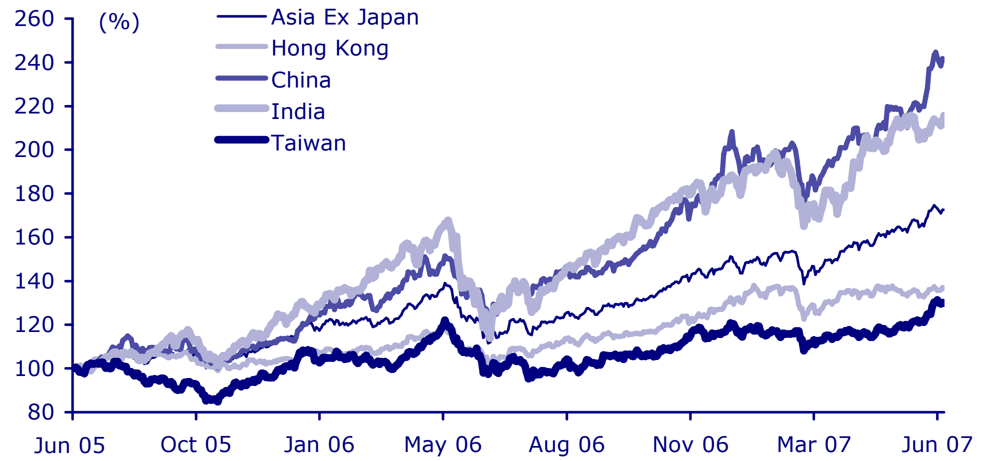
MSCI Asia ex-Japan up 72.5% in US$ terms

Top performers: China (+141), India (+116%)

Underperformers: Taiwan (+30%) and HK (+37%)

Figure 25

MSCI Asia ex-Japan and top/worst-performing MSCI indices



Source: CLSA Asia-Pacific Markets

Foreign institutions as larger share-price driver

A reason that might explain high CG companies outperforming slightly in most of the markets is that it has been foreign institutions rather than domestic retail that has been the bigger driver in the share price performances. While volumes have risen across the markets, in some of these locals have been net sellers rather than rushing in to punt high-risk low-CG companies. The overhang of the Asian crisis is still leading to some caution on the part of Asia's domestic investors.

Foreign institutions would generally prefer higher-CG companies

Where foreign institutions are putting funds in a market, a natural preferred choice would be companies that are seen or believed to have good governance and provide less risk. However, as before, we find that the average stock performance of high CG companies does not give massive outperformance (other than in falling markets when there is a general flight to quality and higher risk stocks fall by more).

Reasonably valued, higher-quality firms for stronger performance

However, when a higher quality company is also at reasonable valuations, the stock performance in absolute terms could be much greater. Thus, although Qarp stocks outperformed in fewer markets (five of the 10 markets surveyed for 2005) compared with top-quartile CG companies (which outperformed in seven of the markets), nevertheless the performance of the Qarp stocks averaged 101% versus 79% for the top-quartile CG companies. One is more likely to find big winners not just buying good companies (at least defined in CG terms) but also good companies with attractive financials and reasonable valuations, which is what we attempt to identify through the Qarp criteria.

Large caps - Qarp and CG performance

Large Qarp picks outperformed over the two years to mid-2007

In our CG Watch 2005, we identified Qarp stocks within each market as well as among the 100 largest companies by market cap in Asia ex-Japan. We had just 10 Qarp stocks from the large-cap list as shown in Figure 26, which is copied from the 2005 report. Their performance is shown in Figure 27 below. Hana Bank was privatised at the end of November 2005 after rising 72% in dollar terms. Hana Bank's return is annualised for one year and given a zero return for the second year in our calculation. All the other returns are for two years and compared with MSCI Asia ex-Japan return. The 10 Qarp stocks outperformed over the two-year period with an average return of 81.4% against 72.5% for the regional index for the two years to mid 2007. Excluding Hana Bank, the other nine stocks on average provided a return of 71.1%, just short of the 72.5% for MSCI Asia ex-Japan.

Large cap Qarp picks from CG Watch 2005

Figure 26

2005 Qarp Asia ex-Japan large cap picks

	05-06 avg ROE (%)	05 PB (x)	Upside (%)	CG quartile
Formosa Chem	26.2	1.9	68	1
Hynix Semiconductor	24.2	1.3	48	1
Posco	13.0	0.8	36	1
Standard Chartered	17.1	2.1	20	1
Chinatrust	18.7	2.0	19	2
Nan Ya Plastics	21.1	2.1	17	1
SingTel	17.8	2.4	17	1
Hana Bank	13.2	0.9	13	1
HSBC	15.7	2.0	12	1
Shinhan Financial	18.8	1.3	10	1

2005 Large cap Qarp picks outperformed MSCI Asia ex-Jpn

Figure 27

2005 Qarp Asia ex-Japan large-cap picks

	Share price 30 Jun 05 (local ccy)	Share price 30 Jun 07 (local ccy)	Local ccy return (%)	US$ return (%)
Formosa Chem	54.3	75.8	39.6	34.5
Hynix Semiconductor	17,000.0	33,350.0	96.2	119.2
Posco	182,500.0	443,500.0	143.0	171.5
StandChart	144.5	250.8	73.6	72.6
Chinatrust	25.7	25.6	(0.3)	(4.0)
Nan Ya Plastics	42.7	72.4	69.4	63.2
SingTel	2.8	3.4	23.4	35.8
Hana Bank[1]	27,700.0	42,800.0	130.8	174.3
HSBC	125.0	142.5	14.0	13.4
Shinhan Financial	26,900.0	56,200.0	108.9	133.4
Average				**81.4**
MSCI Asia ex-Japan	304.18	524.84		**72.5**

[1]Hana Bank return annualised for one year. Source: CLSA Asia-Pacific Markets

A handful of Qarp stocks give superlative performance

Once again, we find within these 10 Qarp stocks, a handful give superlative gains while returns on many of the others were unexceptional. Interestingly, two of the top three companies we identified in 2005 for highest theoretical upside among the large cap Qarp picks (Figure 26 above which reproduces the table of Qarp picks and estimated theoretical upside from our 2005 report) were among the ones that did in fact generate exceptionally high returns. While Formosa Chemical underperformed, the next two of the 2005 large-cap Qarp picks were Hynix Semiconductor, which rose 119% in dollar terms, and Posco, which surged 172% in the two years. The other big outperformer of the 2005 picks was Shinhan Financial, which soared 133%.

Posco, Shinhan and Hynix enjoyed strong rerating

For Posco, investors view changed regarding whether China was a threat to global steel prices, while global consolidation maintained prices for mills ex-China. Shinhan, a serial acquirer, in 2006 executed yet another successful transaction by acquiring LG Card. While integration and the associated execution risk remain, the management strong track record and solid performance on the Chohung deal has the market confident the process will be a success. With the best non-bank positioning in the sector and cash earnings accretion from the deal, the share price performed exceptionally well. For Hynix, its entry into the lucrative Nand flash market in 2004 coincided with an upturn in the Dram cycle. As a result, profits and cash flows surged resulting in the stock's strong multi year performance.

High CG stocks have performed in line with MSCI Asia ex-Japan

The top CG quartile among the large caps for Asia ex-Japan was up 71%, roughly in line with MSCI Asia ex-Japan but the large-cap Qarp basket beat the large cap top CG quartile stocks. Like the individual countries, the last two years has seen the interesting phenomenon of higher CG stocks generally performing reasonably well in rising markets. We attribute this in large part to foreign institutional funds that have driven these markets over this period, and these funds in general preferring higher quality names.

With Qarp investors have better odds of finding stocks that will provide strong returns

Of the 25 stocks in this top CG quartile, five generated returns over 100%. (The highest return is recorded by a stock not selected on the Qarp criteria, Bharti, which rose 267% in the two years in dollar terms.) However, of the 10 Qarp stocks, three provided returns over 100%. It still remains that with Qarp investors have better odds of finding stocks that will provide strong returns rather than just focusing on high CG companies without taking valuations into account.

Less risk with high CG and/or Qarp stocks

That the top CG quartile stocks underperformed MSCI Asia ex-Japan by 1ppt, while the benchmark rose 72% over the two years is quite respectable. The Qarp stocks gave a better return. In general one takes less risk with high CG and/or Qarp stocks. With less risk but getting a return similar and/or higher to the benchmark, a Qarp-based investment approach appears attractive.

Large-cap Qarp picks 2007

Smaller Qarp list in each of the countries

Markets are up substantially compared to mid-2005 when our last CG report was produced; the list of companies that make it on the Qarp criteria in the different countries now is shorter. Nevertheless in a period of market uncertainty and slowing growth from the world's largest consumer, ie, the US, we believe it is quite likely there will be a shift to quality. Companies that are better than average on CG, with ROE above their cost of equity and at reasonable valuations on the Gordon growth model, should thus outperform, although we may need to take into account country and sector backdrops.

One-year upside for stocks should be greater than upside to current theoretical value

Figure 28 presents the Qarp picks from our country sections with market caps above US$5bn. These are companies that are above average for CG in their respective markets, have projected ROE above cost of equity and on the Gordon Growth Model have at least 10% upside to theoretical value. Note that we use current-year book value for calculating the upside, ie, this gives upside to current fair value rather than price targets, which commonly are based on forward projections of earnings or book value. As these companies continue to generate ROE above cost of equity, they are creating shareholder value each year and the upside over one or two years should be much higher than the upside to the current theoretical value.

Current list weighted towards Japan and banks in the region

This list of stocks, however, is very much weighted towards Japan, ie, Nissan, Toyota, KDDI, Nippon Electric Glass, and Asia ex-Japan banks, which are slanted towards Korea, ie, Korean Exchange Bank, Woori Financial, Hana

Financial, as well as other banks like Standard Chartered, Bumiputra-Commerce, Maybank and Hang Seng Bank. Both segments carry risks: for Japan, a significant slowdown in the US will be negative, while for the banks in the region there is still downside risks, with regard to CDO exposure as well as potential for a knockon slowdown in their economies.

Upside particularly if expectations change

However, this bottom-up screen for higher-quality companies shows where the value lies, after three strong years for Asian markets. An investor, thus, needs to assess how much might already be discounted in the price. Certainly any positive newsflow that shifts expectations up could lead to major upside for these stocks.

As an example, in the 2005 large-cap Qarp screen, Posco was one of the stocks we found satisfying the criteria. Two years ago it looked cheap with PB at 0.8x, but there were uncertainties over steel prices and whether earnings were close to cyclical peaks. Instead, consolidation globally and China's continued strong demand led to steel prices firming, and Posco's stock moving up 172% between mid-2005 to mid-2007. Posco remains among our larger-cap Qarp picks with ROE projected at 16.7% and the stock trading at 1.7x book value, which assuming 5% long-term nominal growth would suggest 13% upside to its theoretical value.

Figure 28

Large-cap Qarp picks 2007

	Market	07-08 Avg ROE (%)	COE (%)	LT growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Nissan Motor	Japan	14.4	7.0	3.0	2.84	1.1	147.2
Korean Exchange bank	Korea	24.6	11.0	5.0	3.26	1.5	111.6
Woori Financial	Korea	21.0	11.0	5.0	2.67	1.3	105.8
China Steel	Taiwan	24.9	9.5	4.0	3.80	2.1	80.8
Toyota Motor	Japan	13.9	7.0	3.0	2.73	1.6	75.0
Hana Financial Group	Korea	14.4	11.0	5.0	1.57	1.1	45.9
Formosa Plastics	Taiwan	20.6	9.5	4.0	3.01	2.2	39.5
KDDI	Japan	15.0	5.9	2.0	3.32	2.5	31.8
NEG	Japan	23.2	10.9	2.0	2.38	1.9	26.9
Standard Chartered Plc	Hong Kong	16.3	9.5	5.0	2.50	2.0	26.2
Bumiputra-Commerce	Malaysia	20.0	10.0	5.0	3.01	2.4	25.2
Malayan Banking	Malaysia	20.0	10.0	5.0	3.00	2.5	18.9
Posco	Korea	16.7	11.0	5.0	1.94	1.7	13.4
ST Engineering	Singapore	35.0	8.2	4.0	7.38	6.5	13.2
PTT	Thailand	26.0	12.0	4.5	2.86	2.5	13.0
Hang Seng Bank	Hong Kong	28.5	9.5	4.0	4.46	4.0	10.6
Keppel Corp	Singapore	23.2	8.7	5.0	4.92	4.5	10.3

Note: priced on 7September 2007. Source: CLSA Asia-Pacific Markets

Other Qarp picks also outside Japan and Asian financials

Other than Japanese companies and Asian financials, the larger cap Qarp picks now are China Steel, Formosa Plastics, ST Engineering, PTT and Keppel Corp. We see these as among the higher quality companies in Asia now at reasonable valuations. As in previous years, a handful of these can be expected to provide the strong performance. Especially if the US does slowdown and risk premia move up, a flight to quality will likely favour these names which provide good corporate governance coupled with sound financials as represented by high ROEs and reasonable PB valuations.

CG progress has slackened

Less pressure on firms on the CG front

With the introduction of clean and green (C&G) into our overall CG scoring, the overall scores are not directly comparable to our previous report. However, on common questions, the score for our total sample has overall only risen marginally since 2005, and at a much slower rate than the improvement seen between 2001-05, reflecting less pressure on companies on the CG front in a period when business environment and markets were favourable.

Our sample of Japanese companies has a higher average score

Our 2007 scores for comparable questions show slightly better average CG improvement for companies in India, China and Indonesia, while a slight deterioration in the average score in Taiwan. Japan, which is introduced into our scoring this year with a sample of 40 companies, has a higher average CG score for its firms than the rest of our sample. A smaller sample of companies, however, generally results in an upward bias in the average score. Our CG score for Japan was conducted in conjunction with ACGA, however, only puts it in the middle of the Asian sample. This score, taking into account macro-determinants of CG, gives a better representation of CG consciousness in the market.

Top scores for HSBC, Sharp, HK Ex, TSMC, Infosys and CLP

Of the larger-cap companies CG commitment appears highest, reflected in scores at over 80% for HSBC, Sharp, HK Exchanges, TSMC, Infosys and CLP Holdings. Not surprisingly, the non-Japan companies at the top are similar to that we have had in previous years as underlying strong CG commitment should not vary. Scores at the middle and the bottom of the range however do shift by more depending on the extent a corporate puts forward a positive front which is easier to do when the business environment is favourable. The true test will be maintaining the checks and balances as well as transparency when business conditions deteriorate. Hence it will be in a downturn that the level of real change will be demonstrated, rather than the incremental progress seen in an easier environment.

Changes by country

Net increase of 1.2 points across the sample in average CG score

The introduction of the C&G scoring in our CG scores (replacing the social and environmental responsibility section) and two other new questions (in the accountability section), mean the overall 2007 CG scores are not directly comparable with our previous scores. However, a comparison can be done by examining the scores excluding the new section and the other new questions. With this adjustment, we find that the net average change in score is only +1.2 points across our Asia ex-Japan sample (we did not score Japan in 2005) between 2005 and 2007. This takes the overall sample average CG score this year to 51.8% (or 51.1% for the Asia ex-Japan sample).

Lower overall score than 2007 due to poorer C&G, introduced this year

This average 2007 score is lower than the 57.4% in 2005, mainly because of a lower score that companies are getting for C&G as almost two-thirds of the Asia ex-Japan sample did not respond to the survey or did not get any points and hence scored zero for this section, with C&G having a 10% weight in the overall CG score.

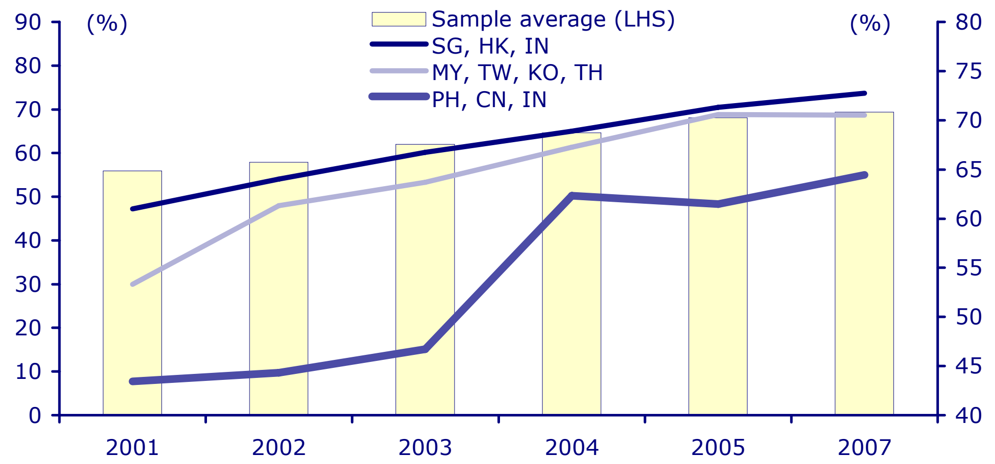
In 2001-05, average CG score rose 3.1 points a year, but this has slowed

Noticeable from the chart of the overall CG scores since 2001 is that the change in score for 2007 compared to 2005 is less than the changes in scores in earlier years. Between 2001 and 2005, the average CG score for companies we covered in our Asia ex-Japan sample increased 3.1 points per year. Yet, from 2005 to 2007, the overall average rose just 1.2ppt. Arguably, the pressure to improve corporate governance has reduced of late. As markets have been rising and investors focused on getting higher returns they have been willing to take greater risk, and hence there is less pressure on management to be reined in with greater CG checks and balances.

Larger increases in corporate CG scores in earlier years

Figure 29

Changes in CG scores for overall sample (2001-07)



Source: CLSA Asia-Pacific Markets

Bigger improvements in 2007 for India, China and Indonesia

Within the country scores, however there are some larger changes. For comparable questions as 2005, the average score has gone up 3-4ppt for India, China and Indonesia, while there is a slight deterioration in scores on average for companies in Taiwan (2.4ppt). However, the changes in average scores even for comparable questions is not very meaningful as this is partly due to changes in sample of coverage and also change of analysts covering a particular company. Excluding the C&G section (where the score is based on the response from the corporations), 16 of the other 56 questions involve an element of judgement by the analyst. On pages 46-48, we discuss the pros and cons of having an element of judgement in the company CG scores.

We prefer the macro CG criteria to assess the markets for CG

Figure 30 shows the average CG scores of companies in each of the countries. While it is interesting to see how they compare, we do not find this as useful an indication of corporate governance and instead prefer instead market rankings by the macro criteria outlined in Second 2 of this report.

Sample bias issues for markets with smaller stock coverage

The main drawback of the ranking of markets by the average CG score of the companies is sample size. In smaller markets where CLSA has less extensive coverage, the selection bias of companies would be the larger caps and better companies in that market. Extending the number of companies under coverage tends to reduce the average score for the market. Thailand with a sample of 29 companies has an average score of 57.3%, but if we took just the top 29 companies in HK for instance, the average CG score would have been 66.6% (instead of the actual average of 56.2% for our HK sample).

Some regulators may have introduced new rules . . .

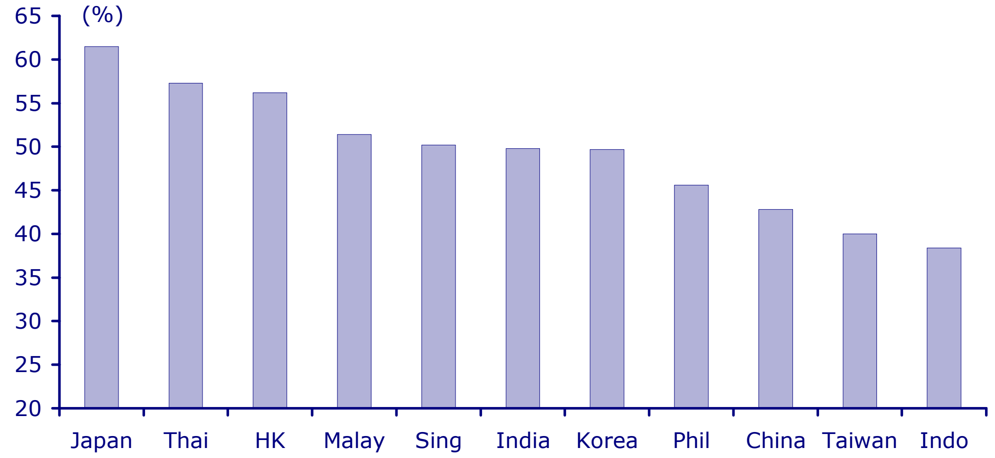
. . . but that might not reflect an improved CG culture

Another drawback of comparisons by the average scores of the companies is that in some countries the rules might well be amended to take on more of the criteria used in the CLSA CG scoring of companies. However the overall macro scores goes beyond rules and scores markets for enforcement, practices, political and regulatory environment, accounting and auditing standards as well as the focus on CG among intermediaries, professional bodies, smaller and medium-caps, etc. The macro criteria are thus superior in determining the overall CG ranking of markets.

Smaller samples for Japan and Thailand help to push the average CG scores

Figure 30

Average CG scores



Source: CLSA Asia-Pacific Markets

Similarities in ranking of markets with larger sample size

Countries with lower sample sizes are Thailand (29 companies), Philippines (22) and Indonesia (27). The 40 companies we have scored in this initial round of scoring Japanese companies for CG represents only one-fifth of our Japanese stock coverage. For these markets, extrapolating from the samples to the overall market is certainly fraught with danger. Of the countries where we have reasonable sample sizes (60 or more for most of the other markets), our rankings by average CG scores of the companies would put Hong Kong ahead with Malaysia and Singapore just behind and followed by India and Korea. Taiwan and China are at the lower end together with Indonesia. This ranking is not very different from the macro CG rankings done with ACGA that we presented in Section 2.

Scores within countries

Japanese firms score high on transparency, fairness, responsibility, and C&G

Figure 31 gives a breakdown of the average scores of the companies in each country by scores for each of our seven categories in the CG score. (See Appendix 3 for the detailed CG questionnaire to score the companies.) Japan with a relatively small sample of 40 companies had higher average scores, in particular for transparency, responsibility, fairness and on C&G.

Figure 31

Average CG category scores by country

(%)	Discipline	Transparency	Independence	Accountability	Responsibility	Fairness	C&G	Overall CG
Japan	55.3	89.3	42.3	27.7	76.0	72.1	45.0	58.9
Thailand	51.3	92.9	62.5	51.1	32.6	66.9	31.8	56.7
Hong Kong	56.3	79.7	47.3	56.8	57.2	69.2	12.0	56.2
Taiwan	68.4	57.2	42.6	51.9	62.6	59.9	28.9	54.3
India	65.4	83.8	43.1	43.1	41.2	49.2	27.5	51.6
Malaysia	63.4	85.3	57.6	37.1	44.4	46.4	13.2	51.4
Singapore	57.6	84.2	72.7	27.2	50.6	36.3	10.6	50.3
Korea	50.3	71.9	42.8	49.2	42.3	59.4	23.4	49.7
Philippines	39.1	65.1	63.1	35.7	26.7	60.4	20.5	45.5
China	45.5	66.6	45.8	44.6	28.6	45.7	7.9	42.3
Indonesia	59.6	44.9	49.1	38.8	21.0	39.6	9.8	38.9
Average	**55.7**	**74.6**	**51.7**	**42.1**	**43.9**	**55.0**	**21.0**	**50.5**

Source: CLSA Asia-Pacific Markets

Thai companies score well on transparency, fairness, accountability and C&G

Thai companies score well on transparency, fairness and accountability and also had the highest average score for C&G in the Asia ex-Japan sample. This is mainly because there is a large representation of petrochemical companies in its sample which are already aware and addressing issues of emissions.

HK firms score better on fairness, responsibility and accountability

Hong Kong companies score better on fairness, responsibility and accountability, while Malaysian companies have higher average scores against the overall sample for transparency and discipline. Singapore companies also score well on transparency and independence but are dragged by lower than average scores for accountability and fairness.

Taiwanese companies lag on accountability, fairness and independence

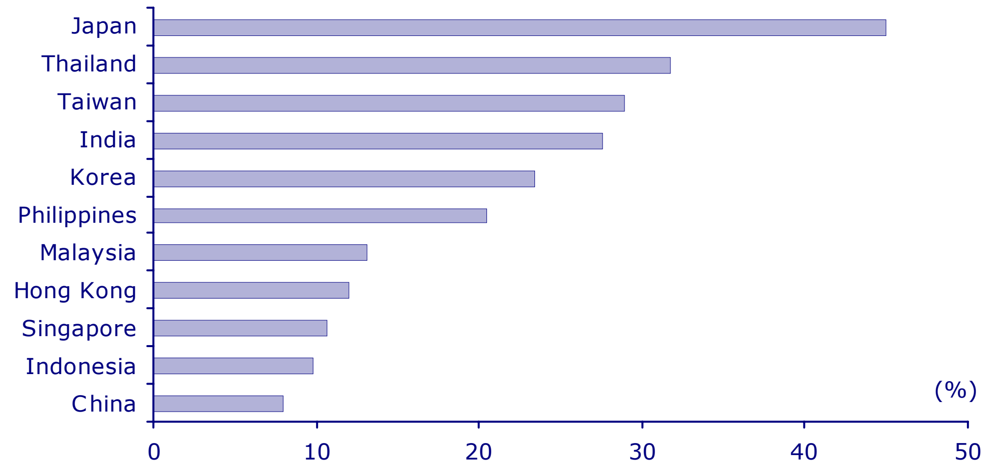
Taiwanese firms average scores are pulled down on accountability, fairness and independence. The somewhat unexpected result of mainland China companies having higher average CG scores is mainly because Taiwanese companies are exceedingly poor on accountability on average 32ppt lower for this category than for Chinese companies. Indonesian companies have lower than average scores for C&G, responsibility and transparency.

Japanese companies score much higher than Asia ex-Japan on C&G

Lowest from Indonesian and Chinese companies

Figure 32

Average C&G scores by country



Source: CLSA Asia-Pacific Markets

Voting by poll

Absence of voting by poll disenfranchises investors

In the report this year, one of the new questions introduced was whether companies voted by poll at AGMs/EGMs. This issue is a major theme that has been highlighted by ACGA in its 2006 report, *Voting For Change*, which sets out how practices of most companies in Asia often disenfranchise investors. Even for the countries where a large percentage of companies vote by poll this needs to be qualified. In Taiwan, companies vote by ballot for directors' appointment but usually not other items on the agenda. The results of the vote are also not published, which is integral to the credibility of such a vote.

Thailand has a hybrid system. Shareholders are given a ballot at meetings and the chairperson conducting the meeting will only take the ballot paper back and do a count where there are any objections to items on the agenda. Japanese companies tend to count the proxy votes before a shareholder meeting and if there are enough proxies, the chairperson will declare this at the meeting, and if there is no objection the resolution is passed. Votes at the meeting are counted only if there is a controversial item on the agenda. However there is no disclosure whatsoever of the votes that came by proxy or the result of the voting during the meeting.

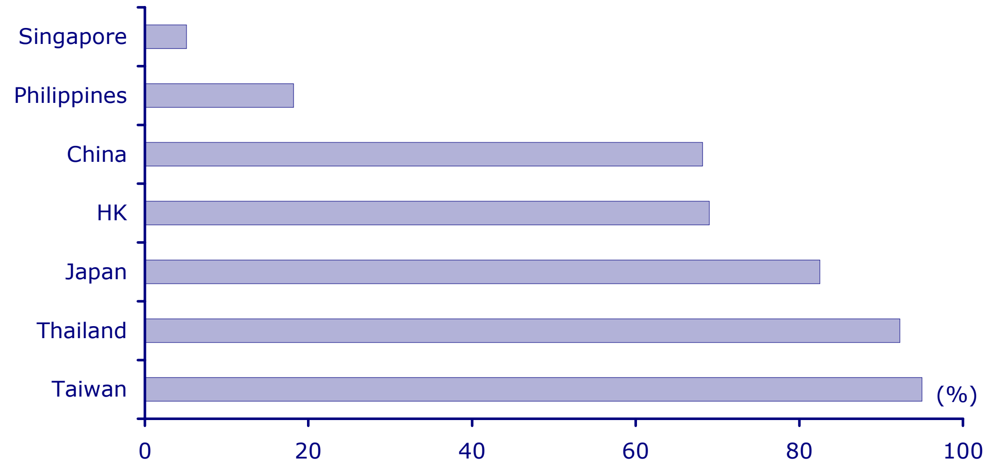
Two-thirds of HK and China sample vote by poll

Only about two-thirds of the companies by our sample vote by poll in Hong Kong and China. Of our smaller sample of Philippines companies, 18% vote by poll; a more extensive sampling would likely take that down below Singapore where we find only 5% of the companies voting by poll. In India, Indonesia, Korea and Malaysia the concept is completely alien to corporate practice.

No voting by poll in India, Indonesia, Korea, Malaysia

Figure 33

Percentage of companies that vote by poll



Source: CLSA Asia-Pacific Markets

Directors' remuneration

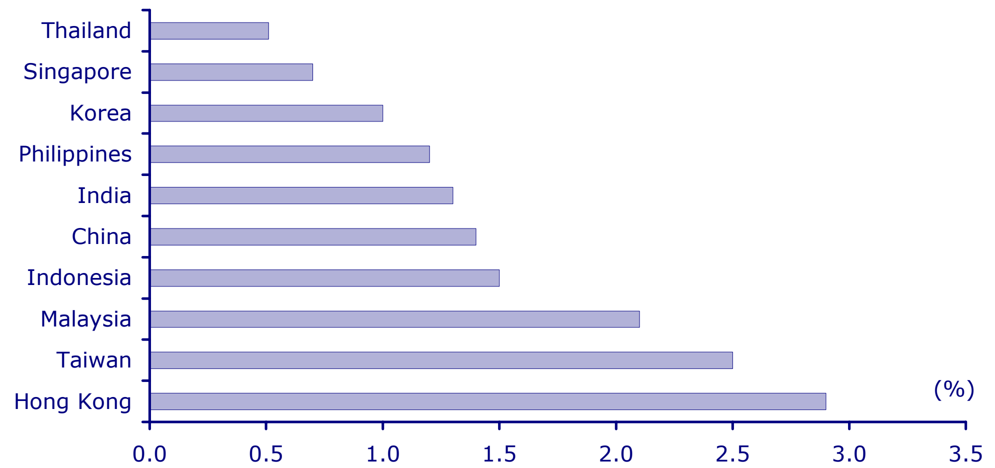
Director remuneration seen as litmus test of CG by some

For some, directors' remuneration is the litmus test on corporate governance. However, for smaller companies to get capable individuals on the board is likely to mean that directors' remuneration becomes a bigger percentage of earnings. Also if a company is incurring losses or going through a turnaround, the ratio may not be meaningful.

Singapore and Thailand have the lowest share of earnings paid to directors

Figure 34

Directors' remuneration as a share of net profit



Source: CLSA Asia-Pacific Markets

Directors get largest share of earnings in HK, Taiwan and Malaysia

Japanese annual reports are opaque on directors' remuneration. Hence, we have left it from the analysis. In Asia ex-Japan, directors on average get the largest share of a company's earnings in Hong Kong (2.9% being the country average but a number of companies paying directors over 10% of net earnings) followed by Taiwan, where a large part of directors' compensation is classified under management/staff expense. However, we estimate that total directors' compensation would be upward of 2% of earnings, going up probably as high as 10%.

Malaysian companies are also reasonably generous to directors, who get 2.1% of earnings on average but with some companies paying directors up to 6.9% of net profit. In Indonesia some companies pay directors up to 7.5% of earnings. In most other countries, directors on average only get about 1% of companies' net profit, with Singapore and Thailand lowest at 0.7%; for both countries, the highest percentage going to directors for the companies in our sample is only 3%.

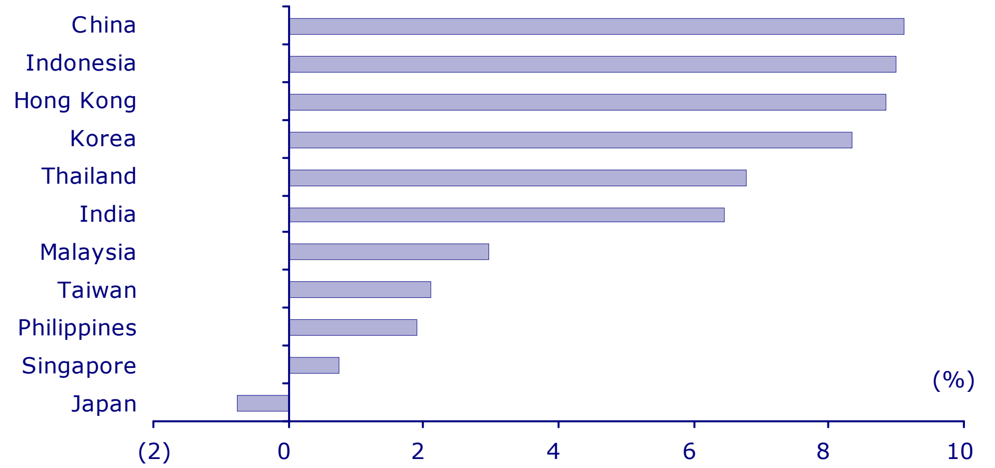
Large caps with not much higher CG?

Largest caps in our Asia universe have slightly lower CG scores

A major difference in score this year compared to previous years is that this time we did not find that larger cap stocks had higher CG scores on average. Our overall Asia ex-Japan average CG score is 51.1, but for the 100 largest stocks in the universe the average score was only slightly higher at 52.6.

Figure 35

Top quintile by market cap average CG score minus country average



Source: CLSA Asia-Pacific Markets

Distorted by more China companies on the large-cap list

The main reason for this is the larger representation of mainland Chinese firms among the top-100 market cap stocks. In 2005 there were only 14 in the Asia ex-Japan list, but with new large listings and the China market the top-performing one over the past two years, the number of mainland Chinese companies from the top-100 list in our current sample has increased to 24. Meanwhile, the number of companies from Hong Kong, which has a larger representation of higher-CG-scoring companies, has reduced from 21 to 17.

Within markets, top market-cap companies invariably had higher CG

However within countries, there was a discernable size effect on CG scores. In every market in Asia ex-Japan, the largest quintile by market cap on average has a higher CG score than the country average. These top fifth market cap companies on average scored 5 ppt above the country CG average. The larger caps had a much higher CG score in China where the largest one-fifth by market cap on average had a CG score 9.1ppt higher than the country average. This is followed by Indonesia (7.6ppt higher CG score for the top fifth by market cap over the Indonesian companies average), Hong Kong (8.8ppt) and Korea (8.3ppt higher).

Less difference in CG scores of large caps in Singapore and Japan

In Singapore and Japan however, the larger cap companies did not have noticeably higher CG scores than the average for their markets. The top-quintile large caps of our Japanese sample actually have an average CG score marginally lower (-0.8ppt) than the Japan average, while for Singapore it was 0.8ppt higher. Arguably the very large caps in these markets do not have CG standards much higher than the overall market. In other markets, the top-market-cap stocks do have more noticeably higher CG scores.

Top large caps ranked for CG

Of the large caps, 10 Japanese firms among top 30 ranked for CG . . .

. . . but only Sharp scores over 80%

The 100 largest companies in Asia ex-Japan have market caps of US$11bn and above. To this, for our large cap universe, we add the 30 of the Japanese companies in our sample with market caps also above this size. Japan then turns out to have the largest representation amoung our large caps with high CG scores (see Figure 36). Of the top-30 CG scores of the large caps, 10 are Japanese companies. However of the top five companies in the high CG large cap list, which score above 80%, only one is from Japan, ie, Sharp. The other Japanese companies CG scores are below 80% which we should regard as good rather than excellent scores.

Three Hong Kong companies dominate at the very top of the list of companies with the highest CG scores, ie, HSBC, HK Exchanges and CLP. In all seven of the top-30 CG companies among the large caps are from Hong Kong. The other two companies in this list at the very top for CG among large caps regionally are TSMC and Infosys.

Singapore among the top markets for CG macro-determinants

Korea has six companies in this list of the top thirty, but none score above 80%, ie, even their top companies have good but not excellent CG scores. Somewhat curious in this list is the absence of companies from Singapore. While Singapore ranks as one of the top two markets for the macro CG score, its companies only get an average CG score (50.3%) similar to our overall sample. Singaporean firms score above-average for transparency and independence (of the board from management), but below average for accountability, fairness and also on C&G.

No companies from Malaysia, Philippines and Indonesia on the list

Also absent from this list is any representation of companies from Malaysia, the Philippines and Indonesia. However, none of the Philippine companies were large enough, Indonesia has just one company in the list of large caps and Malaysia only three.

Financials represent one-fifth of this list

By sector, technology and financial services combined account for just over half of the high CG companies among the large caps. Technology has the largest representation among these with eight companies, or 30%, of the high CG large caps. Anecdotally, technology companies have to be more transparent and be ready to adopt international norms; in addition some like Infosys are led by visionaries who see global best practices as a key competitive advantage not just to win customers but also in the battle for talent. For financials, the ones that score higher have diffused shareholding and thus, lower risk of conflicts. They include HSBC, StanChart, and HK Exchanges (although the Hong Kong government has just announced taking its stake up to 6%).

Property and conglomerates under-represented

Sectors that are under-represented among the high CG companies are properties and conglomerates. Conglomerates by their very nature would have lower CG (see section below for types of companies that are penalised on our scoring) partly as our scoring favours focused companies with less inter-company transactions. To some extent the lack of property companies is because even the largest of these companies tend still to be family/individual-controlled where independence and accountability is generally lower.

Top CG among large caps: HSBC, Sharp, HK Ex, CLP, TSMC and Infosys

Figure 36

Top-CG companies among the large caps (sorted by CG ranking)

	Code	Market	Sector
HSBC	5 HK	Hong Kong	Financial services
Sharp	6753 JP	Japan	Technology
HK Exchanges	388 HK	Hong Kong	Financial services
Taiwan Semiconductor	2330 TT	Taiwan	Technology
Infosys	INFO IN	India	Technology
CLP	2 HK	Hong Kong	Power and Gas
MSI	8752 JP	Japan	Financial services
Nintendo	7974 JP	Japan	Technology
Hynix Semiconductor	000660 KS	Korea	Technology
LG Philips LCD	034220 KS	Korea	Technology
Esprit	330 HK	Hong Kong	Consumer
Inpex	1605 JP	Japan	Petroleum & Chemicals
Bharti	BHARTI IN	India	Telecoms
Kookmin Bank	060000 KS	Korea	Financial services
Mitsubishi Estate	8802 JP	Japan	Property
China Steel	2002 TT	Taiwan	Materials
Li & Fung	494 HK	Hong Kong	Consumer
Swire	19 HK	Hong Kong	Property
Toyota Motor	7203 JP	Japan	Automotive
United Microelectronics	2303 TT	Taiwan	Technology
Standard Chartered	2888 HK	Hong Kong	Financial services
Hana Financial	086790 KS	Korea	Financial services
Posco	005490 KS	Korea	Materials
Shinhan Financial	055550 KS	Korea	Financial services
Nine Dragons Paper	2689 HK	Hong Kong	Miscellaneous
Mitsubishi Electric	6503 JP	Japan	Technology
Resona	8308 JP	Japan	Financial services
Wipro	WPRO IN	India	Technology
Hindustan Lever	HUVR IN	India	Consumer
Honda Motor	7267 JP	Japan	Automotive

Source: CLSA Asia-Pacific Markets

Company score methodology

Seven CG categories

CLSA's corporate governance score for companies is based, as in previous years, on seven key categories. Six of the key categories - discipline, transparency, independence accountability, responsibility and fairness - are unchanged from our previous year's scores, with the seventh category this year being the score for the Clean & Green survey that replaced the previous social responsibility category. Under each of these categories, we assess the companies on issues that are key to constituting good corporate practices. The questionnaire is in binary form to reduce subjectivity and is filled in by our analyst covering each company based on the best information available. (Our questionnaire is presented in Appendix 3.)

CLSA CG assessment summarised

Our CG score is based on how we rate a company on 54 issues under six main aspects, each with a 15% weighting, that we take to constitute the concept of corporate governance, to which we add the C&G score with a 10% weighting. The following is a summary of what we assess in our CG ranking for the six key categories as in the earlier survey, while the key issues in the seventh category, the newly added C&G, was discussed in Section 1.

Public commitment to CG and financial discipline

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 restructurings 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

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

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

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
- Voting by poll at AGM/EGMs
- Making public by the next working day result of votes taken during AGM/EGM

Record on taking measures in case of mismanagement

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

Fairness

Treatment of minorities

- 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

Within these six sections, the only changes in the scoring are two additional questions, both in the accountability section. These are questions 38 and 39 (See Appendix 3). Question 38 is whether companies vote by poll, that is properly enfranchise shareholders for the percentage ownership they have. Question 39 is whether the firms disclose by the next working day the result of votes taken at annual general meeting (AGM) and extraordinary general meetings (EGMs). These two questions would seem to be quite central to having proper accountability and thus are added to our survey.

Questionnaire designed to give a numeric for ranking purpose

The overall questionnaire was designed to give a numeric for ranking in 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 the CG level of the company considered in itself, and provides a ranking for each company within its respective market and within its sector across the markets.

C&G weight in CG score

As described in the first section of this report, the last section of the CG scoring has been amended. In our past reports, each analyst scored the company for social responsibility covering ethical behaviour, not employing the under-aged, an equal employment policy, adherence to specified industry guidelines on sourcing of materials, and whether there were any issues regarding management integrity that arose from investment decisions made or litigation against the company. We only had one question explicitly about the environment which was Question 59 of the previous survey:

Q59. 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?

Social-responsibility section in previous years' replaced with C&G

The social-responsibility section has now been replaced by a more rigorous set of questions on environmental practices in particular relating to emissions of greenhouse gases. This C&G survey is completed by the individual companies, with answers vetted by our analysts. Their score on the C&G survey represents 10% of the overall CG score. Companies that did not respond the C&G survey were given zero for this part of the CG score.

We had given the previous social responsibility section a 10% weight in the overall CG score. We have kept the weight the same at 10% for the responses on the C&G criteria. While arguably responsibility for climate change should now be given a higher weighting, two reasons held us back form giving a higher weighting for C&G.

First, many who prefer a narrow definition on CG would still argue that environmental practices are not central to CG understood in the sense of responsibility to investors. Second, a number of companies that score high on C&G are companies in polluting industries (eg, travel and power) but where the environmental issues have hit home for the sector globally. Thus some of these companies in Asia are ahead of companies in other sectors in starting to calibrate and take measures to reduce emissions etc. But they may nevertheless be inherently in a more polluting business.

Firms with limited direct impact on environment

This raises the question whether, for instance a software company, whose impact on the environment is less than for instance an airline, should have a lower CG score because the software company has not yet started to take its carbon footprint seriously, while the airline company might already be making a start on measures to reduce emissions. Certainly, we would like all companies to be cognisant of their carbon footprint and reducing their direct and indirect impact on the environment. But if a company has a low level direct impact, it is counter-intuitive for these companies CG ranking to be dragged severely because they have not yet started to deal with environmental issues.

Doing nothing on emissions, power usage and the carbon impact of travel would mean a zero by our C&G score, and this reduces the overall CG score by 10ppt compared to a company that is already seriously tackling environmental issues. This is material impact on its CG score by our ranking although this section still has slightly less weight than the 15% weighting for each of the other key categories of CG from our earlier scoring.

Types of companies penalised in CLSA's CG score

Tradeoff in objectifying scoring and assessing of management commitment

No system of scoring is perfect as there is an inevitable tradeoff between scoring companies on the formal structures of CG being in place (board committees, number of independent directors, number of board meetings, reporting results and releasing annual reports within the given time frames, etc) as opposed to 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.

23% of the score requires judgement of the analyst

In our scores, 15 of the 56 questions, excluding C&G, involve an element of judgement on the part of the analyst. In total, these questions account for 23% of the score. However, even on the more objective questions, some companies (less often, fund managers as well) would dispute their relevance 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 whether a company sticks to its core business. Many of these will also have material related party transactions and get penalised on that as well. A company that is a subsidiary of another public-listed company also gets disadvantaged on the question 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 economy rather than the profits of a particular listed company that the government has privatised.

Questions with negative scoring typically lower average score by 10ppt

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 was reduced by 10.6ppt and the maximum reduction in our total sample is a score that declined by 28.5ppt.

Fifteen questions have negative scoring

Figure 37

Questions with negative scoring in the company CG assessment

Q3: Has the company diversified into non-core businesses over the past five 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 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 past three years?

Q42: 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?

Q45: Does the company engage in material related-party transactions?

Q47: Is the controlling shareholder's primary financial interest other than the listed company?

Q48: Have there been controversies over decisions by management where controlling shareholders are believed to have gained at the expense of minorities?

Q53: 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?

Q56: Has the remuneration of the Board increased faster than net profit?

Source: CLSA Asia-Pacific Markets

However, given the questions where negative scoring is applied, see box text above, 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. Equity 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 this annual CG effort that all analysts participate in (each company is scored by the analyst that covers the company, with his score cross-checked by the research head, the relevant sector head); CLSA analysts 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 actual CG commitment of a company relative to another. 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 which are value traps: cheap but because of poor CG likely to remain so.

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China - Revolutionary improvement

China has made a great leap forward by putting a framework in place to promote corporate governance. Initial shareholder reform has seen non-tradable shares converted to tradable stock, allowing for a more equitable playing field among shareholders. The elimination of the current two-tiered structure will encourage more investor activism which will lead to better transparency. But there are obstacles ahead. The risk of fraud is real and we would not be surprised to hear of investigations into corporate executive and director mismanagement ahead.

Significantly improved regulatory framework but enforcement is a key

ACGA's review of China's regulatory framework supports our observation. It noted major legislative and accounting-rule reform that have resulted in an improved overall country score. China amended its Company Law and Securities Law in October 2005 (in force from 1 January 2006.) This was followed by the Administrative Regulations on Listed Companies Information Disclosure, which the China Securities Regulatory Commission (CSRC) announced in January 2007. However, implementation by the core corporate-governance spirit is key, rather than regulatory enforcement. For example, ACGA points out that disclosure on directors' remuneration has become a norm among A-share listed firms, but the data are often confusing.

Li Ning tops our survey scores

In our survey, Li Ning's management is among the most professional, and with its strategy well crafted, it is our top Clean and Green (C&G) pick. China Shenhua and Sinopec also top our list with initiatives towards clean energy production and efficiency. China Resources Power has shown the most CG improvement, establishing a good track record in execution, acquisitions and a well managed balance sheet.

Our 2005 Qarp basket outperformed the MSCI index by 160%. Our Qarp picks this year are all small-cap firms. They include CIMH, Wasion Meters, Weiqiao Textile, Shanghai Forte and Hopson.

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Country CG score

China up a notch in our country ranking

China has climbed one place in the rankings to the ninth in this year's survey, bypassing the Philippines for the first time. The main factors behind its rise have been regulatory, including major legislative and accounting-rule reform, rather than any sudden improvement in its enforcement or CG culture scores. China's "Enforcement" score is actually lower than in our 2005 survey (mainly a result of our stricter methodology), while its CG culture rating remains extremely poor and ranks equal to Indonesia. In a booming stock market like China's, who cares about corporate governance?

But key issue is implementation

This is not to say that some companies in China are not responding, or being forced to respond, to calls for better governance. There are certainly pockets of higher standards, especially among the larger, more internationally competitive firms. Yet, most listed companies seem far more interested in chasing growth than building high-quality governance. To the extent that they are forced to adopt modern governance standards, it often comes across as a case of form rather than substance.

Disclosed data often confusing and inconsistent

Look, for example, at the disclosure on directors' remuneration in the average annual report of A-share companies. Although the pay of individual directors is disclosed as required, the data are often presented in confusing ways:

sometimes as aggregate figures, without any information on the components; or after-tax figures are provided instead of the actual amounts paid by companies. The provision of after-tax salaries and bonuses is especially interesting, since such disclosure downplays the true level of compensation (the figures can be almost half their original amount). We have, moreover, found one major financial company listed in both Hong Kong and Shanghai that discloses full remuneration figures in its English annual report in Hong Kong, but only the after-tax figures in its Chinese annual report in China.

Figure 1

China ratings for maco-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	43	43	Score unchanged
Enforcement	33	40	Remains a key issue; score lower on tighter criteria
Political and regulatory environment	52	50	Shareholding reform kicked off CG reform
Adoption of international accounting/auditing standards	73	68	Major overhaul to close the gap
Culture	25	22	Increasing awareness
Overall score	**45**	**44**	Similar overall score

Source: ACGA, CLSA Asia-Pacific Markets

State -owned companies help spearhead CG reform

State ownership continues to be both help and hindrance to corporate governance in China. The better state enterprises are more concerned about reputation than the average private company, putting a heavier emphasis on best practice. However, even though the Company Law may have stated that the highest authority of a company should come from shareholders' meetings, the government continues to exert a dominating influence through the Party committee system. This leaves the board of directors in a rather uncertain position and creates considerable fuzziness and opacity along the chain of command. Directors can be held accountable for their actions, but do they have the power to make real decisions?

Roaring regulation

Strong reform momentum

China's regulators and parliament have been more energetic than usual over the past two years, enacting major amendments to both the Company Law and the Securities Law in October 2005 (in force from 1 January 2006.) This was followed by the Administrative Regulations on Listed Companies Information Disclosure that the CSRC announced in January 2007 to provide detailed rules and guidelines for implementing the newly amended laws.

Company Law reform

The new Company Law include some key corporate-governance elements.

- Article 20: Any shareholder that causes losses to the company or other shareholders shall make compensation (this sets the basis for minority action against the controlling shareholder).
- Article 122: Shareholder approval is now required for certain major transactions (listed companies only).
- Article 123: The requirement for independent directors is now enshrined in law (for listed companies).
- Article 125: Directors cannot vote on board resolutions if they have a conflict (listed companies).
- Article 148: Directors now have broader and more general duties of "loyalty and diligence". Their duties used to be quite narrowly defined.

- Article 152: Shareholders that individually or collectively own more than 1% of a company's shares for more than 180 consecutive days can petition the supervisory board to initiate legal proceedings against directors or senior officers who cause losses to the company (and vice versa). If nothing happens within 30 days, the shareholders can sue in their own name.

Securities Law reform

In the new Securities Law, some of the more interesting sections include:

- Article 15: The proceeds from a public offer of shares must be used in accordance with the purpose of the funds as described in the prospectus.
- Article 47: A six-month, short-swing disgorgement rule.
- Article 68: Directors/senior officers of listed firms must sign a confirmation that regular company reports are true, accurate and complete.
- Articles 178-87: The functions and powers of the CSRC.

Both amendments represent a significant step forward in the development of corporate governance in China, and provide a firmer foundation for its capital markets. But both also raise some questions. What will be the long-term impact of Article 19 of the new Company Law? It states that Party organisations should be set up 'to conduct Party activities in a company'. Or the whole section on Supervisory Boards, whose functions and responsibilities duplicate those of the board of directors? Or Article 47 of the Securities Law? It applies the short-swing disgorgement rule not only to directors, supervisors or senior officers, but also to substantial shareholders (holding 5% of a company). This may make sense in a dispersed-ownership market, such as the US, where such shareholders could be insiders, but does it make sense in a market with concentrated ownership? Will it deter institutional investors from owning more than 5% of a company and, therefore, limit their capacity to hold companies accountable?

Disclose more, but be careful

More disclosure guidelines have been released in China

The Shanghai and Shenzhen stock markets have enacted several new regulations over the past couple of years, in part to give effect to the amended Company Law and Securities Law. On 4 April 2007, the Shanghai Exchange released Guidelines for the Administration of Information Disclosure Mechanism of Listed Companies. This offers the basic principles for listed companies, including disclosure rules for board secretaries, directors, supervisors, senior management, and shareholders with holding of 5% or above. While the guideline says companies should be encouraged to disclose as much information as reasonably possible, it also specifies that inappropriate release of confidential information shall be punished.

Stricter rule on insiders' shareholdings

Subsequently on 8 May 2007, the Shanghai Exchange issued Guideline for the Administration of Disclosure of Directors, Supervisors and Members of Senior Management Shareholdings in the Company. It requires directors, supervisors and members of the senior management to report to the company any changes to their shareholdings within two working days. The company, upon receiving the information, is required to inform the exchange within another two working days.

Listed firms are to avoid rumour by communicating with investors

On 9 May 2007, the Shenzhen Exchange issued Guidelines for Information Disclosure of Listed Companies (No. 5) – Rumours and Clarifications, urging listed companies to avoid rumours by being careful in their communications with analysts and the media regarding sensitive information. Should rumours surface, the company should report them to the exchange and the exchange will act accordingly, such as suspending trading of the stock. In addition, the company should investigate the incident and clarify the rumours to the exchange in accordance with the guideline within two working days.

Material contract disclosure

On 18 June 2007, the Shenzhen Exchange released Guidelines for Information Disclosure of Listed Companies (No. 6) – Material Contracts, clarifying the type of contracts that need to be disclosed. Contracts that involving 50% or above of the audited asset or more than Rmb1bn have to be disclosed, as do contracts that may have a material effect on the financial position of the company. In disclosing the contracts, the company shall provide information on the risks of the contracts, information on the contracting party, the content of the contracts, the effect on the listed company and any auditing procedures.

Accounting revolution

Major overhaul of accounting standards

In February 2006, China announced a major revamp of its national accounting and auditing standards. The Ministry of Finance released 39 new accounting standards for business enterprises (ASBEs) and 48 new auditing standards for certified public accountants. Both sets of standards took effect for listed companies from 1 January 2007 and bring China's accounting and auditing regime largely in line with international standards. While the implementation of these standards is bound to be difficult (eg, problems in determining the fair value of assets where no ready market exists), and while China is not following all IFRS standards (eg, related-party transaction accounting rules) at this stage, these changes are nevertheless momentous and should set the stage for a steady improvement in the quality and comparability of Chinese listed-company accounts. This, in turn, should significantly boost mainland companies' ability to attract capital in the future.

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Corporate CG issues over the past two years

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Shareholder reform has been a major catalyst towards effective corporate governance in China. Regulators have smoothly and swiftly implemented the vast and complicated task of converting non-tradable shares into tradable stock and over the past two years, essentially eliminating the two-tiered shareholding structure. Allowing parent group's assets to be transferred to listed companies, in turn, has promoted operational transparency and improved efficiency. The consensus approach in determining the right compensation for non-tradable conversion has been a key step toward equitable treatment of minority shareholders.

Policy initiatives thus far

In time, shareholder reform, along with enlarged QFII programs, will enhance domestically-listed firms' shareholder base. Strategic shareholders will be brought in. The policy also aims at wider long-term initiatives. The government is encouraging companies to implement a share-based management incentive program that will align both majority and minority shareholders' interests. The State Asset Supervisory and Administration Commission (SASAC) has tightened its supervision of state-owned enterprises (SOEs) and is more focused on profitability. Asset-injection programs more often than not are value accretive to minority shareholders, in particular, H-share holders. Domestic accounting policy has been brought into line with international standards. These policy initiatives, while aimed at domestically-listed firms, send a strong message to all Chinese corporations.

Li Ning and financial institutions top our first-quartile list

Figure 2

Companies in the top-two CG quartiles for China (China coverage)

Top quartile	Second quartile
Bank of China	Anhui Expressway
Bank of Comm	Beijing Capital Int'l Airport
China Construction Bank	BYD
China Infrastructure Machinery	China Mengniu Dairy
China Life Insurance	China Mobile (HK)
China Merchants Bank	China Resources Power
China Overseas Land	China Shenhua Energy
Clear Media	China Vanke – B
Ctrip	Dynasty Fine Wines Group
Hengan International	Fu Ji Food & Catering Services
ICBC	Hopson Development
Li Ning	Shanghai Electric Group
Lianhua Supermarket	Shanghai Forte Land
PICC Property & Casualty	Shenzhen Expressway
Ping An Insurance	Sohu.com
Sina.com	Tencent
Sinofert	Wasion Meters Group
Wumart Stores	Weiqiao Textile
Yanlord Land	Zhejiang Expressway

Source: CLSA Asia-Pacific Markets

Financials, perhaps surprisingly, dominate our top quartile. The sector is a recent addition, listing in the past year or so. The banks scored well against domestic firms as a result of regulatory disclosure requirements.

Li Ning is among the most professionally managed firm

Li Ning achieved the highest score. Management interests are aligned with minority shareholders, disposing founding-family stakes before listing. An employee share scheme whereby the company buys back shares and distributes them to employees as incentive plans, rather than issuing new shares which are dilutive, is also testament to good corporate governance.

Management integrity is under the microscope

Implementation will take time. Investigations into misconduct at the chairman and executive level continue to raise questions about management integrity. **Focus Media**, China's largest out-of-home media company, is a case in point, currently unfolding as this report goes to print. A Nasdaq listing does not necessarily indicate that a company has better corporate governance. Focus Media missed the deadline to file its 20F 2006 annual report on 2 July 2007 and Nasdaq is threatening to delist the stock. The firm has requested a hearing and will present its case to Nasdaq on what it plans to do and why it deserves to remain listed.

Difficulty getting annual report signed off by auditors

Despite having announced unaudited financial results for 4Q06 and FY06 on 26 February 2007, the firm appears to be having difficulty getting its annual report and financial statements signed off by auditor Deloitte Touche Tohmatsu. In a press release, Focus Media said it was postponing its SEC filing as its audit committee needed more time to complete an internal inquiry in matters raised in letters received from 'an unidentified investor holding a short position' in Focus Media shares. The letters raised questions on certain related-party transactions, in particular, an advertising agency, when placing advertisements with Focus Media, received payments from Everease (a firm related to the chairman), without providing any goods/services to Everease.

We suspect there are other issues. The chairman of Focus Media's audit committee sold US$2.8m of shares around 31 May 2007 (ie, around the time the letter from the short seller was received).

Chairman's purchase of original Wumart deemed improper

In another case, **Wumart**'s chairman is under investigation on allegations that the deal in which he bought the original Wumart was improper. The share price has been suspended for more than six months. Worse, the planned acquisition of Jiangsu Times Supermarket was then scrapped and a Rmb2m deposit has been forfeited. The situation is reminiscent of Guangdong Kelon. Though the case was made public a few years ago, the verdict only came last year and revealed serious fraud that lead to prison terms. We would not rule out more investigation cases like this in the future. Private enterprises are more vulnerable.

Investigation regarding chairman's connection with Beijing mayor

Political infighting has been the focus of other investigations. **Beijing Capital Land**'s chairman was under investigation last year due to his connection with the vice mayor of Beijing who was then placed under house arrest. The chairman was later acquitted. Shanghai Electric's chairman and directors were under investigation on allegations of project corruption. The case is widely viewed as part of the larger political endeavour to clean up former Shanghai municipal leadership. The company later made an announcement that the directors and chairman committed wrongdoings in their personal capacity. In any case, both stocks had been suspended for some time.

Clean & Green survey

Big policy initiative . . .

Environmental improvement has been a cornerstone of government policy as Beijing's objectives shift from high growth to quality growth (more investment in clean technologies). Structural adjustment is taking place in heavy, high energy consumption industries as well as energy sectors. Small and inefficient power plants have been earmarked for closure. Polluting factories are under close scrutiny. Projects approvals have become more stringent, going so far as blocking bank loans to companies in violation of environmental rules.

. . . but not enough awareness all round

Yet, awareness among firms is not high based on our survey response. Only 27 companies of the 88 under our coverage chose to participate in our C&G survey. Those that did not participate said it was not relevant to their core business. Most see the issue as only relevant to energy and heavy industries - reflected in our survey where our top-10 list includes mainly energy-related companies. China Shenhua and Sinopec top our list with their clean energy initiatives, most notably coal conversion technology. China Water Affair comes in third as the largest tap-water supplier in a water-scarce country.

Our top list includes energy and heavy industrial firms

Figure 3

Clean & Green scores

	(%)
China Shenhua Energy - H	75
Sinopec	75
China Water Affairs	70
Maanshan Iron and Steel	70
Dongfeng Motor	65
CNOOC	40
PetroChina	40
Huadian Power International	40
BYD	40
China Resources Power	35

Source: CLSA Asia-Pacific Markets

Voting by poll

Chinese companies score well on voting by poll

Three-quarters of the Chinese corporations under our coverage voted by poll. This is a rather an impressive outcome. The table below shows the companies in the first CG quartile that have such a system in place.

Figure 4

Companies that vote by poll

	CG quartile
Li Ning	1
Bank of China	1
China Merchants Bank	1
ICBC -H	1
Ping An Insurance	1
China Life Insurance	1
Ctrip	1
Bank of Communications	1
China Construction Bank - H	1

Source: CLSA Asia-Pacific Markets

Directors' remuneration

Chinese firms do not overpay directors

Chinese executive salaries are still low by European or American standards. We expect directors' pay to rise in recognition of their roles in protecting miniority shareholders' interests. Technology and media firms in our survey pay directors the highest renumeration. Four out of the top 10 listed firms saw directors' rise faster than net profit over the past five years. Energy and infrastructure-related firms pay less than 1% of earnings to directors. Yet, four out of the bottom 10 saw directors' salaries rising faster than net profit.

Figure 5

Companies with directors remuneration at highest % of net profit

	Directors' remuneration as % of net profit	Has director remuneration risen faster than net profit over the past five years?
Sina.com	10.9	Yes
Clear Media	10.6	No
Sohu.com	7.6	Yes
New World China Land	6.7	No
Wasion Meters Group	5.0	No
Tianjin Port Development	3.5	No
Beijing Capital Land	2.9	Yes
China Southern Airlines	2.3	No
Lingbao Gold	2.1	No
Yanlord Land	1.6	Yes

Source: CLSA Asia-Pacific Markets, company reports

Figure 6

Companies with directors remuneration at lowest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
Shenzhen Expressway	0.03	Yes
Angang Steel	0.05	No
China Telecom	0.05	No
China Shipping Dev	0.07	No
Jiangsu Expressway	0.07	Yes
China Netcom	0.08	Yes
China Shenhua Energy	0.09	No
Yanzhou Coal	0.09	No
Bank of China	0.10	Yes
China Mobile (HK)	0.10	No

Source: CLSA Asia-Pacific Markets, company reports

Changes in CG scores

China Resources Power saw biggest improvement

China Resources Power showed the most improvement in our CG scoring, having established execution track records in greenfield construction and asset acquisition over the past two years. Along with good power-plant management, its balance sheet has maximised shareholder value -

uncommon among Chinese firms. Sohu and Ctrip, Dongfang Electric and Jiangsu Expressway have also seen some improvement as they grow in scale and better respond to the needs of the investment community.

Figure 7

Companies with changes in CG scores: 2005-07

	Chg in CG score (ppt)	2005 quartile ranking
China Resources Power	16.0	4
Sohu.com	15.6	3
Ctrip.com International	13.9	2
Dongfang Electrical	11.7	4
Jiangsu Expressway	9.2	4
China Eastern Airlines	7.5	4
China Vanke - B	7.3	3
Anhui Expressway	7.3	3
China Mobile (HK)	7.1	3

Source: CLSA Asia-Pacific Markets

Qarp stocks 2005

Qarp picks 2005 returned 306% on average

Our Qarp stocks of 2005 delivered an average return of 306% over two years, massively outperforming MSCI China return. The stocks selected include Hopson, Cnooc, Zhenhua, PetroChina, China Vanke, and China Netcom, with China Vanke being the best performing firm.

Figure 8

Performance of 2005 Qarp picks

Company	CG quartile	ROE 04-05 (%)	Share price		Performance (%)
			Jun 05 (Rmb)	Sep 07 (Rmb)	
Hopson Dev	1	15.0	3.80	21.95	477.6
CNOOC			4.65	8.86	90.5
Zhenhua Port			0.33	1.86	459.8
PetroChina			5.75	11.52	100.3
China Vanke			2.27	16.19	614.2
China Netcom			11.30	21.60	91.2
Average return of Qarp stocks					305.6
MSCI China two-year return					142.3

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

Qarp picks 2007

Our Qarp picks for 2007 focus on small-cap firms

Our Qarp analysis reveals fewer companies still having share price upside after the big rally. Companies in the first quartile are priced at a premium relative to market peers. Only one firm in our first quartile list makes it to our Qarp top pick for this year. All the others are in the second quartile. Our top list includes high-growth consumer, infrastructure and property names, as well as CIMH, Wasion Meters, Weiqiao Textile, Shanghai Forte and Hopson. These are among the leaders in their respective markets.We estimate 10% COE for China, which consists of a 5% risk-free rate and 5% risk premium.

Figure 9

Qarp list: September 2007 valuations

Company	CG quartile (1-4)	Avg ROE 07-08 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Weiqiao Textile	2	15.6	10.0	3.0	1.8	1.2	43.7
Wasion Meters	2	31.4	10.0	5.0	5.3	3.8	37.5
CIMH	1	26.0	10.0	5.0	4.2	3.6	16.6
Hopson	2	34.2	10.0	3.0	4.5	4.0	12.9
Shanghai Forte Land	2	27.3	10.0	3.0	3.5	3.1	12.2

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Hong Kong - Up in the rankings

Average CG scores barely changed from 2005

Although our macro CG scoring of Hong Kong has seen the score reduced slightly owing to stricter guidelines, the market ranking has moved up, with Hong Kong pipping Singapore after being second in our market rankings in the past few years. At the corporate level, however, issues remain ranging from whether privatisation proposals are fair to minorities, companies placing shares just before announcing poor results, poor guidance to outright fraud. Our average CG score for HK corporations is barely changed from 2005.

Only 13% of Hong Kong sample scored 50% or over on C&G

Despite its pollution, and data from the HK Observatory that over the past century the city's temperature increase has been doubling the global average, the awareness of companies on climate change is surprisingly low. Some 62% of our sample declined to respond to our C&G survey, most of whom stating the issues did not relate to them, apparently oblivious that any company which uses electricity and arranges for its people to travel will have a carbon footprint. Only seven or 11% of the sample has a reasonable 50% score for C&G; these were mainly the large international banks and companies in power and transport where the issues are impacting these industries globally.

Current Qarp picks: I.T, StanChart, L&M Paper and Hang Seng Bank

In the two years to end of June 2007, MSCI HK rose 37% but the five Qarp stocks selected for Hong Kong increased an average of 114%. At current market valuations, we have just four Qarp stocks: smaller-cap I.T Limited, as well as StanChart, Hang Seng Bank and Lee & Man Paper.

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Country CG score

Hong Kong has edged into first place in this year's survey, up from second in 2005. Looking at the market in context, its corporate-governance regime continues to display noticeable weaknesses, such as in the frequency and timeliness of financial reporting, the limited legal remedies available to minority shareholders, and institutional investors' low level of involvement in policy discussions and debate. But Hong Kong is stronger than most of the region in several areas: shareholder voting; disclosure of regulatory enforcement activities; protections offered to minority shareholders in privatisations and voluntary delistings; freedom of the media; and the responsiveness of listed companies to the views of investors. In short, Hong Kong is where good practices can sometimes be set by the market. Issuers and investors do not always wait for the rules to change before they act.

Improvement in score for CG culture; overall macro CG score little changed

Figure 1

HK ratings for maco-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	60	64	Slight decline on stricter criteria
Enforcement	56	58	Score little changed
Political & regulatory environment	73	78	Score little changed
Adoption of international accounting/auditing standards	83	91	Lowered on tighter criteria
Culture	61	54	Improved score
Overall score	**67**	**69**	Overall score reduced slightly

Source: ACGA, CLSA Asia-Pacific Markets

Lowered score on stricter criteria that reveal some short-comings

But before popping the champagne, the authorities in Hong Kong may like to compare the category scores this year with those from our last survey in 2005 (see table above). In only one category, "CG Culture", is the new score higher than the previous one. As with all markets, the lower scores this year are partly due to a stricter scoring methodology and the addition of new questions. But they also reflect genuine problems with the quality of rules and enforcement in Hong Kong, an ambivalence towards regulating auditors more stringently, and the apparent inability, or unwillingness, of most market intermediaries (and regulators) to ensure that newly listed companies have well-prepared governance structures. To drive a car in Hong Kong requires lessons and a license. To drive a listed company requires no special training in how to be a director or any substantive corporate-governance qualifications.

A legislative merry-go-round

Plant to give statutory backing to Listing Rules

On the legislative front, the government has been working on two major initiatives: a plan to give statutory backing to key parts of the Listing Rules; and an overhaul of the Companies Ordinance. "Statutory backing" means codifying rules into law. Since the Listing Rules are merely a contract between the Stock Exchange and its clients, the listed companies, they have no basis in law. As a result, says the SFC, the Exchange 'does not have full investigative powers' and 'lacks a broad range of disciplinary responses to deal with breaches' of its own rules (SFC Annual Report 2006-07, p36).

In October 2003, the government released a consultation paper on "Proposals to Enhance the Regulation of Listing". The catalyst for this was a growing concern that Hong Kong's regulatory structure was less than optimal and a realisation that, in a global economy, the city had to 'keep pace with best international standards'. There was much debate at the time (and later) that this meant completely shifting enforcement of the Listing Rules from the stock exchange to the Securities and Futures Commission (SFC), since the former was a for-profit company and exposed to possible conflicts of interest, while the latter was a central regulator with a much broader range of powers. Following vociferous (and expected) resistance from the Exchange and listed companies, this bold option was shelved. Instead, the government came up with a quintessentially Hong Kong compromise: give statutory backing to certain parts of the Listing Rules - and then allow the SFC to enforce these things - while leaving the rest of the system as it was. (The 2003 consultation offered various options, but it was clear which one the government favoured.)

Only some parts of Listing Rules to have legal backing

Having consulted the market, the government announced its conclusions in March 2004. It declared that the 'status quo is not an option', that there was a 'need for continuous improvement' and that there was overwhelming support for statutory backing. It proposed giving such backing to three key parts of the Listing Rules: financial reporting and other periodic disclosure; disclosure of price-sensitive information; and shareholder approval for certain notifiable and connected transactions. At the time, it said it wanted to introduce an amendment bill into the Legislative Council in early 2005.

In January 2005, however, the government produced two more consultation papers, one on proposed amendments to the Securities and Futures Ordinance (SFO) to allow for statutory backing and the second on detailed proposed changes to related legislation. In view of the enhanced enforcement powers that these amendments would give to the SFC and a new Market Misconduct Tribunal, most listed companies and their directors were less than delighted at these developments.

Delays; status quo triumphed for now

The original aim had been to have the amendments enacted into law sometime towards the end of 2006 or at the latest during 2007. But strong opposition from the business sector and the Legislative Council led to a watering down of the original proposals and long delays in the drafting process. It appears at this stage that the bill is in abeyance-and the status quo has, unfortunately, triumphed for now.

Modernising company law

Consultation paper on Companies Ordinance released in March 2007

With regard to the Companies Ordinance, the government released a consultation paper in March 2007 on improving the accounting and auditing provisions in the company law. The proposals deal mainly with raising standards of disclosure and transparency in annual accounts, improving compliance, and lowering the cost of compliance for companies. For example, there are proposals to make the directors' report more forward-looking, to introduce a directors' remuneration report, and to enhance the rights of auditors. It should be noted that these changes would apply to the 600,000 or so companies incorporated in Hong Kong, and that some of the provisions already apply to listed companies under the Listing Rules.

Tentative target to introduce new Companies Bill towards end of 2010

This consultation paper is the first of a series on a comprehensive review of the Companies Ordinance. Having made various "piecemeal" amendments over the years, the government decided in 2004 that a complete rewrite was now needed. As the paper notes, Hong Kong company law was last "substantially reviewed and amended" in 1984, bringing the ordinance into line with the UK Companies Acts of 1948 and 1976. The rewrite was launched in mid-2006 and will be carried out in a phased manner, with a "tentative target" to introduce a new Companies Bill into the Legislative Council towards the end of 2010.

Runs on the board

SFC making progress in other areas of regulation

While the SFC has been having a hard time of it over statutory backing, it has made progress in other areas of regulation. For example, A new sponsor regime was instituted on 1 January 2007. From that date, the regulation of IPO sponsors shifted from the Stock Exchange to the SFC, with enhanced eligibility requirements for sponsors.

SFC now able to request assistance of CSRC in gathering

But SFC not yet able to seek extradition of suspects from China

There is an expanded bilateral cooperation pact with the China Securities Regulatory Commission (CSRC) in Beijing. The new agreement will allow the SFC to request the assistance of the CSRC in gathering information in its mainland investigations. Following changes to the PRC securities law, the CSRC can now seek a court sanction against any person who refuses to comply. Previously, the CSRC could only seek the voluntary cooperation of suspects. The quid pro quo in the new pact is that the SFC will also help the CSRC with its investigations in Hong Kong. While this enhanced cooperation should help improve the SFC's cross-border investigations - a major weakness in Hong Kong's regulatory regime - certain fundamental obstacles remain, not least the inability of the SFC to seek extradition of suspects from China.

The world is welcome

HK govt instructed SFC and HK Ex to facilitate listings of foreign firms

Hong Kong Exchanges and Clearing (HKEx), the holding company for the stock and futures exchanges, has been working on several policy initiatives over the past year. One of the more interesting was a decision in late March 2007 to encourage more listings of overseas issuers from jurisdictions outside the usual quartet of Hong Kong, China, Cayman Islands and Bermuda. Faced with the possibility of declining listings from China - due to a policy decision by Beijing to effectively force new mainland SOE listings to go to Shanghai and Shenzhen, not Hong Kong - the government in Hong Kong panicked and instructed the SFC and HKEx to come up with a way to facilitate more rapid listings of companies from around the world.

Companies from other jurisdictions might need to make by-law changes

The issue here is not that such companies are not welcome to list in Hong Kong, but that they may need to make changes to their bye-laws to bring their standard of shareholder protection in line with Hong Kong's company law. If incorporated in a jurisdiction with a similar company law, such as Australia or Canada, the company may need to make few changes. If incorporated in places with a substantially different company law regime, such as the US, Korea or Germany, then changes would be required. In the past HKEx would negotiate with each applicant on a case-by-case basis - something that companies and their advisors found burdensome and costly. The policy change in March of this year set down a clear list of the things that companies would need to do to meet Hong Kong investor-protection standards.

Taiwanese firms finding it attractive to list in HK

Ironically, while the Hong Kong government, HKEx and market intermediaries have been worrying about the possible loss of business from China listings, the stock exchange has been benefiting at the expense of Taiwan. Due to a law that limits the percentage of assets a Taiwan listed company can have in China, several Taiwanese firms have listed their China-based subsidiaries in Hong Kong. But these companies skirt the problem raised above-of having the wrong type of bye-laws-by incorporating their subsidiaries in Bermuda or the Caymans before coming to list in Hong Kong. This may be good for Hong Kong, but is causing a high degree of angst for the Taiwan Stock Exchange, where new listings have been lacklustre.

Other initiatives by HKEx . . .

Other recent initiatives of HKEx include clarifying in September 2006 the formal reporting requirements under the Listing Rules on the need (or not, as the case may be) for an external accountant to review a profit forecast, and reminding companies of their obligations to disclose price-sensitive information on a continuous basis. Continuous disclosure in Hong Kong is well below standards in developed markets such as the UK.

. . . abolished the need for paid advertisements in newspapers

HKEx has also abolished the requirement for paid advertisements in newspapers for full company announcements from late June 2007 and, at the same time, launching an "electronic disclosure project" for enhanced online disclosure of such announcements.

Consultation for developing the Growth Enterprise Market

HKEx launched a consultation paper in July 2007 on ideas for developing the Growth Enterprise Market (GEM). Although most respondents to an earlier 2006 "discussion paper" on the GEM favoured its transformation into an AIM-like market, HKEx and the SFC decided against this option. Their view is that it is "too early to adopt the AIM model", principally because the Hong Kong market has a larger retail component, a less developed institutional investor base, and a sponsor regulatory system in a state of flux (see above under "Runs on the board"). This may be a polite way of saying that they do not believe sponsors in Hong Kong are ready to take on the responsibilities of the nominated advisors ("nomads") in London. The current proposal for developing GEM is to strengthen it as a genuine second board to the main board, and to make listing quicker and cheaper for smaller companies.

Preparing consultation paper on quarterly reporting

The Exchange is also preparing a new consultation paper for later this year on introducing quarterly reporting in Hong Kong, reducing the deadlines for periodic reporting, and several other Listing Rule changes.

Watching the auditors

In July 2007, Hong Kong set up its own Financial Reporting Council (FRC), a formally independent body whose task will be to investigate audit problems in

HK-listed companies, and to look into non-compliance in the area of financial reporting. Despite having the same name as its counterpart in the UK, the powers of the FRC are far more limited. It takes over the investigation role of the Hong Kong Institute of Certified Public Accountants (HKICPA), but cannot initiate disciplinary proceedings itself-it must pass its findings back to the HKICPA. Much of its work will be done in response to complaints received from the public or regulatory bodies. But with a tiny budget, expectations in the market are not high that the FRC will achieve a great deal.

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Corporate CG issues over the past two year - Privatisations

At the corporate level, there has been no lack of CG issues among Hong Kong firms, ranging from the merits of privatisation bids, placing of shares before releasing poor results, guidance to investors, poor general disclosure relating to market-sensitive information through to outright fraud. A major CG issue cropping up arises from privatisation proposals. Controlling shareholders would only make these bids if they see upside from the price they intend to privatise at. Yet, in HK there is little fiddling with nominees, and privatisation bids are often rejected by minority shareholders. Henderson Land made two bids to privatise **Henderson Investment**, which investors voted down.

Lower hurdle for required approval to dispose assets

The hurdle of acceptance required to privatise a company is relatively high: the proposal needs approval from over 75% of independent shareholders and no more than 10% vote against it. However, it is much easier to dispose assets from a listed company, which only needs a simple majority of shareholders to approve. Thus ultimately, Henderson saw greater opportunities to maximise value by putting in the other assets of Henderson Investment in other vehicles, and so in 1H07 it stripped the company of all other assets other than its holding in HK Gas.

Beijing did not approve the attempt to acquire assets of HK's main telco

The **PCCW** privatisation saga was one of the key corporate news of 2006 and was a major attempt by private equity firms (Newbridge and Macquarie) to acquire the assets of Hong Kong's main telco, but was thwarted by Richard Li's mainland partner, China Netcom which has a 20% stake in PCCW. Netcom and mainland officials made it clear that they had no intention of divesting their stake and were not agreeable to control of Hong Kong's main telco going to a foreign party. Richard Li appeared to have been somewhat clumsy in initially pushing for the privatisation proposal and announcing it without first getting agreement of China Netcom. There had been an agreement with Netcom that there would be no change in stake in the company without agreement from the mainland company; however because the formal proposal at that stage was to dispose PCCW's assets and liabilities rather than the company itself, technically this did not violate the letter of the agreement between Richard Li and China Netcom.

The mainland partner was unsurprisingly nonplussed by these attempts and the private equity firms then appeared to back down rather than risk the long-term consequences of crossing on the wrong side of Beijing. Ultimately Francis Leung came up with an alternative offer to buy over PCCW. However, when it transpired that Richard Li's father, KS Li, had part-financed the deposit for this acquisition, Richard changed his mind and then stated that he was no longer keen for the sale to go through to Francis Leung and his backers. Ultimately minority shareholders of PCRD, Richard Li's Singapore-listed holding company through which he holds 23% of PCCW, voted against the proposal to sell PCCW.

Beijing exerting influence in HK affects ability of companies to realise full shareholder value?

The key significance of these events was whether Beijing could be exerting influence in the Hong Kong market in a manner that prevented companies from realising full shareholder value for investors. However, given that a mainland company had actually taken a significant stake in the company which was proposing to dispose of its main business, quite plausibly one could take the view that the issue here was company-specific rather than more generally negative for Hong Kong companies' ability to maximise value. The moral, if any, is that having a mainland party as a strategic investor in a company is a double-edged sword. While potentially a mainland investor might open opportunities to expand in the PRC, but the mainland party might well have other interests in mind rather than maximisation of shareholder value, i.e. the share price. Because a mainland party was a strategic investor in PCCW, it certainly appeared to have been an obstacle to the company getting the maximum value from disposal of its assets.

Attempts to privatise Chinese Estates

Chinese Estates in recent months has had two occasions when the stock was suspended over potential bids to privatise the company. In both instances nothing materialised. This has led to some volatility in the stock. A charitable interpretation is that the directors are seeking to maximise value in attempting to get a private equity / hedge fund buyout price. The company subsequently announced in September 2007 an injection of its Macau and China assets into a separate listed subsidiary, which gives investors in Chinese Estates only an indirect interest in these key growth areas. It still has issues on transparency and on having a portfolio of HK$11.6bn of securities on its balance sheet equivalent to 40% of market cap.

CG issues - Smaller companies

Next Media placed shares two months before giving disappointing interims

Of lesser significance but leading to the biggest change in our CG score is events surrounding **Next Media**. Jimmy Lai, the controlling shareholder, had convertibles that had to be converted into ordinary shares by October 2006 which would have increased his stake to 81% in the company, crossing over the 25% free-float requirement. Thus one month before the required conversion of these notes, Lai placed out 7.4% of existing shares in Next Media. [This transaction was arranged by CLSA.] Regrettably, two months after the placement, the company announced interim results that were a major disappointment for the six months to September.

It would appear almost certain that when the placement was being done, management would have known that the company was not performing as well as the market anticipated. The growth in advertising revenues in Taiwan slowed and in Hong Kong, one of its magazines suffered a backlash from advertisers as a result of printing a photograph of a star in her underwear while she was changing, which many people in Hong Kong considered to be in poor taste. Management had neglected to inform the investing public of the negative trend in the momentum of its businesses in both Taiwan and Hong Kong. As a result, when the interim results were announced, the market had to downgrade earnings estimates in line with our analyst who cut FY07 and FY08 earnings by 40%. Because of the misleading communications of management, highly opportunistic placement conducted just before announcing poor results, the company's CG score has been marked down by 20.7-points (for comparable 2005 questions).

Purported fraud at Ocean Grand, which is now in liquidation

Other CG issues that arose were mainly of smaller companies including cases of purported fraud. **Ocean Grand** and its listed subsidiary **Ocean Grand Chemicals** went into receivership in 2006. David Webb (Webb-site.com) gives a detailed analysis of the warning flags over the years on the company.

This includes mysterious loans by the company to third parties, debts of OG from other companies related to the controlling shareholder, while OG was giving interest-free unsecured loans to other companies of the shareholder. Options equivalent to 10% of the paid-up capital had been granted to directors six months after the company was listed at a 63% discount to the IPO price; further options were granted a year later after a bonus issue, when it was questionable if the Listing Rules permitted the issuance of these options.

Dodgy track record

OG invested HK$148m in an internet company in 2000 for which it was not clear who received this consideration; by 2003 the internet company had been disposed of for an amount not clearly stated but was no more than HK$10m. OG acquired a subsidiary involved in sub-contracting work to produce Palladium salt which apparently generated a gross margin of 86%, but 15% of revenues were received immediately while 85% were receivable within 12 months. The gross margin for this business rose apparently to 99% after the acquisition but trade receivables also ballooned, more than half of which became more than 12 months old. This subsidiary was listed in 2003 as Ocean Grand Chemicals (OGC).

In early 2006, the auditors of OG, Moores Rowland Mazars resigned, apparently owing to disagreement on audit fees and were replace by PriceWaterhousecoopers. By mid-2006, OGC announced that auditors highlighted 'certain potential accounting irregularities . . . concerning the recoverability, validity and genuineness of certain accounts receivable, accounts payable and sales and purchases'. Liquidators were appointed in late July 2006. At about this time, four directors at OG/OGC resigned citing personal reasons. The liquidators found that a week before their appointment Rmb809m had been transferred from the group; of which the payees for Rmb468m were traced but were not part of the listed group. The financial controller of one of subsidiaries absconded. The liquidators have applied to wind up the company.

Top in our CG rankings are HSBC, HK Ex, Esprit, CLP, Li&Fung

Figure 2

Companiess in the top-two CG quartiles for Hong Kong (CLSA coverage)

Top quartile	Second quartile
Bank of East Asia	BOC HK
Cathay Pacific	Galaxy
CLP	HAECO
Esprit	Hang Lung Props
Giordano	HK & China Gas
Hang Seng Bank	HK Electric
HK Exchanges	Hongkong & Shanghai Hotels
HSBC	I.T Limited
Lee & Man Paper	Johnson Electric
Li & Fung	Kerry
Nine Dragons Paper	Ports Design
Sa Sa	SHKP
Solomon Systech	Sino Land
Standard Chartered	Smartone
Swire	Techtronic Industries
Wing Hang Bank	Wharf

Source: CLSA Asia-Pacific Markets

Complex web of inter-company transactions led to trouble

Another case to note is where investigations are ongoing. The Independent Commission again Corruption (ICAC) is charging the chairman of **Grand Field Group** for alleged conspiracy to defraud shareholders of the company over an investment in a gas project in Chongqing. Also charged were three directors of **Upbest Group**, which owned a securities company that was financial advisers to Grand Field. One of the directors of Upbest who was charged is also a director of **EganaGoldpfeil**. These stocks have all suffered including Egana which had been viewed as a potential consumer play for HK/China. A detailed examination of the accounts of Egana is also presented at Webb-site.com. This reveals a history of Egana selling and buying back assets to boost declared profits, using cash to make investments in ELNs, promissory notes and advances to other listed companies subtracting which net cash stated on the balance sheet would have actually been net debt. In addition the company had substantial investments in unnamed assets, including in a gas project by this consumer brand company. The gas project was not named but appeared to have been the same gas project that Grand Field invested in which resulted in the ICAC bringing charges. To top it all, EganaGoldpfeil had three auditors within a space of three years.

Lack of communications from Prime Success

Against these, other misdemeanours may look somewhat trivial. Of late, a Hong Kong listed Taiwanese-controlled, **Prime Success** is seeing its stock hit because of news that one of its co-founders has been arrested in Macau and was being sent back to Taiwan where he had been convicted of charges relating to corporate fraud in 2004. While he had resigned from his position as Chairman of the company three years back, his 25% stake had been passed on to his children who are on the board of the company; questions arise over how much control he exercised via his children although he had no formal position in the company. The company made no statement on the matter, which proved to be obviously a price-sensitive development, and only arranged for conference calls after the stock started to fall when the news of the former chairman being detained filtered through to the market.

Poor guidance led to disappointing set of results after listing

Win Hanverky was listed in September 2006 and was also seen as a potential play on the consumer spending in China. However, it failed to guide analysts for the sharp compression in its margins in the 2H06 (the period during which it had been listed) and the result was that the full-year results were a major disappointment leading to the market cutting forecasts by 20%.

Also worth noting is undue capital conservatism by some of the corporates that leads to questions whether the companies are driven by maximisation of shareholder returns. The larger property groups have almost all in the last two years taken advantage of the rising market to issue new equity, when their balance sheets have usually been not stretched. Some would defend this by stating that the equity is required for potential expansion into China as well as replenishment of landbank in Hong Kong, but it is unclear if their balance sheets will indeed get stretched over the coming years as they undertake their expansion, as many will get cash from existing project sales.

Tongda's share placement brought its stock down

Once again, the worst offenders are the smaller caps. **Tongda**, a company that manufactures in-mould design for handsets, etc, was expanding capacity for potential new orders, which would have taken its gearing towards 30%. But rather than taking on this level of non-excessive debt, it undertook a placement of 19% new shares after the share price had begun to run up. (The placement was arranged by CLSA.) This issuance, however, took the stock down 35% within a week.

To some extent, these developments are to be expected with smaller caps. They underscore the need for background checks on the individuals involved, the history of corporate events, intergroup transactions, controlling shareholders' business interests, risks in cash misuse, views of management on capital management, investor relations of firms that were recently listed - and the need for a higher risk premium generally on small caps.

Independent chairman - Hang Seng Bank

Independent chairman appointed at Hang Seng Bank

In August 2007, Hang Seng Bank announced the appointment of an independent director as chairman. The previous chairman, Michael Smith, was HSBC's Asia-Pacific chief executive but had resigned from the group. The new chairman is Raymond Chien, who is also chairman of the MTRC. He will be the first chairman of Hang Seng Bank in a decade that is not from the management of parent, HSBC. Although Chien is an independent director of HSBC's Asia Pacific unit and was an INED of HSBC Holdings from 1998 to May this year, he does not represent HSBC management.

Particularly with HSBC and Hang Seng Bank both pursuing expansion into the mainland, having a Chairman who is independent gives greater credibility to Hang Seng's position that its expansion into China will not be hindered by the goals of its parent. Apart from this specific issue, having an independent chairman is key to the board being independent from management and thus able to exercise checks and balances more effectively.

Only four other companies in HK have an independent chairman

Of our universe of 64 HK companies, only four other companies have independent chairmen: HK Exchanges, MTRC, HTIL and Solomon Systech. While this question is only 1.9-points in the overall CG score, with this improvement, Hang Seng Bank moves up from quartile two of our HK CG rankings in 2005 to quartile one this year.

Clean & Green survey

Only 24 companies of 64in HK responded to our C&G survey

Of the 64 Hong Kong companies surveyed for CG and sent the C&G questionnaire, 24 responded. Typical of the firms that did not respond to the C&G questionnaire was the reply that these issues did not apply to their sort of industry/businesses, which was the almost standard response for companies across the spectrum of industries listed on the market.

Scores ranged from zero to 95% on C&G

Figure 3

Clean & Green scores

	(%)
HSBC	95
Standard Chartered	90
Cathay Pacific	90
CLP	85
HK & China Gas	75
MTRC	55
Swire Pac	50
Hang Seng Bank	45
NWS	40
Esprit	30
SHKP	30
HK Exchanges	15
Li & Fung	15
Next Media	15
Hang Lung Prop	5
Sa Sa	5
Solomon Systech	5
Bank of East Asia	5
Hopewell	5
New World Dev	5

Source: CLSA Asia-Pacific Markets

The awareness of Hong Kong firms on climate change and environmental issues range quite a bit as reflected in the C&G scores, which were from zero to 95%. The two large international banks listed in Hong Kong, HSBC and StanChart, come out at the top, followed by companies in transport and power, for which emissions are an issue globally and these companies in Hong Kong are more sensitive on the impact of their businesses on the environment.

C&G issues are no more or less relevant to, for instance banking, than it is for other businesses. That does not stop companies like HSBC and Standard Chartered taking the issues of greenhouse gas emissions and climate change seriously - and coming out with the highest scores for this section.

HSBC has a Carbon Management Task Force;

HSBC came in with the highest score among the companies we surveyed for Hong Kong on the C&G score. The commitment of the bank on climate change comes through in the response provided in the survey. The bank has set up a Carbon Management Task Force spearheaded by the Group Chief Executive, Stephen Green. It made a decision early on to involve external experts like ICF Consulting and The Climate Group to assist in determine the best way to achieve its goals. In 2005, the bank set a target to reduce carbon-dioxide emissions by 5% by this year and is on target to achieve this.

The bank has set target to reduce CO_2 emissions by 5% within two years

HSBC has also contracted to purchase verified emission reductions (VERs) to offset its CO_2 emissions. The VERs, sourced from several renewable energy projects in China and Thailand were evaluated and selected based on their credibility, cost-effectiveness and sustainable development benefits. HSBC encourages all its suppliers and contractors to adopt environmental business practices by stipulating environmental criteria in tenders and supplier contracts. The group incorporates environmental considerations into credit and risk assessment of customers, and expect borrowers to undertake to comply with legal and regulatory environmental requirements. It has issued a series of sustainable lending guidelines on sectors with potentially high environmental or social impacts including forest land and forest products, freshwater, infrastructure, chemicals and energy sectors.

HSBC underscored its priority on environmental issues by appointing Nicholas Stern, former World Bank chief economist and author of the recent report of the British government on climate change, as special advisor to the Chairman.

StanChart set target to reduce CO_2 emissions associated with air travel

Standard Chartered has set up a Corporate Responsibility and Community Committee, which is appointed by the Board and chaired by the group chairman with membership including the group CEO, as well as several non-executive directors, which has overall responsibility for the bank's approach to sustainability, including environment strategy. The group set a two-year target to reduce CO_2 emissions associated with air travel and electricity consumption by 10% per employee on 2006 levels. Through renegotiating electricity supply contracts for London offices it has increased the proportion of electricity derived from renewable sources from 17% of its UK electricity consumption in 2004-05 to 63% in 2005-06. All UK offices where it has sole control over electricity supply now use electricity generated from renewable sources; these four offices which used a total of 5.35GWh electricity last year, equating to a reduction of 2,500 tonnes of carbon emissions in 2006. Chairman Mervyn Davies is a participant in the UK Corporate Leaders Group on climate change.

Cathay has improved fuel efficiency . . .

Cathay Pacific is among the top scorers in our C&G survey, which may at first seem surprising. In 2006, Cathay Pacific burnt 3.6m tonnes of fuel resulting in 11.3m tonnes of CO2 emissions. The aviation industry however is estimated at accounting for 2% of man-made CO2 emissions globally, representing 13% of the emissions from the transport sector. However, with various fuel-saving initiatives Cathay has improved overall fuel efficiency by 10.8% relative to ATK (ie overall capacity) and 19.9% relative to RTK (ie traffic volume) in 2006. Freighters have been stripped bare of most of their paint to give instead a new polished look that makes a Boeing 747 about 200kg lighter. This reduces fuel usage by approximately 600 tonnes per year and CO2 emissions by over 1,800 tonnes across the freighter fleet.

. . . its 2006 CSR report verified by AsrIA

New aircraft are being ordered e.g. the Boeing 777-300ER which are up to 24% more fuel efficient than existing fleet. Lighter, more durable cargo containers are being introduced which is estimated would save 2,730 tonnes of fuel and reduce CO2 by 8,500 tonnes per year. The airline has also succeeding in improving its routing over mainland China for flights to/from Europe which on an annualised basis is estimated to save 4,800 tonnes of fuel and over 14,000 tonnes of CO2. Cathay also states it fully supports the fuel efficiency goal of a 25% improvement between 2005 and 2020 established by the International Air Transport Association (IATA). Its 2006 report corporate social responsibility report with data on emissions and efficiency was verified by the Association for Sustainable and Responsible Investment in Asia (AsrIA).

While the impact of burning fuels is a major contributor to greenhouse gas emissions, airlines regulators in Europe are already dealing with the issue and any international airline with significant revenues from European routes will need to put in measures to be seen proactively monitoring and reducing emission of carbon. Cathay's high score, and that of for instance the power companies e.g. CLP and HK Gas, does not signify that they are cleaner than other companies - but that they have already started to deal with the carbon footprint of their business activities to reduce if not minimise the impact of their operations on the environment.

CLP has received approval to register a Guangdong project as CDM project

CLP has introduced nuclear power and natural gas to its power generation since the 1990s thus reducing total emissions of NO2 by 79%, SO2 by 56% and particulates by 76% while increasing total electricity output by 82%. In 2006, its Hong Kong power stations saw a reduction of over 20% in both SO2 and particulates and a reduction of 10% in NOx resulting from increased use of ultra low sulphur coal at the Castle Peak Station. The group has received approval to register a Guangdong Nanao wind project as a Clean Development Mechanism (CDM) project and started the process of formal validation audit by a UN designated entity for another 4 projects. Its main initiative going forward is a plan to build an LNG terminal in Hong Kong by 2011, which is subject to government approvals. LNG has practically no SO2 emissions and is the clearest fossil fuel available. CLP's target is to increase the use of gas to 50% of its fuel mix. Meanwhile, work is underway to retrofit its Castle Peak Power Station with emissions control facilities which will reduce SO2 emissions further. In August 2007, CLP also announced a US$125m investment in a 100 MW wind power project in India, the group's biggest and first wholly-owned wind farm to date.

Meanwhile **HK Electric** took the typical HK corporate approach and declined to respond to our C&G survey.

HKG efforts to improve feed stock

HK Gas in 2004 became the first commercial organisation in HK to replace air-cooled condensers with water-cooled evaporative chillers, saving over 500,000 kWh at their North Point headquarters. Total greenhouse gas emissions of 391,062 metric tonnes of CO2 equivalent for the group in 2006 was down 6.7% from the year before. Its landfill gas project will pipe the treated gas to partially replace naphtha as a fuel for town gas production by mid-2007. The group has also introduced natural gas as partial feedstock replacement for naphtha. The change in feedstock mix is estimated to reduce overall emissions of CO2 by 26%, SOx by 40% and NOx by 42%.

Measures by MTRC and Swire as well

The **MTRC** has installed a chopper system and replaced traditional motor alternators with solid state inverters which have improved energy efficiency by 17% and 10% respectively. Individual cars air conditioning is managed by a weight cell to adjust the temperature according to passenger-load. Platform screen doors also help reduce air-conditioning cost by 10%.

Swire's investment portfolio in HK comprises a total of 1.16m m2 of gross floor area (office, retail and residential). After implementing an energy saving programme, a saving of 11m kWh of electricity per year was achieved in 2005 compared to 2002 which resulted in a 5% saving on their electricity bill of HK$250m.

But overall low response rate on C&G from HK corporations

While some of the companies in HK are aware and responding to climate change issues, disappointingly 62% of the 64 companies we cover in HK did not respond to our C&G survey or responded only to say the issues were not relevant to their business. A larger sample of HK companies would probably have had a bigger percentage that is not yet sensitive to climate change issues, even though pollution has become a major issue for the territory. The pressure for corporate to be more responsible in this regard will have to come externally and may yet take a while to become part of HK corporate culture.

Voting by poll

69% of companies vote by poll at AGM/EGMs

In this year's CG survey we have also reviewed the notices of annual general meeting (AGM) resolutions to see how many of these carry out the vote during AGM/EGMs (extraordinary general meetings) through a poll rather than the usual practice of a show of hands. From our sample of Hong Kong companies under coverage, 44 of the 68 (69%) did conduct their votes now by poll. While we did not survey the companies on this issue in our last 2005 report, our impression is that companies in Hong Kong have become more sensitive to the issue of voting by poll and thus more companies are now conducting the vote at AGM/EGMs by poll than previously.

As a rule, companies that do not vote by poll are also among the lower ranked for overall corporate governance by our scoring. Of the 20 companies under our Hong Kong coverage, only five were in the upper half of our CG scoring. That is, three-quarters of the corporations that did not vote by poll at AGM/EGMs were also companies in the lower half of our CG ranking for the market, as shown in the table below.

Most that did not vote by poll are in lower half of our CG rankings

Figure 4

Companies that do not vote by poll

	CG quartile
Solomon Systech	1
Techtronic Industries	1
Johnson Electric	2
I.T Limited	2
Ports Design	2
Hopewell Holdings	3
Sim Technology Group	3
Tongda Group Holdings	3
MTRC	3
Hopewell Highway Infrastructure	3
First Pacific Company	3
Neo Neon	4
Lifestyle	4
Kingboard Laminates	4
NWS Holdings	4
Kingboard Chemical	4
Hutchison Whampoa	4
Midland	4
Foxconn International Holdings	4
Regal Hotels Int'l	4

Source: CLSA Asia-Pacific Markets

Directors' remuneration

On average directors got 3% of net profit

On average, by the companies in our coverage, directors got 3.0% of net profit for FY06. By and large, bigger companies pay their directors a smaller percentage of overall earnings; while smaller companies pay their directors less in absolute terms but as a percentage of earnings it tends to be higher.

Among our coverage, companies that pay the directors the most as a percentage of earnings are shown in the table below. For HTIL, FY06 was the first year of profit and on a low base on net earnings, the directors remuneration of US$5.7m works out to 26% of earnings, which does not necessarily reflect the remuneration being out of line.

High % of net profit for those where earnings just turning positive . . .

. . . or had a bad earnings year

Figure 5

Companies with directors' remuneration at highest % of net profit

	Directors' remuneration as % of net profit	**Has directors' remuneration risen faster than net profit over the past five years?**
HTIL	25.9	na
Rexcapital	17.7	No
Solomon Systech	13.3	Yes
Giordano	9.0	No
Regal Hotels	8.1	Yes
PCCW	7.3	No
Kingboard Chemical	7.0	No
Shangri-La Asia	6.4	Yes
Shun Tak	6.0	No
Sa Sa	5.5	No

Source: CLSA Asia-Pacific Markets, company reports

Rexcapital last year turned around to a small profit on which its directors remuneration of HK$5.5m (US$700k) represented 18% of earnings. In the case of Solomon Systech, earnings for FY06 fell 71%, but directors' total compensation went up 15% mainly owing to the value of options and shares vested the value of which doubled, although discretionary bonuses for directors were reduced 61%. Similarly Regal's high figure for remuneration for directors is largely due to marking to market the value of options issued earlier; this more than doubled the value of share option benefits to directors and increased overall directors emolument by 46% YoY

Large slice of earnings to directors for some of the small caps

Note that some of the smaller companies have slipped out of core coverage but also pay their directors a fairly large slice of earnings, as much as 26% for Linmark and Oriental Press, 15% for Texwinca and 12% for Fountain Set.

At the other extreme, HSBC pays its directors just 0.1% of earnings, similar to BoC-HK and Hang Seng Banks directors get 0.2%. Directors of property giant SHKP don't get much more at just 0.3% of the group earnings.

The large banks only give directors 0.1% of earnings

Figure 6

Companies with directors' remuneration at lowest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
Sino Land	0.4	Yes
SHKP	0.3	Yes
Chinese Estates	0.3	No
Midland	0.3	No
Smartone	0.2	No
Hang Seng Bank	0.2	No
Foxconn International	0.2	No
HSBC	0.1	No
I.T Limited	0.1	Yes
BOC HK	0.1	Yes

Source: CLSA Asia-Pacific Markets, Company reports

Changes in CG scores

Comparison of overall CG score with 2005 not meaningful

Because of the change in the questionnaire a year-on-year comparison on the overall CG score is not meaningful. The Clean & Green survey now represents 10% of the overall score, a major change replacing the six questions on social and environmental responsibility that we had in our 2005 survey. The other change is the addition of two questions in the accountability sub-score, on whether companies vote by poll and how quickly after AGMs and EGMs they post the notice of the decisions and vote at the meetings.

Average change in score is just 0.3% for HK sample

However to indicate the overall direction in CG over the last two years, we compared the scores for the 54 questions that we had in the previous 2005 CG survey which are also in this year's scoring. In essence, taking out the score for C&G and questions 38 and 39 (the two new questions), we compared the score for companies sampled this year and in 2005. We find that on average the score has reduced by 0.3% pts, not a material change.

To note, there were slightly more companies that had a higher score on the comparable questions (21 of the 46 companies that were scored for both 2005 and this year) than there were companies that had a lower score (18 companies). Seven companies had no change in their score for comparable questions with 2005. Of the 46 companies surveyed this year and in 2005, 26 (ie 57%) had a score within 3% of the score in 2005 for the comparable questions, i.e. for more than half of the companies surveyed in 2005 and 2007, the net change in score on comparable questions was not significant.

Bigger changes in scores were on the downside

Although there were more companies that had a higher score than in 2005, the bigger changes in scores however were on the downside. Next Media had the biggest change in score; as described above a placement that was followed by a very disappointing set of interims raised issues on management's guidance and integrity over the placement. The effect in our scoring of similar questions is a 20.7 point reduction in the score for Next.

Six other companies had declines of between 5% to 7.5% in their scores for comparable questions. In some instances this is owing to more stringent scoring, e.g. on whether the companies specifically state that they rotate their auditors or the audit partner at least every 5 years. A number of companies had positive points for increasing the number of independent directors in the 2005 scoring, but did not score for continuing to increase independent directors on the board over the three years to 2006.

Minor decline in scores for stricter scoring and where improvement has stalled

Thus the decline in scores for most of the companies with minor reductions in CG score is mainly owing to more stringent scoring and a change in the dynamics of whether improvement has continued.

Biggest score change for Next Media

Figure 7

Companies with changes in CG scores: 2005-07

	Chg in CG score (ppt)	2005 quartile ranking
Dah Sing Banking	5.6	3
Kerry	5.4	2
Swire	5.3	1
HK Land (US$)	5.3	3
Sa Sa	5.1	1
Hopewell	(5.6)	3
New World Dev	(6.3)	4
Hopewell Highway Infrastructure	(6.6)	3
Standard Chartered	(6.6)	1
Kingboard Chemical	(6.8)	4
Hutchison Whampoa	(7.5)	4
Next Media	(20.7)	4

Source: CLSA Asia-Pacific Markets

Improvements in scores were not major

Only five companies had improvements in scores of more than five points; for all of these the increase were in the range of 5.1 to 5.6%-points, i.e. the improvements in scores for these companies were not major. For property companies, the previous Hong Kong accounting standard of revaluing investment properties and including that in the P&L statement used to be an anomaly in the presentation of HK accounting standards but has now become an international norm, leading to slightly higher scores for most of the property names. Some of the companies have increased the number of independent directors (eg, Dah Sing Bank), others have shortened the time from end of their financial period to reporting the results (eg HK Land) and others have introduced the committees under the board (remuneration/nominating) which also increased their score (eg, Sasa).

Qarp stocks 2005

2005 Qarp stocks for HK outperformed significantly

The Qarp stocks selected for Hong Kong as at mid-2005 on average performed very well when compared against the overall market. In the two years to end of June 2007, MSCI-HK rose 37% but the five Qarp stocks selected for HK increased an average of 114%. As usual, this performance was driven by one or two stellar performances. Ports Design, in particular, was the key stock that drove the performance, up 289% for the two years while OOIL also performed strongly rising 125% in the same period.

Ports Design and OOIL were major outperformers among 2005 Qarp picks

For Ports, this was owing to momentum at its high end retailing business in China that the market has been willing to pay up for and with the valuation multiple also increased as the market cap got larger. Having doubled in the past two years, it now has a market cap of US$1.5bn and trades at a forward PE of 27x not dissimilar to other PRC retailers. OOIL's share price was strong in 2006 as it sold non-core terminals in North America, recognising an extraordinary gain of US$1.95bn. From the US$2.3bn proceeds, the company paid out 21% or US 80 cents per share special dividend.

As major moves in stocks are usually the result of beating expectations, these two examples signify the likelihood of better managed companies - picked out by our Qarp criteria - to come out with positive surprises.

HSBC was the main underperformer of the 2005 Qarp picks

Two of the other Qarp picks also did well, StanChart and Wing Hang. StanChart's stock performance was driven by generally strong performance across the emerging market countries that it operates in but also higher than expected contributions from Korea where it had recently made a major acquisition. Wing Hang is a high ROE bank with its stock performing strongly on the back of being a potential M&A target for any international bank looking for a strong footprint into Hong Kong as well as Macau. HSBC was the sole Qarp pick in 2005 for Hong Kong which underperformed, dragged by sub-prime woes in the US that has held the stock down particularly in 1H07.

2005 Qarp picks offered average two-year 114% return versus 37% for MSCI-HK

Figure 8

Performance of 2005 Qarp picks

Company	CG Quartile	ROE 04-05 (%)	Share price Jun 05 (HK$)	Share price Sep 07 (HK$)	Performance (%)
Orient Overseas	1	15.0	34.00	76.40	124.7
Wing Hang Bank	1	14.0	50.75	86.45	70.3
StanChart	1	14.0	144.50	250.80	73.6
HSBC	2	12.0	125.00	142.50	14.0
Ports Design	2	10.5	5.65	22.00	289.4
Average return of Qarp stocks					114.4
MSCI HK two-year return					37.3

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

Qarp picks 2007

Our current Qarp picks are once again determined by those companies with CG above average for the market (ie with a CG score in the top two quartiles), with ROE above cost of equity and the theoretical PB by the Gordon growth model showing at least 10% upside to theoretical value against the current PB valuation of the stock by the market.

We use 9.5% COE for HK

We use a cost of equity of 9.5% for the market, derived from a 5% risk-free rate (close to the current yield on the US 10-year bond) and 4.5% market equity risk premium with 4% being the international risk premium (as derived by recent studies in the US) with 0.5% ascribed for Hong Kong's country/currency risk. The ascribed growth is the estimated long-term *nominal* growth for the respective companies for which we use a range between 3.5% to 6%. Theoretical PB is determined using the Gordon growth model and that is compared against the current market PB valuations to get the theoretical upside as shown in Figure 9 below, where the stocks are sorted by theoretical upside by this formula.

Small-cap I.T has highest theoretical upside among HK Qarp stocks

I.T Limited, a small-cap retailer in Hong Kong with ambitions in China but which has todate been largely ignored by the market comes out with the highest upside of our four current Qarp picks. It generates an ROE of 19.5% and we have factored in a long-term nominal growth of just 3%.

StanChart and Hang Seng Bank also emerge as Qarp picks

Of the larger caps, we have two banks among the Qarp picks. We use 5% long-term nominal growth for StanChart's Qarp valuations, given its growth potential in emerging markets as well as developed countries like Korea where it has only just started to build out; this gives 13.5% upside to theoretical value for the bank currently trading at 2.2x book value. For Hang Seng Bank we use 4% long-term growth to take into account some growth to come from its expansion into China.

L&M Paper makes it to Qarp list with high 6% long-term nominal growth

We use a relatively high 6% long-term nominal growth for Lee & Man Paper given the aggressive growth over the coming years. Quite likely, there will be further growth opportunities as it goes upstream for its corrugated paper manufacturing operations and also through expansion of production facilities in Vietnam. This gives 11% upside to theoretical value for the stock.

Figure 9

Qarp list: September 2007 valuations

Company	CG Quartile (1-4)	Avg ROE 07-08 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
I.T Limited	2	19.5	9.5	3.0	2.6	1.7	46.2
Standard Chartered	1	16.3	9.5	5.0	2.5	2.2	13.5
Lee & Man Paper	1	24.6	9.5	6.0	5.3	4.8	11.1
Hang Seng Bank	2	28.5	9.5	4.0	4.5	4.0	10.6

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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India - Impact of large acquisitions

Some of the leading companies in India witnessed large declines in CG scores this year on account of large acquisitions done at significant premia to market values, among them, Tata Steel, Hindalco, Dr Reddy's, Ranbaxy and Wockhardt. Some of these companies did not share adequate information to enable investors to assess the impact of these acquisitions. HCL Infosystems witnessed the largest drop in CG in our universe on the back of promoters selling shares ahead of a substantial negative announcement.

Infosys, Bharti, Wirpo, HDFC and HDFC Bank are top CG companies

Infosys continues to be the undisputed leader in terms of corporate governance in India and scoring among the highest in Asia. It leads the runner-up in India by a wide margin. Bharti Televentures has seen a substantial improvement in its CG score and ranks second in our CG ranking. The other companies among top five are Wipro, HDFC and HDFC Bank.

Infosys, ITC, Suzlon, Tata Steel, HLL are top scorers on Clean & Green score

Infosys and ITC lead the pack on C&G score with both companies scoring 70%. Suzlon, Tata Steel and HLL are the other companies among top five scorers. The awareness of environment issues is rising in the country. The government has constituted a separate Ministry for New and Renewable Energy Sources. This had enabled India to emerge as the world's top five countries in terms of installed wind power generation capacity. However, a lot more needs to be done to spread the awareness about environment consciousness.

India's macro CG ranking stays third behind Hong Kong and Singapore

ACGA's score for India's macro CG factors has moved down somewhat partly as a result of tightening scoring methodology, with the addition of extra questions. A greater focus on practices, not just rules, has also brought down the score for most markets. However India remains third in the overall CG rankings of markets in Asia, behind just Hong Kong and Singapore.

Our 2005 Qarp picks offer 14% more return than the market

The average return offered by our two Qarp picks of 2005 is 88% over two years, versus MSCI India return of 102%. The better performing Qarp pick, Concor, rose 154% over this period while the other, HCL Infosystems was up just 20% over the two years. Interestingly, HCL Infosystems poor return is related to a CG mishap which has taken its CG ranking from first quartile to third quartile for our India universe.

HLL, Grasim this years Qarp picks

This year, our Qarp picks are HUL and Grasim. HUL is one of the top scorers in our CG and C&G rankings, generates an ROE of 78% RoE and the Qarp model suggests 10% upside to theoretical value. Although the 75% theoretical upside to Grasim does reflect some distortion as a result of high commodity prices boosting FY08-09 ROE, we note that even with 13ppt fall in ROE from current levels, Grasim's theoretical PB will be higher than the current FY08CL PB.

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Country CG score

Although progress continues to be made in India's corporate governance regime, its macro score is slightly lower in this edition of "CG Watch" for several reasons. First, a further tightening of our scoring methodology, the addition of extra questions, and a greater focus on practices (not just rules) has brought down the overall score for most markets. Second, while the capital market in India has a sound base of rules and regulations on paper, there remain weaknesses in implementation and enforcement (as in all markets). And third, evidence suggests that regulators are having a hard time keeping pace with the increased workload generated by India's booming economy and stock market. Infighting among factions of the ruling coalition, ministries stepping on each other's toes, and companies chaffing against "too much regulation" all erode the force of regulatory initiatives and new laws.

Overall macro score for CG reduced by five points

Figure 1

India ratings for macro-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	59	66	Focus on practices reduces the score.
Enforcement	38	56	Lowered score on enforcement with tougher criteria in this year's scoring
Political & regulatory environment	58	65	Score slightly lowered
Adoption of international accounting/auditing standards	75	75	Unchanged score for accounting/auditing
Culture	50	43	Higher score for greater awareness of companies towards CG
Overall score	**56**	**61**	

Source: ACGA, CLSA Asia-Pacific Markets

Amendments to Listing Agreement

Despite this difficult political context, it is possible to be positive about India's direction of corporate governance. Regulators are pushing listed companies to improve their governance practices through amendments to the Listing Agreement. A soon-to-be-announced new Companies Act will strengthen the basis for shareholder rights and the judicial system in India. The Ministry of Corporate Affairs is dragging itself into the new century and trying to clean up its act with a far-reaching plan called MCA-21. And the improved score in this survey for "CG Culture" reflects greater awareness on the part of companies towards corporate governance, as well as the expanded involvement of shareholder groups and business associations in the reform process.

Clause 49 - Box-ticking bonanza

Quarterly box-ticking for companies

The revised Clause 49 issued by the Securities and Exchange Board of India (SEBI) became effective for all listed companies as of 1 January 2006. Intended to help companies pursue corporate governance practices in spirit, it has been more of a box-ticking exercise to date: companies need only fill out quarterly compliance reports to the stock exchanges.

Clause 49 was initially introduced in February 2000, when SEBI revised its Listing Agreement to incorporate the recommendation of the country's new code of corporate governance, produced by the Birla Committee in late 1999. It took effect in phases over 2000-03. Key recommendations included:

- Both executive and non-executive directors to make up board of directors, with not less than 50% of the board comprising non-executive directors.
- Independent directors to make up at least half of the board if the chairman was an executive director; or at least one-third in the case of a non-executive chairman.
- A qualified and independent audit committee with a minimum of three members, all of whom should be non-executive directors, with the majority being independent.

Amendments to Clause 49 in 2004

In October 2004, SEBI introduced a revised version, following the recommendations given by the Narayana Murthy Committee in February 2003. Major changes in the clause included:

- Amendments/additions to provisions in relation to definition of independent directors.
- Strengthening the responsibilities of audit committees.
- Requiring the board to adopt a formal code of conduct.

The first quarterly compliance report for the revised Clause 49 was to be on 30 June 2005. However, in March of that year the regulator extended the date to 31 December 2005, because many companies complained they could not meet the original deadline.

SEBI has not penalised companies not complying with revised Clause 49

By November 2006, more than 90% of the companies listed on the National Stock Exchange (NSE) and between 60-65% of companies on the Bombay Stock Exchange (BSE) were complying with the revised Clause 49. Yet SEBI had not penalised those firms not complying, arguing that the rules were new and it would take time for both the companies and the regulator to get used to them. If non-compliance continues, however, it is likely that one or two of the larger transgressors will be taken to task to send a message to the market.

CG grading for IPOs . . .

Although lagging in the enforcement of its own rules, SEBI has found innovative methods to try to improve investor protection. In May 2007, it introduced mandatory corporate governance grading for all new initial public offerings (IPOs) - the first market in the world to do so. This process includes validation checks, where necessary, with what is heard in the market; plant visits, where required; meetings with company top management, the CEO and independent directors. The IPO grading team would prepare a report and submit it to the IPO grading committee to deliberate and assign the grade.

. . . but seen as unsuccessful experiment

While IPO grading had been a voluntary exercise for more than a year, SEBI deemed the experiment unsuccessful since few companies availed themselves of the option. Those that did fared poorly. SEBI says the grading is not a recommendation to buy shares (or not) in a new issue, but is rather a way to help investors understand the fundamentals of the business and whether a firm's governance is good or bad.

MCA-21: Sending in the cleaners

Constitutional tangle over proposed National Company Law

The Ministry of Corporate Affairs (MCA) has spent much of the past two years finalising the draft of a new Company Law, which it had hoped to present to Parliament during the winter 2006 session. The process has been delayed, however, with end-2007 the earliest date now for a first reading. MCA, meanwhile, is in a legal battle with lawyers who claim a proposed National Company Law Tribunal, one of the key ideas in the new bill, is unconstitutional. The matter currently sits before the Constitution Bench of the Supreme Court, where it is expected to languish for some time.

Companies (Amendment) Act however passed in 2006

On a more positive note, MCA scored a victory last year with the passing of the Companies (Amendment) Act 2006. This ushered in an e-governance initiative called "Ministry of Company Affairs in the 21st Century" (MCA-21), a programme designed to weed out deadwood within the ministry's bureaucracy and create a new world of operating efficiency. Key highlights included:

- Introduction of a director identification number (DIN), a unique identifier for all existing or future directors, containing personal information.

- E-filing of almost all events stipulated in the Companies Act, including inspection of documents and annual filing/registration of a company, thereby minimising corruption. Liquidation-related filings excluded.
- Authentication of documents by digital signature.

According to the Ministry, the initiative also means that only 20% of its manpower is needed for paper filing and registration, freeing up its remaining workforce for compliance and enforcement work.

Amendments to company law required before full adoption of IFRS possible

Convergence with Indian characteristics

Last year (2006) also saw the Institute of Chartered Accountants of India (ICAI) form a committee to create a roadmap for the convergence of Indian accounting standards with International Financial Reporting Standards (IFRS) by 2008. However, amendments to Indian company law and the regulatory environment will be required before full adoption of IFRS is possible. For example, IAS 21, which deals with foreign exchange rates, violates Schedule VI of the Companies Act, 1956, which requires fluctuations in the exchange rates of foreign currency loans raised to acquire foreign assets to be reflected in the cost of the fixed assets. IAS 21 only requires the same to be charged to the profit and loss account. To get around this problem, the corresponding Indian accounting standard prescribes the accounting treatment contained in IAS 21, but through a separately issued ICAI announcement the local company law prevails.

July 2007, the ICAI Council agreed to fully converge with IFRS standards on or after 1 April 2011, citing the need to take up the matter of convergence with the government and other regulators such as the Reserve Bank of India and SEBI as well as train Indian accountants to effectively adopt and implement IFRS standards.

SEBI, meanwhile, formed a committee on disclosures and accounting standards in 2006 to advise on disclosure requirements for listed companies and to facilitate the implementation of ICAI accounting standards as they relate to the capital markets.

New code for state enterprises in June-07

Public-sector reform

Not to be left behind, the Ministry of Heavy Industries & Public Enterprises issued a new code for state enterprises in June 2007, Guidelines on Corporate Governance for Central Public Sector Enterprises. While the code is voluntary, all central public sector enterprises (CPSEs) are expected to follow it and the ministry will grade them on the basis of their compliance. Listed CPSEs must comply with these guidelines in addition to fulfilling Clause 49 provisions.

Key areas covered by the guidelines include: composition of the board of directors; setting up of audit committees, their roles and powers; issues relating to subsidiaries; disclosure; accounting standards; and risk management. The guidelines have been issued on an experimental basis for a year, after which improvements will be made 'in the light of experience gained'. The government wants more CPSEs to enter the capital market and it hopes that these guidelines will ensure that proper corporate governance practices are in place to provide 'appropriate public accountability'.

Top-tier companies show willingness to advance governance reforms . . .

India, with its varied problems, remains unique in Asian corporate governance terms in certain respects. It was the first country in the region to produce a detailed code on corporate governance in early 1998 (a document created by business, not government) and the only place where business provided the first real impetus for reform (driven by a desire to compete internationally following the economic opening of the early 1990s). As a result, many of its top-tier companies have shown a willingness to advance governance reforms voluntarily - and to a far greater degree, generally, than their counterparts in the rest of the region.

. . . but are a small percentage of the nearly 9,000 listed companies

But these achievements need to be put in context. In a country that boasts nearly 9,000 listed companies, 50 to 100 well-governed firms remains a small percentage of the total (albeit a large percentage of market cap). Corruption, the wielding of clout by some large companies, and political interference continue to stymie the efforts of regulators to act. And there remains a worrying penchant among Indian entrepreneurs for adopting the latest business buzzword and fad. In these respects, the country looks very much like everywhere else.

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Corporate CG issues over the past two years

Since our last CG report, various CG issues have surfaced with the corporations. Some are cases of insiders selling of shares before announcing negative corporate developments, but the main issues revolved around M&A.

Alembic Glass acquired land in Bangalore which appreciated a lot . . .

Alembic Glass, a manufacturer of glassware, had acquired 150 acres of land in Bangalore's Whitefield area (near the new international airport) to start a new plant. However, due to operational issues the plant could not commence operations. Meanwhile, Whitefield emerged as prime commercial area and the value of the asset rose manifold.

. . . promoters decided to merge the company with a loss-making private firm

Given the high value of this land, promoters, who held 71% in the company, decided to merge the company with a loss-making privately held group company Shreno and then to delist Alembic Glass. But the value assigned to Alembic Glass ignored the value of the land, resulting in the shares of Alembic Glass plunging by 40%. Minority shareholders have complained to the Securities and Exchange Board of India (SEBI) that the restructuring plan has been against the interests of minority investors.

Promoters sold stock before negative announcement

The largest drop in the CG ratings of the companies under our coverage has been for **HCL Infosystems**. The company's changed agreement with Nokia was the subject of much controversy in early 2006, as one of the promoters, HCL Corp (owned and controlled by Shiv Nadar) reduced its stake in HCL Infosystems in the run-up to the announcement. The announcement was detrimental to HCL Infosystem's business and the share price plummeted after the announcement.

Pharma companies did not share sufficient details on their acquisitions

A number of CG issues arose following large M&As in India during the past year where details about the acquired companies were somewhat lacking. Acquisitions by Pharma companies such as Betapharm by **Dr Reddy's**, Terapia by **Ranbaxy**, Pinewood and Negma by **Wockhardt** are material in size and significantly impact overall profitability, balance sheet ratios and valuation. However, not enough information has been shared with investors, which has precluded objective analysis of the impact of these acquisitions. Capital raisings, often at near peak levels is another reason for CG rating drop for pharma companies.

Wockhardt - quality issues

There were quality issues in the Insulin vials sold by Wockhardt during 4QCY06. The contents of the vials were not effective. Wockhardt was asked by Maharshtra FDA to take the product of the shelves. Investigation is going on currently. Workhardt is also facing law suits from a few patients. Wockhardt also received a 483 warning letter from US FDA for its cephalosporin plant.

Infosys continues to be the highest CG scorer by a wide margin

Shoppers Stop and UTI Bank are the mid caps in first quartile

Bharti's CG score has improved substantially

BHEL and NTPC are the two PSUs in first quartile

Figure 2

Companies in the top-two CG quartiles for India (CLSA coverage)

Top quartile	Second quartile
ABB	Asian Paint
Bharti	Cipla
BHEL	Concor
Biocon	Crompton Greaves
Colgate-Palmolive India	HCL Technologies
Glaxo India	Hexaware Technologies
Grasim Industries	ICICI Bank
HDFC	ITC
HDFC Bank	L & T
Hero Honda	Nestle India
Hindustan Lever	Patni Computer Systems Ltd
Infosys	Ranbaxy
NTPC	Satyam Computers
Shopper's Stop	Shriram Transport Finance
Sun Pharmaceuticals	Suzlon
TCS	Tata Motors
UTI Bank	Tata Power
Wipro	Tisco

Source: CLSA Asia-Pacific Markets

Hindalco was silent on Novelis merger for a long time

Hindalco acquired loss making Novelis during FY07. The acquisition value for Novelis was 80% of Hindalco's market cap at that time and the acquisition price was at a 57% premium to Novelis' previous three month average trading price. However, Hindalco did not share details about Novelis, which would allow analysts to assess the impact of the acquisition, for next few months, citing confidentiality agreements with Novelis. The company did not share much data about Novelis even during the analyst meet held after acquisition.

Hindalco and Tata Steel penalised for mergers at aggressive prices

This was in contrast to **Tata Steel**, which held an analyst meet soon after acquiring Corus and shared data with the analysts. In our CG rating both Tata Steel and Hindalco have suffered reduction in CG score on account of making large acquisitions at substantial premium to market prices of acquired companies. The returns on investment on these acquisitions are likely to be relatively low (in the case of Tata Steel's Corus acquisition the near term RoE could be high because of the subsequent increase in steel prices). Stock prices of Hindalco and Tata Steel fell sharply on announcement of these acquisitions. The decline in CG score of Hindalco is higher because of the lack of disclosures after the acquisition.

Aditya Birla Nuvo - swap ratios favoured promoters

In FY06, **Aditya Birla Group** merged group companies Indo Gulf and Birla Global Finance with Indian Rayon. The merged entity was renamed Aditya Birla Nuvo. While determining swap ratio for merger the companies with higher promoter holdings were valued at premium to the market price. The promoters' stake in Birla Global Finance was also raised to 75% through a preferential allotment to promoters at a steep discount to the valuation used to fix swap ratio, a few months before the merger.

Clean & Green survey

Infosys and ITC are top scorers in Clean & Green survey

Another change in our CG scoring is the introduction this year of C&G scores to replace the previous score for social and environmental responsibility. 83% of the companies under our coverage responded to our C&G survey. Infosys and ITC have the highest scores for Clean and Green Survey followed by Bharti, Suzlon and Reliance Energy.

Infosys details its energy consumption and GHG emissions

Per capita energy consumption down 3% YoY

Infosys devotes a substantial part of its annual report disclosures on environmental issues. There is a quantification of energy needs - for example, 45% of Infosys' energy needs go towards chillers and air conditioning, 35% for UPS systems, and 10% for lighting. Infosys has targets for per capita reduction of energy consumption - this was down 3%YY in FY07. Infosys is also focused on reduction of GHG emissions - 43% of its GHG emissions last year came from power consumption, 21% from travel, 28% from fuels and 8% from air conditioning chillers. 292kilotonnes of GHG emissions were quantified by Infosys in FY2007. The company is also ISO14001 certified.

Top scores: Infosys, ITC

Lowest scores: Gail and ONGC

Figure 3

Clean & Green scores

	(%)		(%)
Infosys	70	HCL Info	30
ITC	70	Shriram Transport Finance	30
Suzlon	65	HDFC Bank	30
Tata Steel	65	ACC	30
Hindustan Lever	60	TCS	30
Reliance Energy	55	Reliance Capital	30
CESC	55	Concor	30
Glaxo India	50	Hindalco	30
Reliance Industries	50	Mastek	25
Tata Motors	50	HDFC	25
Biocon	45	Polaris Software Lab	25
Bharti	40	Hexaware Technologies	25
Cipla	40	Patni Computer Systems	25
Ranbaxy	40	HCL Technologies	25
Grasim Industries	40	IOC	20
VSNL	40	State Bank of India	20
L & T	40	Bank of Baroda	20
BHEL	40	Colgate-Palmolive India	20
Hero Honda	40	Maruti	20
Wockhardt	35	Unitech	20
MTNL	35	Shopper's Stop	20
Sun Pharmaceuticals	35	Gujarat Ambuja	20
Zee Telefilms	35	HPCL	20
NTPC	35	UTI Bank	20
Tata Power	35	Nestle India	20
ABB	30	BPCL	20
Satyam Computers	30	PNB	20
Wipro	30	Gail	15
Bajaj Auto	30	ONGC	15
ICICI Bank	30		

Source: CLSA Asia-Pacific Markets

Per-capita water consumption down 5% YoY

Last year, Infosys reduced per capita water consumption by 5%YY. All waste water is recycled and treated in Infosys's own sewage treatment plants. No waste water is discharged outside. During FY2007, 2.2million kilo litres (2.2MKL) of water was consumed at Infosys, and 1.6MKL was recycled and used again, mainly for landscaping purposes in campuses. Most development centres are carrying targets of 5-20%YY reduction in paper consumption - Infosys' stated aim is to head towards a paperless office.

The plantations by ITC sequester more CO_2 than total emissions making ITC carbon positive

At ITC all the businesses benchmark their energy performance to minimise CO_2 emissions per unit of production. The company has completed 41,000 hectares of plantations, which sequester more CO_2 than total emissions making ITC a carbon-positive corporation. All the manufacturing units & large hotels of the company are certified in accordance with ISO 14001. Different elements of emissions reduction are built in to "Key Result Areas" of many managers in different businesses at various levels. The company is currently developing a strategy to motivate and include their supply chain in adopting triple-bottom-line approach that would include GHG reduction.

The company reports on triple bottom line performance

Most businesses in ITC are in the growth phase and sustainability is an important criterion in ITC. The company regularly reports on triple bottom line performance. ITC shares Environmental performance highlights with the shareholders. The company also brings out an annual sustainability report, in accordance with Global Reporting Initiative guidelines. The report is verified by PriceWaterhouse. ITC, in association with Confederation of Indian Industry, has launched the CII-ITC centre of Excellence for Sustainable Development, to recognise and encourage sustainability practices in Indian industry.

Being one of the world's largest wind turbine suppliers, Suzlon scores high on C&G score

One of the world's leading wind turbine suppliers, Suzlon scores high on the C&G score. India is today the fourth largest country in the world in terms of installed wind power capacity and the credit largely goes to Suzlon. The company recognised India's wind power potential earlier than global majors and pioneered the concept to commissioning approach for wind power projects in India, which enabled the exponential growth in India's wind capacity. Suzlon is now emerging as a global player and over 80% of its current order backlog is from other countries. The company also generates wind power for its captive use.

REL generates power using wind energy

Reliance Energy is one of the very few companies in the Asia which states it has linked salaries of their director/employee to achievement of reduction in carbon emissions. The company also generates wind power and has placed orders for installing more wind turbines. A couple of years back, Reliance Energy had to a fine for environment violation at its Dahanu unit, which may have been the motivation for the company to take these issues more seriously now.

HLL sets environmental parameters far below the statutory requirements

HLL has made initiatives to promote greater environment responsibility a key business principle. For maintaining this principle, the management committee of the company has nominated environment co-ordinators at each plant and the corporate level, to operationalise various aspects of its environment policy. All manufacturing sites work on five-year rolling targets for achieving planned improvements for various environmental parameters which are set far more stringently than statutory requirements. Some of the key parameters monitored on a daily/monthly basis are energy usage, GHG emissions, water usage etc.

Tata Steel lays tremendous stress on sustainability

Tata Steel can said to be the leader among the manufacturing companies in India in terms of good environment management. Its steel works in Jamshedpur, all its mines, collieries and manufacturing divisions are certified to ISO-14001. Jamshedpur is the only town in the country which has an ISO-14001 certified service provider. Tata Steel issues a sustainability report every year detailing the emissions and the steps taken by the company to help improve the environment. Tata Steel has substantially reduced its energy intensity and raw material consumption ratios over last few years.

HLL's soap manufacturing technology has qualified for carbon credits

Through induction of new technologies the unit energy consumption has dropped by 50% over the past five years, thus reducing carbon emission. The company's has patented a technology for soap manufacturing that has qualified for carbon credits. To spearhead the energy conservation drive the company has constituted an energy board comprising of senior technical experts who guide the plants on future programmes.

Voting by poll

Most resolutions are passed by show of hands

A change in our CG scoring regionally is the introduction of a question on whether companies vote by poll and whether the results of these votes are announced by the next working day. In India, however, most resolutions are passed through show of hands. Voting by poll is done only for special resolutions like mergers and acquistions or if some class of shareholders demand it. However this is not the norm for AGMs/EGMs and is a factor that has reduce the CG scores of Indian corporates somewhat. The two questions are 3% of the overall CG score.

Directors' remuneration

Directors' remuneration in India as % of sales is low be regional standards

Directors' renumeration in India averages around 1.3% of net profits, similar to the regional average of 1%. Government owned entities pull down the average. The directors (including executive directors) for public sector enterprises are among the most underpaid employees in India. managing directors of large companies like ONGC, NTPC, SBI and BHEL are paid lower than middle level employees in many smaller commpanies.

Hero Honda, Polaris, Colgate top the list in directors remuneration

Directors remuneration are a higher share of profits at Hero Honda and Polaris Software followed by Colgate. For these three companies, directors' remuneration has also grown faster than profits over the last five years.

High-remuneration firms see director pay grow faster than profit

Figure 4

Companies with directors remuneration at highest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
Hero Honda	6.8	Yes
Polaris Software Lab	6.8	Yes
Colgate-Palmolive India	6.1	Yes
Bharat Forge	4.5	No
Biocon	4.4	No
Shopper's Stop	4.0	na
Dr Reddy's	3.9	No
HCL Info	3.8	Yes
Cipla	3.7	Yes
Wockhardt	3.7	No

Source: CLSA Asia-Pacific Markets, company reports

Government needs to rethink salaries for public-sector companies

Some of the public sector companies have done remarkably well in business. However, in future these companies could face difficulties unless the government revises its compensation policy for senior officers. With the growth in economy and rapid growth of IT and financial services sector in India, job opportunities have grown substantially. To attract and retain the best talent the companies need to pay attractive salaries. The inability of public sector companies to do so will see them losing employees to the private sector, which is willing to pay multiples of the salary paid by the public sector. Unless the government addresses this urgently, public sector companies are likely to face serious human resource challenges ahead.

Nine out of 10 with low director remuneration are public companies

Figure 5

Companies with directors remuneration at lowest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
BHEL	0.04	No
Nalco	0.04	No
Bank of Baroda	0.04	No
Oriental	0.04	No
Canara	0.04	No
Gail	0.03	No
IOC	0.03	Yes
State Bank of India	0.02	No
NTPC	0.02	No
ICICI Bank	0.01	No
ONGC	0.01	No

Source: CLSA Asia-Pacific Markets, company reports

Changes in CG scores

HCL Infosystems has had the highest drop in CG scores . . .

HCL Infosystems has suffered on CG scoring. The company's changed agreement with Nokia was the subject of much controversy in early 2006, as one of the promoters, HCL Corp (owned and controlled by Shiv Nadar), reduced its stake in HCL Infosystems in the run-up to the announcement. The announcement was material to the business - instead of having exclusive pan-India rights for distribution of Nokia mobile GSM handsets, HCL Info would now own only 50% of the market, with a 12 month transition towards splitting territories in favour of Nokia.

. . . reflected in poor performance of its stock

This event changed the revenue and earnings growth profile substantially, as HCLI derived nearly half of its operating profits and more than two-thirds of revenue from this alliance. The sale by the promoter group was received unfavourably by all investors and the stock has been beaten down ever since, trading materially below its pre-announcement prices even today, despite the rally in the Indian market.

Bajaj Auto's restructuring exercise was complicated

The sharp decline in Bajaj Auto's CG scores is largely driven by the firm's restructuring exercise carried out in May 2007. Besides its core two-and-three wheeler (automotive) business, Bajaj also had two insurance subsidiaries with Allianz (Germany) as well as large accumulated surplus funds.

Shareholders suffered on account of indirect holding in businesses . . .

Instead of opting for a clean de-merger of the two business where existing shareholders would have got proportionate shareholding in new businesses, Bajaj Auto followed a complicated structure. As per Bajaj's scheme, two new companies were formed to house (a) the automotive business and (b) the insurance and investment businesses. The existing listed company would become a holding company which would hold a 30% stake in both companies, as well as retain a bulk of the surplus funds. The remaining 70% stake in these companies will be given to Bajaj Auto (listed) promoters and minority shareholders in proportionate basis.

. . . Bajaj Group retained a high effective -voting right

The demerger failed to unlock full value as the parent company retains 30% holding in these businesses, implying that minority shareholders could suffer a holding-company discount for this holding. This structure also allowed higher effective voting rights to Bajaj Auto promoters. The combined voting rights of Bajaj Auto and Bajaj Auto promoters in the new businesses is 70%, versus the effective financial stake of Bajaj promoters at 45%.

The stock fell 16% over two days after this announcement

Along with the de-merger structure, Bajaj Auto also announced that its insurance joint-venture partner, Allianz, had a call option to increase its stake in their life insurance joint venture from 26% currently to 74% at a pre-determined formula (at par value + annual interest of 16% on the invested capital). The revelation of this call option was a negative surprise which, coupled with the disappointing de-merger structure, triggered a 15% fall in stock within two days of the announcement.

Figure 6

Companies with changes in CG scores: 2005-07

	Chg in CG score (ppt)	2005 quartile ranking
PNB	16.4	4
M & M	16.1	4
L & T	16.0	3
Bharat Forge	14.9	4
State Bank of India	14.5	4
Nestle India	13.7	3
Oriental	13.5	4
Gail	13.2	4
Maruti	11.9	4
Tata Steel	(3.9)	2
Mastek	(6.1)	2
Satyam Computers	(6.5)	1
Hindalco	(7.6)	1
Tata Tea	(8.9)	4
Dr Reddy's	(10.1)	1
Ranbaxy	(10.4)	1
Wockhardt	(11.6)	2
Bajaj Auto	(17.0)	2
HCL Info	(18.8)	1

Source: CLSA Asia-Pacific Markets

Satyam's cash levels have increased and also suffers on C&G score

Other companies with lowered CG scores are Mastek and Satyam. Satyam is penalised in our scoring on account of its dividend policy: high levels of cash have built up in the company, ahead of capex needs. Repeated investor demands for increased dividends have not borne fruit. Satyam scores poorly on the Clean & Green score. While it scored high on social responsibility in the earlier CLSA CG matrix, the replacement of social responsibility with environment focused questions reduces Satyam's overall CG score - environmental disclosures are not as detailed in its annual report as for peers (eg, Infosys).

Mastek - strategic changes, transfers, complex JVs pull down CG

Mastek's CG score suffered on account of repeated strategic changes, management transfers, complex joint venture and alliance arrangements that change contours frequently. In our view, Mastek's management needs to do a finer job of articulating its strategy and risks - as there are several instances of financial impact coming from its unique alliance model. As an example, a large chunk of revenue relates to the UK NHS project, which could terminate by mid-CY2008, and impact revenues by up to 25-30%.

Pharma's CG suffered on account of limited disclosure on acquisitions

The main reason for the decrease in CG score for pharma companies is the large overseas acquisitions they have undertaken in the last few years. Acquisitions such as Betapharm by Dr Reddy's, Terapia by Ranbaxy, Pinewood and Negma by Wockhardt are material in size and significantly impact overall profitability, balance sheet ratios and valuation. Not enough information was shared to help investors analyse their impact objectively. Capital raisings, often at near peak levels is another reason for CG scores to drop.

Tata Steel, Hindalco got lower CG scores due to large & costly acquisitions

Tata Steel and Hindalco have suffered reduction in CG score on account of making large acquisitions at substantial premia to market prices of acquired companies. The returns on investment on these acquisitions were low (in case of Tata Steel's Corus acquisition the near term RoE could be high because of the subsequent increase in steel prices). Stock prices of Hindalco and Tata Steel fell sharply on announcement of these acquisitions. The decline in CG score of Hindalco is higher because of lack of disclosure after the acquisition.

Hindalco was silent on Novelis merger for a long time

Hindalco acquired loss making Novelis during FY07. The acqusition value for Novelis was 80% of Hindalco's market cap at the time and the acquisition price was a 57% premium to Novelis's average trading price in the previous three months. Hindalco did not share details about Novelis to allow analysts to assess the impact of the acquisition, for the next few months. This was in contrast to Tata Steel, which held an analyst meet soon after acquiring Corus and shared data with the analysts.

Public sector banks have shown a sharp increase in CG scores in 2007

Public-sector banks have shown the biggest improvement in CG scores. These banks have improved their investor relations and senior management are more easily available to analysts compared to before. Most of them are now specifically focussing on their ROE & ROA. The post-results disclosure is more detailed and reflects a better picture of what has happened in the past quarter. Websites for the banks are updated regularly and most announcements/results are updated within a day of the results being declared. These banks have raised their lending rates, going against the political pressure and acting in the interest of shareholders. PNB, SBI and Oriental banks have shown big improvements in CG scores versus 2005.

M&M's disclosure levels have improved

M&M's improvement in CG comes on the back of the company's initiatives to improve disclosure by way of quarterly reports, which in FY07 have begun to include segmental disclosures for the consolidated entity. Full year results were declared a month earlier (in April) in FY07. During FY07, M&M also listed its IT venture - Tech Mahindra - on the bourses, unlocking significant value. This follows the listing of M&M Financial Services in early 2006. The company has also indicated that it would look at listing M&M Holidays in FY08.

Suzuki's decision to expand India operations

In Sept-04, Suzuki's decision to expand its Indian operations via separate ventures with Maruti (rather than via Maruti directly), raised issued of corporate governance. However, with Maruti deciding to acquire Suzuki's stake in one of these ventures, these concerns were allayed to some extent and eventually (April 2006) Maruti merged its greenfield car subsidiary (earlier to be a Suzuki JV) with itself. Management also regularly holds post-result conference calls with senior management participating on the calls, providing guidance over key issues.

Bharat Forge has improved its quarterly disclosures

Bharat Forge has improved its quarterly report disclosures, now giving consolidated financials with detailed breakdowns for revenues. The company has been coming out with consolidated financials since FY05, which is relevant considering the size of acquisitions made by the company in the past. Management holds regular analysts meet and conference calls and has of late also provided access to the heads of their overseas operations.

Qarp stocks 2005

The two Qarp picks in our 2005 report were Container Corporation and HCL Infosystems. Over the past two years, Concor is up 144%, significantly outperforming the market. Our second Qarp pick, HCL Infosystems, however fell from glory when the promoter group sold shares before announcing a change in their agreement with Nokia which was a substantial negative for its businesses. As a result, HCL Infosystems, although up 46% from June 2005, has substantially underperformed the market during this period. HCL Infosystems' CG score has declined the most and the company has gone from the first to third CG quartile for India.

Figure 7

Performance of 2005 Qarp stocks

Company	CG Quartile	ROE 04-05 (%)	Share price Jun 05 (Rs)	Share price Sep 07 (Rs)	Performance (%)
Container Corporation	2	27.8	920	2,242	143.7
HCL Infosystems	1	47.6	157	229	45.9
Average return for Qarp stocks					94.8
MSCI India two-year return					112

Note: priced on 7 September 2007. Source: CLSA Asia Pacific Markets

Qarp picks2007

Qarp picks for 2007 are HLL and Sriram Transport Finance

Given the sharp stock-market runup over the past few years, only a few stocks fulfil the criteria of higher-than-average CG score, ROE above COE and theoretical PB being higher than actual PB. Yet, in many cases, average ROEs for FY08-09 are inflated due to strong commodity cycles, or are at risk due to an appreciating currency (software, pharma companies). Our two Qarp picks for 2007 are Hindustan Unilever (HUL) and Grasim.

HLL is the largest consumer goods company in India

HUL a subsidiary of Unilever, is India's largest consumer company with annual revenues of US$3bn. The company has a strong brand franchise and is a market leader in most of its product categories. HUL has the strongest consumer company distribution network in India (>4,000 distributors - products sold in >6m retail outlets). Through its distribution strength, HUL derives nearly 30% of domestic revenues from rural India. The company has been in India for close to a century and is respected for high CG standards.

Earnings growth to surpass that of Sensex over medium to long term

Management has effected a turnaround in the company over the past three to four years and topline growth has rebounded to double digits. We expect that at 18% YoY in CY07, HUL's earnings growth should outstrip Sensex. A combination of product mix change, customer upgrade, price increases and solid volume growth should drive margin expansion and also help mitigate the increase in raw material prices. By the Qarp model, we estimate 10% upside to theoretical value for HUL, using 12% as cost of equity and ascribing nominal growth of 8%.

Grasim - GGM suggests upside even with softer commodity prices

Grasim, one of the largest domestic producers of cement and a global leader in viscose staple fibre (VSF) production, is further consolidating its position through low-cost expansion that will increase cement capacity by 50% over the next 18 months. Although we believe sustainable ROE is lower than the FY08-09 average (since new capacity additions will result in a moderation of domestic cement prices), Grasim will have upside as per the Gordon Growth Model even if ROE were to fall 13ppt from current levels.

Figure 8

Qarp list: September 2007 valuations

Company	CG quartile (1-4)	Avg ROE FY08-09 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Grasim	1	30.5	12.0	8.0	5.6	3.2	75
HUL	1	71.5	12.0	8.0	15.9	14.5	10

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Indonesia - What I say, not what I do

Corporate governance in Indonesia is a ship that has not yet arrived. While there has been a vast improvement in overall governance at the macro level, implementation and adherence to best corporate practices remains piecemeal at best.

Corporate governance is a mixed bag in Indonesia

Indonesia's best companies in terms of corporate governance have not changed. They are Astra International, Indosat, Bakrie Bros and Telkom Indonesia. This is because of the level of disclosure to investors, the demands of foreign regulatory authorities who demand higher standards of governance, and the existence of a strong foreign controlling investor.

Attitudes take time to change

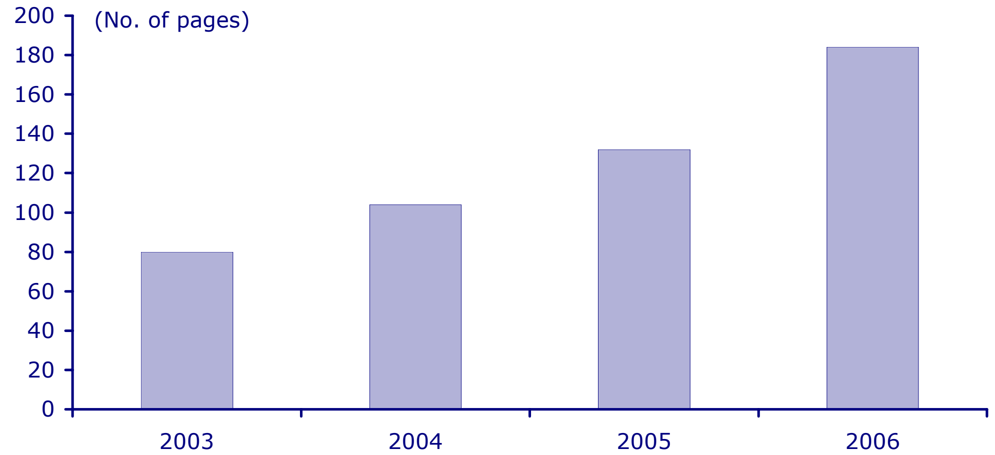
This is not to say that Indonesia is not changing. Governance has been an important issue at the macro issue and the government has made it an important policy gangplank to clamp down on corruption. Dozens of government bureaucrats, economic rent seekers, petty politicians and their accompanying henchmen have been sent to jail for defrauding the state. So successful has the campaign been that behaviour patterns have begun to change, although fostering a revolutionary change in mindset will still require a generational issue.

But at the corporate level, arguably change has been felt more slowly. Corporate governance remains an important box to tick for regulators and indeed the number of pages dedicated to promoting corporate governance has gone up, but capital is cheap and equity prices high.

Although a lot more is being written about it

Figure 1

Aggregate number of pages in annual reports dedicated to corporate governance



Source: CLSA Asia-Pacific Markets

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Country CG score

Indonesia recorded the lowest overall score of all 11 markets surveyed and retains the same ranking as in our last "CG Watch" survey in 2005. Indonesia scores badly in every category: placing either last or second last in all five fields, as demonstrated by the table below, with its weakest scores predictably in "Enforcement" and "CG Culture". Moreover, there is little evidence that matters have improved in CG in Indonesia since our 2005 survey, with scores in this year's similar or weaker.

Overall country macro CG score unchanged from 2005

Figure 2

Indonesia ratings for macro-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	39	33	Improved new code introduced
Enforcement	22	29	Still a major issue; score reduced on tighter criteria
Political and regulatory environment	35	30	Political environment improved with positive signs of regulatory changes
Adoption of international accounting/auditing standards	65	68	Conformity with IGAAP only targeted by 2008
Culture	25	28	Remains poor
Overall score	**37**	**37**	

Source: ACGA, CLSA Asia-Pacific Markets

Corruption continues to plague the economy

The scores indicate the current parlous state of corporate governance in Indonesia and underline the scale of the task ahead for Indonesia's government if it is going to tackle the fundamental issue of rampant corruption that continues to plague the economy.

Initial steps to tackle corruption; new code on CG issued

On a more positive note, the administration of President Susilo Bambang Yudoyhono has made some initial steps to tackle corruption within the public sector, including high profile investigations, arrests and prosecutions of errant public servants and government officials, most notably its continuing campaign against the family of former president Suharto. The government has also made efforts to improve CG standards. A new body has been established, the National Committee on Governance, and a new code on corporate governance introduced. Indonesia's central bank has also issued separate governance standards for the country's banks. Hopefully, these early measures will help to improve Indonesia's CG scores in our next survey from what is already a very low base.

A compliance-based approach to CG, against weak rules

Like the political and regulatory framework, Indonesia companies score badly in most aspects of CG. Almost all companies adopt a compliance-based approach to CG, meeting minimum criteria for what are already weak rules. And with enforcement of these rules practically non-existent, companies have no cause to worry about non-compliance. Even the best-managed Indonesian companies do not split chairmen and CEO roles, voting by poll at company meetings is unheard of and there have even been instances of companies adopting practices at meetings designed to discourage dissent by minority shareholders, including bundling of resolutions.

Firms continue to be run for the benefit of their controlling shareholders

With many Indonesian companies remaining in the control of wealthy families, weak rules on independence of non-executive directors, material and connected transactions and takeover protections for minority shareholders, most Indonesian companies continue to be run for the benefit of their controlling shareholders.

Accounting standards to not meet IGAAP - but target to conform by 2008

Local accounting standards still do not meet IGAAP, although there is a definitive policy to achieving conformity with both international accounting standards by 2008 and auditing standards for the 2007 audit. Quarterly financial reporting is mandatory in Indonesia and tends to be of a good standard, although non-financial disclosure is often weak and formulaic.

Group of larger companies that make an effort are a minority

There is a group of larger Indonesian companies that makes considerable effort to maintain higher CG standards, including such firms as Unilever, Astra and several banks, including Bank Danamon and Bank Permata. These companies also tend to adopt more advanced investor relations practices. However, these companies are very much a minority in Indonesia and even then, none adopts full international CG practices. Apart from this small group of larger companies, CG practices among smaller companies remain extremely poor and show no sign of improvement. There is simply no evidence that Indonesian companies in general see CG as being of benefit to the operation of their businesses.

Little activism, although class-action legislation exists

Among investors, there is also little sign of activism towards improving CG standards among Indonesian companies. Although class action legislation exists in Indonesia, a cumbersome, costly and corrupt legal system effectively puts paid to any such litigation in practice. Most international institutional investors, faced with CG-related difficulties with Indonesian companies, are faced with little practical choice but to liquidate their holdings. Nominating directors in opposition to a controlling shareholder is effectively impossible and even if minority shareholders were successful in nominating and electing independent directors, Indonesia's system of split boards and commissioners as well as weak definitions of independence mean that controlling shareholders will always be able to control boards.

There are no Indonesian domestic CG or activist funds and few non-governmental organisations (NGOs) tackling corruption and CG issues. Those of note are The Indonesian Society for Transparency, The Indonesian Institute for Corporate Governance and Forum for Corporate Governance in Indonesia.

Regulatory overview

Weak regulatory system; little cooperation between regulators

Although Indonesia's market regulatory system is reasonably clear in theory with Bapepam (Penggabungan Badan Pengawas Pasar Modal, or the Capital Market and Financial Institution Supervisory Agency) acting as the main securities-market regulator, and stock-exchange rules generally following Bapepam regulation, in practice the system is weak with little cooperation between the two regulators. Bapepam reports to the Ministry of Finance and its chairman is appointed by the Finance Minister for an indefinite period, strengthening the regulator's political ties to the government but weakening its independence and increasing the likelihood of political interference.

Few changes to corporate and securities laws

With corruption the key problem facing the government, overhauling securities legislation understandably becomes less of a priority and there have been few changes to corporate and securities laws since our last report in 2005. That said, a new national code on corporate governance was introduced in October 2006 and Bank Indonesia, the central bank, issued separate CG guidelines for banks also in October 2006.

New code is an improvement, but differ from global standards

The new code is a definite improvement on the previous code issued in 2001 and follows international CG principles fairly closely. However, it continues to differ from international standards in certain important ways including composition of audit committee and the distribution of detailed AGM circulars. The definition of independent commissioner in the new code, while focusing on the right principles (ie, independence from controlling shareholders, boards of directors, management and family) remains generally worded and envisages that former directors and officers/employees may become commissioners after an unspecified period of time.

Definition of independence questionable

Recent amendments to the CG code for banks also include some tightening of the definition of independence for commissioners, stipulate that a board of commissioners should comprise a minimum of 50% independent commissioners who must also meet the Bank of Indonesia's fit and proper criteria and seek to limit the number of similar posts they can hold simultaneously. However, the robustness of the definition of independence is also questionable and falls far short of international standards.

Lack of monitoring and enforcement

It should be noted that even if these new guidelines and regulations did meet international standards, a lack of adequate monitoring and enforcement from overstretched, under-resourced and politically connected regulators render the changes largely meaningless in practice.

Accounting and auditing

Convergence with IFRS by 2008

Indonesia's accounting standards continue to differ from IGAAP despite an ongoing process of gradual conformity. It is expected that Indonesian Financial Accounting Standards will be converged with International Financial Reporting Standards (IFRS) by 2008. The Indonesian Institute of Accountants has decided to adopt international standards of auditing in full for 2007 financial year audits.

Despite this progress, a World Bank report issued on the accounting and auditing standards of Indonesia in 2005 concluded that while statutory audit reviews have strengthened, in practice, locally applied accounting and auditing standards continue to diverge with internationally-accepted practices principally due to weak enforcement and sanctions. Among the report's recommendations were that Indonesia should prioritise adoption of IFRS and International Standards of Auditing (ISA) despite impending convergence.

Judiciary and prosecutors

Judiciary widely regarded as politically influenced and corrupt

Indonesia's judiciary is widely regarded as heavily politically influenced and corrupt. The recent judgments against creditors in the Asia Pulp and Paper debt restructuring suggest that the judiciary is not impartial and favours domestic interests ahead of foreign investors.

Class action suits permitted but impractical

Insider trading and market manipulation are commonplace in Indonesia and offences go unpunished due to weak surveillance and enforcement by market regulators as well as the cumbersome legal process. As noted earlier, class action litigation, while permitted, is impractical due to the lengthy, corrupt and unpredictable legal system. While the current administration under President Yudoyhono has started to pursue and prosecute corrupt officials, overhauling the country's legal system and its judiciary will take many years.

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Corporate CG issues over the past two years

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The biggest CG snafu in recent memory was the government's placement of 5% in Perusahaan Gas (PGas), the state-owned gas supplier in December last year. Management reiterated their view on gas sales and construction of a new gas pipeline when speaking with investors only to suddenly retract those statements and substantially push back final construction dates a few weeks post the placement to investors. Not surprisingly the stock fell 25% in one day and has yet to recover to its placement place despite a strong rebound in the market since then.

PGas pushed back construction of a gas pipeline

Regulatory investigations inevitably followed and in the final outcome the affair cost senior management their jobs and almost US$500k in fines out of their own pockets and ultimately the Minister for SOE's own position. The affair has also left directors scrambling for personal liability insurance.

A small list of stocks at the top

Figure 3

Companies in the top-two CG quartiles for Indonesia (under CLSA coverage)

Top quartile	Second quartile
Astra International	Bank Central Asia
Bakrie Brothers	Bank Rakyat Indonesia
Bank Danamon	Berlian Laju Tanker
Indonesian Satellite	Indocement Tunggal Prakarsa
International Nickel Indonesia	Ramayana Lestari Sentosa
Telekomunikasi Indonesia	Sumalindo Lestari Jaya
United Tractors	Unilever Indonesia

Source: CLSA Asia-Pacific Markets

Clean & Green survey

Issues remain more about growth, income and job security

Very few Indonesian companies provided us with Clean & Green surveys. In all, six companies provided us with data on this issue. This should not come as a surprise. Indonesia is ranked as one of the largest carbon polluters in the world through deforestation. There is also no tradition of communal responsibility for the environment. Jakarta for instance experienced its worst flooding in five years earlier this year, in part because of the inability of the land to absorb water due to forest loss and clogged waterways from rubbish. . For most Indonesians the issue remains more about growth, income and job security rather than environmental concerns, although this attitude is changing at the margin as a growing number of people realise that past behaviour cannot sustain the future environment.

Astra Intl has the highest C&G score in Indonesia

Astra scores the highest in Indonesia on C&G. The company's senior executives KPIs include the environment, health and safety. The company has set a target to reduce natural resources consumed by 10% against the 2006 base, and capex is judged partly according to the policy of the Astra Green Company Standard. Over 30 of the subsidiaries are ISO 14001-certified. The company is in the trial phase of using bio-diesel as a fuel and is already using as charcoal the eggshell of palm oil fruit. It is undertaking further R&D on bio-diesel from palm oil and there is extensive discussion on emissions in the President Director's message in the annual report.

Two other companies that score well for C&G are Bakrie Bros and International Nickel Indonesia (Inco). The other companies score below 50% with the bulk of Indonesian corporates not yet registering any score on C&G.

Only a handful of Indonesia companies get any score for C&G

Figure 4

Clean & Green score

	(%)
Astra International	85
Bakrie Bros	60
International Nickel Indonesia	60
Berlian Laju Tanker	45
Perusahaan Gas	15
Bank Niaga	10

Source: CLSA Asia-Pacific Markets

Voting by poll

No voting by poll

Voting by poll is not mandatory in Indonesia, although regulators do allow voting by proxy. Not surprisingly, no company chose this option.

Directors' remuneration

On average, Indonesian directors earn 1.5% of corporate profits

Indonesian companies are not required to disclose individual directors salaries and need only show total compensation paid to directors. Also, a number of firms do not separate between directors and commissioners on fees; we have therefore included both. On average, Indonesian directors earn 1.5% of corporate profits as renumeration.

Even so, Indonesian directors are not well compensated for board directorships. A ranking of directors' remuneration (see tables below) ranks some of the country's largest firms and financial instutitions as paying the lowest amount to directors. While this partly reflects the large earnnigs base of these companies, it is also no surprise that many of these firms are also state-owned where directorships are given based more on political patronage than industry knowledge.

Half of firms where directors' remuneration is low as a percentage of profits are state-owned

Four of the eight companies where director renumeration is low as a percentage of profits are state-owned. Three of the companies are also commodity producers whose profits have been boosted by the rise in base metal prices. At the other end of the scale, Astra directors receive the highest compensation for work done.

Figure 5

Companies with directors' remuneration at highest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
Astra International	7.5	No
Truba	7.1	na
Indocement	4.7	Yes
Global Mediacom	4.4	No
Indofood	3.8	Yes
Bank Danamon	3.7	Yes
Gudang Garam	3.4	Yes
Indosat	2.7	Yes
United Tractors	1.8	No
Semen Gresik	1.3	No
Astra Agro	1.3	No
Perushaan Gas	1.1	No

Figure 6

Companies with directors' remuneration at lowest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
Bank Central Asia	0.9	Yes
Antam	0.8	No
Inco	0.5	No
Bank Rakyat Indonesia	0.4	No
Bank Mandiri Persero	0.0	Yes
Unilever Indonesia	0.0	No
Bumi Resources	0.0	No
Telkom Indonesia	0.0	No

Source: CLSA Asia-Pacific Markets, Company reports

Changes in CG scores

Only mild changes this time around

There were only a few changes to the overall CG scores this time round. Interestingly, it was a case of the higher ranked companies continuing to improve their overall scores. Clean & Green submissions almost certainly helped as well. Improvements also took place due to greater disclosures. Page counts for write-ups dedicated to corporate governance has doubled since 2003. However, we feel that for many companies this is more about style than substance. Few companies outside of the large blue chips have made a concerted effort to adopt international best practices.

Figure 7

Companies with changes in CG scores: 2005-07

	Chg in CG score (ppt)	2005 quartile ranking
Indonesian Satellite	23.0	1
Astra International	14.0	1
Telekomunikasi Indonesia	14.0	1
United Tractors	16.1	2

Source: CLSA Asia-Pacific Markets

Qarp stocks 2005

There were two stocks we listed as Qarp stocks back in 2005. Both have done well, Inco spectacularly reflecting the rise in nickel prices over the period and the tremendous gains investors have seen in that stock as a result. Both these Qarp picks from 2005 outperformed the country MSCI over the two years to mid-2007. Indeed, it has been difficult for Indonesian stocks not to do well in recent years given the strong run-up in commodities prices. Against the MSCI, Indonesia has outperformed the MSCI Asia ex-Japan every year since 2003.

Our 2005 picks were strong outperformers

Figure 8

Performance of 2005 Qarp picks

Company	CG quartile	ROE 04-05 (%)	Share price		Performance (%)
			Jun 05 (Rp)	Sep 07 (Rp)	
Inco	1	15.0	14,150.00	55,500.00	292.2
Bank Niaga	1	14.0	389.69	820.00	110.4
Average return of Qarp stocks					201.3
MSCI Indonesia two-year return					81.6

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

Qarp picks 2007

Only one stock makes the grade this time round

Of companies in the top two quartiles for CG, using average ROE for 07-08, a cost of equity of 15%, a long-run inflation rate of 6% we have then come up with a list of companies that still offer some upside to theoretical PB. Not surprisingly, given the rally in prices in recent years, the list is very short; only one stock makes the grade – Indonesian Nickel or Inco.

There is considerable sensitivity to our application of COE and long-run growth rate. Lowering the cost of equity to 12% for instance adds another two stocks to our Qarp list: Telkom and Bank Rakyat. Assuming a long-run nominal growth rate of 10% (6% for inflation plus 4% for GDP) would add Telkom, Bank Rakyat and Sumalindo to the list.

Figure 9

Qarp list: September 2007 valuations

Company	CG quartile (1-4)	Avg ROE 07-08 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Inco Indonesia	2.0	52.9	15.0	6.0	5.2	3.4	51.3

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Japan - Slow to change

Maximising shareholder value often overlooked

Maximising shareholder value as a core objective of a corporation is more often than not treated as merely a suggestion in Japan rather than a rule to be adhered to. Japanese companies will often put stakeholders first, such as employees and board members, with shareholders following a distant second. While this approach has not resulted in many major corporate blow-ups in the past 12 months, Japan's companies with a low cost of capital and grossly underleveraged balance sheets against a backdrop of the longest post-war period of economic growth are not exactly facing a challenging operating environment. However, this being said, even without pressure, Japan continues to move in the right direction in relation to corporate governance, albeit at a snail's pace. This snail, in its first year of inclusion in our Asia CG Watch survey, ranked fifth in Asia, slightly above Korea and Malaysia.

Moves in the right direction

More shareholder -friendly boards

Since 2003, Japan has twice amended its 117-year old Commercial Code to encourage more shareholder-friendly structures and auditing. First, in April 2003, rules were introduced requiring an independent outsider among the traditional auditors or for companies to adopt US-style committee-based boards dominated by outsiders. In addition, many companies, such as Sony, Toshiba, Toyota and Nissan, have either pared down the size of their boards or adopted US-style structures. Second, Japan will as of next year adopt its own form of Sarbanes-Oxley, which will result in more stringent auditing. It should also be noted that companies are increasingly focusing on return on equity and payout ratios as opposed to simple dividend-per-share figures.

Taboos broken

Hostile bids positive

Another positive, while not yet to have succeeded, is the growing number of hostile takeover attempts. The recent bid by landlord DaVinci Advisors to takeover TOC failed to succeed by only 5%. However, it should be noted that many shareholders were TOC's tenants who probably and quite rightly feared rents would be sharply higher had DaVinci taken over and become their landlord. However, the more significant bid in 2006 was traditional Japanese company Oji Paper's attempt to make a hostile takeover of Hokuetsu. It was ultimately blocked by competitor Nippon Paper's white knight rescue. Several years ago, it would have been unthinkable and unacceptable for a Japanese company of Oji's stature to even attempt such an action, particularly with a Japanese investment bank's support.

More vocal shareholders

Japan's PFA using its voice

While many hedge funds and activist investors have tried to get corporate Japan to change, the methods they have employed have been too brash for the establishment. One of its more infamous proponents, Yoshiaki Murakami, has recently been jailed for insider trading. This has only further fueled suspicions that such investors are nothing more than corporate vultures. As a result, even those who are not being "abusive" find it difficult to get the support of minorities to force boards to change. On this front, it is worth noting, however, that Japan's Pension Fund Association is starting to make the right noises. After suffering several years of losses at the beginning of the century, they have become a proponent of corporate governance and vote against the re-election of boards where ROE targets of 8% are not being met. While still lacking bite, the PFA is a respected establishment that could help force boards to act in a more shareholder-friendly manner.

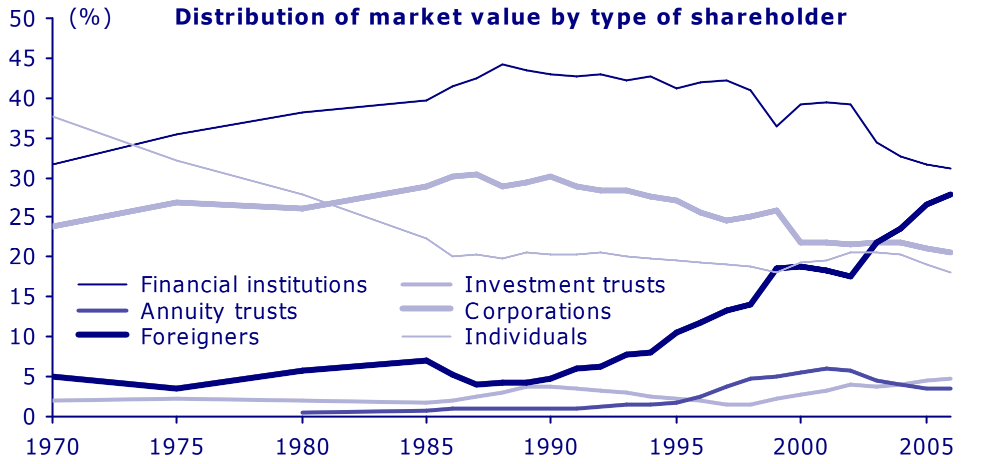
Foreign ownership in Japan trending up

More overseas shareholders

While domestic investors have been slow to vote against boards not serving them well, they are becoming less important. Japan's equity market now has its highest level of foreign ownership, about 27%, despite very lacklustre performance over the past 12 months versus global equities. As the rest of the world, with its relatively younger population, continues to grow the base of pension assets, all those checking a box that entails an allocation to Japan will ensure foreign ownership continues to tick up. With foreign shareholders increasingly dominanting shareholder registers, corporate Japan's life will only get tougher. Particularly if the government follows through with the regulatory changes required if they are serious about Japan regaining its lost stature amongst global financial centers.

Figure 1

Business and financial institutions own less of the market



Source: CLSA Asia-Pacific Markets

Why are foreign-Shareholder proposals failing?

Legal and perception hurdles

Stephen Givens, who has practiced corporate law in Japan for some 20 years and who recently authored a report for CLSA, *Indecent Proposals,* gives a clear outline of the enviroment in which activists operate and how to play to win. While some aspects of CG in Japan do limit the ability of foreign shareholders to succeed with proposals, a far larger enemy is themselves. For foreigners, and indeed any shareholder in Japan wishing to be successful with a proposal, must succumb to the fact they need to embark on Japanese-style coalition building to get other shareholders, particularly domestic, to support proposals. Otherwise, we are likely to have to wait until 2015, which is approximately when, based on the current trend, foreign ownership of all Japanese equities will be nearing 50%, to see successful proposals. It should also be highlighted that many proposals are likely already succeeding but that they are not brought into the public arena where face will be lost. Evidence can be found in Japan's steadily increasing payout ratios and higher dividends.

* * *

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Country CG score

This is the first year that Japan has been included in our CG Watch survey. It ranks fifth out of 11 markets and achieved an aggregate score of 51%, slightly above Korea and Malaysia. In terms of the category scores, while Japan did poorly in an absolute sense in three areas - CG Rules & Practices, Enforcement and CG Culture - it performed somewhat better in Political and Regulatory Environment and quite well in IGAAP. In relative terms, some of Japan's lower scores, such as in Enforcement, stand up reasonably well - mainly due to somewhat stronger private enforcement activities compared to other markets.

Overall Japan ranked fifth in Asia. Most scores are very much the average

Figure 2

Japan ratings for macro-determinants of CG

(%)	**Rating**	**Comments**
Rules & regulations	43	Still doesn't favour minorities
Enforcement	46	Selective and lacks uniformity
Political & regulatory environment	52	Improving, but needs to step up the pace
Adoption of international accounting/auditing standards	72	Japan is introducing its version of SOX
Culture	49	Binary, either embraced or not, majority not
Overall score	**52**	

Source: ACGA, CLSA Asia-Pacific Markets

These scores reflect the heightened policy commitment of the Japanese government and market regulators in recent years to corporate governance, manifested in major changes to company and securities laws and regulations, ongoing convergence with international accounting and auditing standards, and enhanced regulation of the auditing profession. The scores also highlight the continuing gulf between corporate-governance rules and practices in Japan and international norms, which many companies in Japan believe offer little of value. While this position may be tenable for some time - at least for as long as the weak yen helps to drive exports and corporate profitability - it could ultimately prove counter-productive and may increase the business and financial risks facing Japanese firms, both at home and in overseas markets.

Unlike the rest of Asia, Japan largely not impacted by 1998 crisis

Japan is something of an anomaly in Asian corporate governance. It was not deeply affected by the Asian financial crisis of the late 1990s - the initial catalyst for corporate-governance reform in much of the region - because its economy and financial markets had already been in decline for several years. When the government did institute certain reforms in 2003, namely the Company with Committees System, the package was promoted with some ambivalence: listed companies could choose between adopting the new system (which meant having outside directors and committees on audit, nomination and compensation) or a revamped statutory auditor system, the traditional mechanism for supervising the board of directors. And there was no requirement that the new outside directors or outside auditors be genuinely independent of management or the controlling shareholder.

In other areas, however, Japan's corporate-governance regime is far more sophisticated than any other market in Asia. Precisely because of the stock market's long decline during the 1990s and poor returns to investors, the country's Pension Fund Association (PFA), which manages and invests funds as well as acting as an industry body for corporate pension funds, decided to start voting its shares as a way to encourage listed companies to improve their governance and value. There is no private, or even state, pension fund in the rest of the region that is as actively interested in corporate governance as the PFA (though the seeds are being planted in China and Thailand, and to a lesser extent in Korea). To be fair to other markets, their macro-economic problems and cycles have been quite different from Japan's, while the pension systems of most are in an earlier stage of development and/or much smaller in terms of assets under management.

Activism continues to build momentum, success will come

Japan has also produced a much more fertile environment for shareholder litigation and investor activism in recent years. The number of derivative lawsuits increased sharply in the 1990s after the government made them quite cheap to undertake, while this decade has seen the emergence of numerous investment funds that have sought to enhance their returns through engagement with company management. The most high profile have been activists such as Yoshiaki Murakami (recently convicted on insider trading charges) and a US fund called Steel Partners. The activities of Murakami and the aggressive tactics of Steel Partners has created a backlash in corporate Japan against shareholder activism in general and clouded the fact that not all funds are cut from the same cloth: some want to engage constructively with management because they believe they can help companies improve their value. Like any market, Japan has its fair share of underperforming companies. Surely, such investor participation can only, on balance, be good for the economy.

Government understands need to change corporate Japan . . .

. . . but does it really have the will to act?

Significantly, the Japanese government appears to believe that the pendulum has swung too far in favour of the status quo. In early August, it advised companies against too readily implementing poison pills (defensive measures against hostile takeovers) and encouraged them to be more open to unsolicited takeover bids. The government argued in a white paper on the economy that defensive measures may only protect the interests of inefficient management at the expense of their company's profitability and national productivity. Its concerns take on an added sense of urgency in light of the weak macro-economic data coming out of Japan recently, including a slowing in both consumer and corporate capital spending.

Financial-sector modernisation

The government's emphasis on strengthening corporate and financial competitiveness is not new. In recent years, the Japanese government has produced a number of policy initiatives to move the country towards what it calls a 'financial services nation'. In December 2004, the Financial Services Agency (FSA), the principal securities and financial regulator, produced a program outlining plans for, among other things, expanding the range of financial products and services, using IT more strategically and developing a financial administration with more of an international perspective.

More recently, a government-appointed committee, the Study Group on the Internationalization of Japanese Financial and Capital Markets, produced a document called the *Interim Summary of Issues (Phase 1)* that covered some similar ground. It listed a number of urgent reasons why reforms were needed, including: the country's ageing population meant that financial assets owned by Japanese households must be effectively utilised to produce high value-added returns; the declining importance of Japan's capital markets in the global arena; and the need to ensure risk capital was efficiently allocated to the market. The Study Group envisaged an important role for both 'investment funds from overseas' and the listing of foreign companies in

Japan, and stated that the internationalisation of the country's financial sector was 'expected to lead to improving the efficiency and productivity of economic activities and have a positive effect on the economy as a whole'.

Regulatory tensions

This focus on modernisation of the economy and strengthening of corporate competitiveness was also the rationale for two major legislative developments - the new Company Law, which came into effect in May 2006, and the new Financial Instruments and Exchange Law, which was promulgated in June 2006 and has been coming into effect in phases starting from July 2006. But like much in Japan's corporate-governance system, the changes reflect an ongoing conflict between reform and investor protection on the one hand versus the status quo and protection of management on the other.

Breaking the status quo is not easy

The new Company Law sought to deregulate controls over companies, such as allowing more flexible financing mechanisms, enhanced M&A opportunities, and more varied and simplified company structures. It also aimed to improve corporate governance by, for example, requiring companies to adopt stronger systems of internal control. While the law is a step forward in many respects, it has also undermined the interests of minority shareholders in certain ways, such as removing the power of shareholders to approve dividends at each annual meeting and making it easier for companies to design takeover defences. As one investor noted, there has been an increased incidence of companies exploiting legal grey zones. There has also been a rapid take-up in poison pill defence measures following guidelines issued in 2005 by the Ministry of Economics, Trade and Industry (METI).

The Financial Instruments and Exchange Law (FIEL), which the government describes as a 'new legislative framework for investor protection', is generally more straightforward in its intent. It will enhance disclosure by introducing a statutory quarterly reporting system for listed companies by shortening the reporting deadlines for substantial (5%) shareholders and by strengthening systems of internal control over financial reporting. The latter element follows part of SOX in the US and is why this law is often referred to as J-SOX. This section will come into force for fiscal years starting on or after 1 April 2008. FIEL, however, also brings into effect new rules governing the operation of takeover bids, many of which appear to be designed to benefit the target company.

A more active exchange

In parallel with these legislative changes, the Tokyo Stock Exchange (TSE) has undertaken a broad-based review of its listing rules. It started in March 2006 with a *Discussion Paper on Improvements to the Listing System*, which was sent out for consultation, then followed up with a paper on the *Development of a Comprehensive Improvement Program for the Listing System* in June 2006. Some of the ideas in the latter paper included: improving the timeliness and disclosure of material events and price-sensitive information; reviewing delisting criteria; and improving collaboration with the Securities Exchange and Surveillance Commission, the enforcement arm of the FSA.

In August 2006, the TSE appointed a Roundtable on Listing System Improvement, a committee comprising representatives from academia, listed companies, institutional investors, intermediaries and others. The group produced a report in April 2007 that recommended a variety of measures. Shortly afterwards, the TSE announced those it intended to implement immediately, including: incorporating a corporate code of conduct into its listing rules governing such things as moving strike convertible bonds (which can dilute existing shareholders); repositioning the Mothers market as a market 'closely combined' with the First and Second Sections of the TSE, not as a market 'parallel' to them; and improving the efficiency of its supervision system for companies that have engaged in false disclosure and face possible delisting.

For the past two years, meanwhile, the TSE has required all listed companies to produce a fairly detailed report on their corporate-governance systems (based on a template that it devised). This started in June 2006 and the reports can be found on the TSE website. In March 2007, the Exchange published a *White Paper on Corporate Governance 2007,* which summarised reports from listed companies to the end of October 2006. The White Paper contains a range of detailed statistics on the governance structures of 2,356 listed companies. The data show, for example, that just 59 listed companies - 2.5% of the total - have opted for the committee system. While this almost certainly understates the number of large firms that have adopted hybrid systems (that is, forming one or two new board committees alongside a traditional statutory auditor model), it highlights the challenge that regulators face in promoting new forms of corporate governance in Japan.

*   *   *

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Changes in CG scores

While the above gives an insight into how far Japan has come it should be appreciated that corporate goverance is still very far from being embraced with arms wide open. Toyota only this year appointed its first foriegner to the board, 60-year old Jim Presser, who is a long-time employee and head of Toyota's North America business. However, Presser has since been lured to a big-three competitor. Despite this, few would argue that Toyota is deserving of a high CG score and stands out as a leader among global auto companies from an investor standpoint.

Sharp, simply the best

Figure 3

Companies in the top-two CG quartiles for Japan (CLSA top-40 coverage)

Top quartile	Second quartile
Advantest	Asahi Glass
Honda	Fujitsu
Inpex	Ibiden
Mitsubishi Elec	KDDI
Mitsubishi Estate	Murata
MSI	Nidec
Nintendo	Nissan Motor
Resona	Shin-Etsu Chemical
Sharp	T&D
Sompo	Tokyo Electron
Toyota Motor	Toray

Source: CLSA Asia-Pacific Markets

Clean & Green survey

A leader for the region

Clean and Green is a strong point for Japan, which is natural given that it is home to the Kyoto Protocol and its relative wealth versus regional peers. Clean and Green is also a major export opportunity for Japan given its technological leadership and experience from having transformed from a polluted nation into one that is far cleaner. Aside from scoring well in terms of Clean and Green, Sharp is the global leader in solar panels. In addition, other high scorers, such as Asahi Glass, were the first to manufacture arsenic-free glass for TFT-LCD screens. The companies in our survey faring worse than expected were Japan's property leaders. The waste from old buildings being torn down is the key issue. However, the buildings replacing these are on the surface far greener, such as Mitsui Fudosan's Mid-Town project.

Many are world energy-saving leaders in terms of products

Figure 4

Clean & Green score

	(%)
Sharp	95
Toyota Motor	95
NEC	95
Fuji Film	90
Asahi Glass	85
NTT DoCoMo	85
Ibiden	80
Shin-Etsu Chemical	80
Millea	80

Source: CLSA Asia-Pacific Markets

Directors' remuneration

If anything too low

Japan, despite being the world's second-largest economy, does not feature the mega CEO salaries that are found elsewhere in the US and Europe. If anything, Japanese management's personal wealth is not closely enough associated with the performance of the company. Toyota, Japan's largest company in 2005, paid its top 26 executives a total of US$17.6mn, or an average of US$675,000 per director.

Qarp stocks

Qarp, getting cheap

After the recent sell-off, a few stocks have become cheap on a Qarp basis, albeit a generic 2% long-term growth maybe too generous for the likes of KDDI. However, Yamaha, Nippon Electric Glass and Toyota, the world's best, can continue to grow and expand into emerging Asian consumption growth, something not reflected in current valuations.

Figure 5

Qarp list: Setpember 2007 valuations

Company	CG quartile (1-4)	Avg ROE FY06-07 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Nissan Motor	2	15.8	8.2	2	2.2	1.5	46.7
KDDI	2	16.3	5.9	2	3.6	2.5	44.0
Nippon Electric Glass	3	23.2	10.9	2	2.4	1.9	26.3
Yamaha Motor	3	19.8	11.8	2	1.8	1.5	20.0
Toyota Motor	1	14.7	8.8	2	1.9	1.7	11.8

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Korea - Getting there?

Korea continues to take a mixture of steps forward and back

Korea continues to take a mixture of steps forward and back. Since our 2005 report, there has been at least one episode of high-profile activism, with Carl Icahn's aggressive approach at KT&G. Unfortunately, if anything, this caused a backlash. In July, KT&G entered a mutual understanding with Shinhan Bank to own each other's shares. This is an unfortunate step back (though small in absolute won value) for both companies who were ironically seen as bastions of the positive governance changes in Korea prior to these events.

Hanwha's Seung-Youn Kim was sentenced to 18 months in prison

Also since our 2005 report, two *chaebol* chairman have been convicted of embezzlement: Hyundai Motor's Mong-Koo Chung and Hanwha's Seung-Youn Kim. Chung was sentenced in February to three years in jail for breach of trust and embezzling more than US$100m in company funds to set up a slush fund prosecutors say was used for paying off lobbyists to gain government favours. However, after a decision to make a 1tn won donation to the Korean public, his sentence has been suspended with the judge taking into account "the potential cost to the economy". Prosecutors are looking to appeal this decision on the basis that the judge has moved beyond his jurisdiction is allowing such a suspension. Kim meanwhile was sentenced to 18 months in prison for attacking bar workers with his feet, fists, a steel pipe, a stun gun and his bodyguards. These episodes have not done much to help the image of corporate Korea.

Change in the holding-company requirement

In terms of regulation, one major change of late has been to lower the holding company requirement that the parent must own 30% of all subsidiaries. This appears in the short term to have had a positive impact, leading to several companies reforming themselves into holding companies, including SK. However, it will be some time before it is clear as to whether this is a net positive move. SK, for example, is now more transparent and without a circular ownership structure, the overt shenanigans of the past are unlikely to be repeated. However, Chairman Tae-Won Chey's control of the group has actually been increased via this transformation.

Top-scoring CG companies

Among the 19 companies in the top quartile, six are banks

This year, we scored 76 companies. Among the 19 companies in the top quartile, six are banks. This reflects the financial sector's post-crisis cleanup, their distributed ownership (with limited *chaebol* connections) and high foreign ownership. One major financial institution which scored poorly in the 2005 survey but can now be considered on a similar level to its peers is Woori Financial. The two main reasons are that the history of restructuring is now outside our five-year window of consideration and that the new chairman has called for all senior executives to buy stock in the group and shift from an employee to an owner mindset.

High foreign ownership or foreign affiliation helps a company score highly

The second-best-represented group among high-scoring companies is large companies with high institutional ownership. Posco, Samsung Electronics, LG Electronics, LG Philips, Hynix and KT fall into this category. The drivers of best practice among these companies include former government or pseudo-government ownership (KT, Posco), a history of financial distress that required a major cleanup in a similar way as at the banks (Hynix), foreign affiliation (LG Philips) or a history of activism among shareholders (Samsung Electronics).

Figure 1

Companies in the top-two CG quartiles for Korea

Top quartile	Second quartile
Daegu Bank	Daewoo Engineering & Construction
Daelim Industrial	Daewoo Shipbuilding & Marine Engineering
GS Holdings	GS E&C
Hana Financial	Hana Tour Service
Hankook Tire	Honam Petrochemical
Hanwha	Hyundai Development
Hynix Semiconductor	Hyundai Steel
Kookmin Bank	Industrial Bank of Korea
KT	Korea Investment
LG	Korean Exchange Bank
LG Household and Healthcare	KT Freetel
LG Philips LCD	KT&G
Posco	LG Dacom
Pusan Bank	LG Electronics
Samsung	NCsoft
Samsung Electronics	NHN
Samsung SDI	Samsung Securities
Shinhan Financial	Semco
Woori Financial	SK Telecom

Source: CLSA Asia-Pacific Markets

Top-scoring Clean & Green companies

Companies in industries where climate change is too big an issue to ignore

In Korea, 53 companies (70%) responded to the C&G survey. Of those responding, 19 scored 50% or higher. The level of discussion on climate change is very mixed. Companies in industries where climate change is too big an issue to ignore are already taking steps to keep up with consumer and NGO concerns. Thus, Hyundai Motor scores 75%, Kia 85%, Kumho Tire 85%, Hankook Tire 50%, S-Oil 60% and Posco 95%. Posco, in particular, provided impressively detailed responses to our survey.

Companies that own major consumer brands seem more aware

Large companies that own (or are affiliated to) major consumer brands also score highly. This presumably reflects their concern that negative PR related to environmental issues can potentially inflict significant damage on their businesses. This category includes Samsung SDI (100%), Samsung Electronics (75%), LG Philips LCD (65%) and Semco (65%).

Most non-manufacturing firms fail to see relevance of climate change

Companies in industries not directly related to climate issues do not yet have green issues on their radar screens. Thus, most non-manufacturing firms fail to see the relevance of climate change to their businesses. A common response was that the climate change issues are not relevant. Therefore, the tipping point in climate change consciousness apparently reached in many OECD boardrooms does not appear to have yet been reached in Korea.

Government contributions

The Korean Ministry of Environment has set reduction targets on six major air pollutants including carbon dioxide, ozone, and particulate matters. Motor vehicle emissions are the highest contributor to the degradation of air quality. In 2006, emission standards on newly manufactured gasoline and natural gas vehicles were strengthened to the level of ULEV (ultra-low-emission vehicle) and on diesel vehicles to the level of EURO-4.

Tele-monitoring systems (TMS) have been installed on smoke stacks

To control pollution generated from industrial sites, emission restrictions have been set on various pollutants. Tele-monitoring systems (TMS) have been installed on smoke stacks of high emission discharge industrial sites to monitor and report the level of discharge.

The government-funded Korean Environment Institute (KEI), is currently in the final year of its three-year study on the impact of climate change. The impact study by sector (agriculture, forestry, water resource, public health and industry) and vulnerability assessment were completed in 2006. The project's goal for 2007 is to establish an integrated national climate change adaptation framework, with results to be released in early 2008.

* * *

Country CG score

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Korea has maintained the same ranking as in our last CG Watch survey in 2005 when it was equal sixth with Thailand. This year, it shares the same position with Malaysia. As the table below shows, Korea scores poorly in most categories, especially in Enforcement and Culture, although better in IGAAP. Yet even here, its score is below all other markets except Indonesia.

Korea's overall macro CG score similar to 2005

Figure 2

Korea ratings for maco-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	45	51	Reduced score on tighter criteria
Enforcement	39	40	Similar score as in 2005
Political & regulatory environment	48	43	Improvement in score
Adoption of international accounting/auditing standards	68	82	Markedly lower on stricter criteria
Culture	43	39	Improvement in score from 2005
Overall score	**49**	**50**	

Source: ACGA, CLSA Asia-Pacific Markets

Progress on corporate-governance reform has languished

The scores indicate that the progress of Korea's corporate-governance reform, quite promising in the first half of this decade, has languished significantly in recent years. President Roh Moo-Hyun's government has promoted few new policy ideas and instead vacillated between a reformist and a conservative agenda that casts doubt on the country's commitment to raising corporate-governance standards. Local commentators indicate that while President Roh is serious about CG reform, his administration has been hampered by strong political opposition to financial market reform, particularly among elements within the National Assembly. The erstwhile head of the Financial Supervisory Commission, Chairman Yoon Jeung-Hyun, has also been a vocal opponent of CG reform advocating anti-takeover measures against foreign buyers of Korean companies. The new chairman is making some encouraging statements about foreign access to markets, industrial control of financial capital and general governance principles, however it is far too early to draw conclusions. We also need to assess stated positions against any eventual signs of tangible action.

Korean companies generally score poorly on many aspects of CG

Korean companies also generally score poorly on many aspects of corporate governance. For example, voluntary voting by poll at meetings appears to be nonexistent. One market practitioner pointed out that a poll is generally only held if the company believes there may be opposition to its proposed resolutions. Many Korean companies, especially smaller ones, do not disclose consolidated accounts: Korean GAAP falls far short of IGAAP in several key areas, although there are now at least firm plans to address this.

Meanwhile, in a survey of large listed Korean companies, we failed to find a single company that discloses individual remuneration for board members, a standard best practice in most developed markets. While there are notable exceptions to these poor standards - notably amongst banks and securities companies as well as foreign-listed companies - Korean companies generally follow the letter of CG regulation rather then the spirit of CG reform.

Class action suits now apply to all listed companies

Even the much-heralded class action legislation, a first in Asia, introduced in 2005 against companies with assets of more than 2tn won (US$1.98bn) and extended in 2007 to apply to all companies on the KSE and Kosdaq, has failed to live up to expectations. While a class action may be initiated by a minimum of 50 shareholders whose aggregate equity in the company is 0.01% or more, to date, not a single suit has been undertaken, due, commentators say, to the excessive financial burden placed on plaintiffs.

Judiciary becoming more independent and powerful

Despite this rather bleak picture, some developments in Korea are positive. Recent cases against errant directors and controlling shareholders of *chaebol* suggest that the judiciary is becoming more independent and powerful. Shareholder activism has increased with, most significantly, the emergence of several domestic institutions actively promoting CG, including the National Pension Corporation, which published a detailed set of proxy voting guidelines, and the Korea Corporate Governance Fund, dedicated to improving CG standards in Korea through active investment. Korea also has one of Asia's strongest CG-related NGO lobbies, including PSPD, the Center for Good Corporate Governance, Asian Institute of Corporate Governance and the Korea Corporate Governance Service.

While these more encouraging aspects of Korea's CG scene may not be immediately evident from the aggregate scores above, the full survey included in appendix 1 provides more detail. Korea, for example, is the only market in Asia where minority shareholders have been willing to take errant directors to court.

Larger companies beginning to realize benefits of better CG

Among some of the larger companies, there is also growing evidence of a trend towards improving CG. According to several market commentators, Korean companies are beginning to realize the benefits of better CG, especially the larger companies. In the vanguard of this trend are the country's large banking groups as well as some securities and technology companies. Investor relations' efforts amongst larger companies, particularly in the English language, have also improved significantly in recent years as larger companies embrace foreign shareholders.

CG practices of smaller companies remain poor

The key issue is whether this leading group of firms will implement best practices. One possible example of this happening is SK, which has endured its fair share of CG issues in the past. One commentator noted that SK's recent decision to reorganize into a holding company structure, which aims to improve transparency and valuation, demonstrates that the company is serious about improving its CG standards. While there is evidence of progress in improving CG standards among some larger companies, CG practices among smaller companies remain poor and show no signs of improvement.

Regulatory overview

Political infighting seems to have stymied progress on reform

Political infighting seems to have stymied progress on the reform of companies and securities regulation with little significant amendments since the 5% disclosure rule in 2005. However, ongoing proposed amendments to the Commercial Code commenced in 2006, including proposals to define directors' duties and significantly increase accountability among executive directors, prove that the government is serious about raising standards of CG, according to commentators. Yet, resistance to these changes remains strong.

Stock exchange not made any significant revisions to listing regulations

According to market commentators, the stock exchange has not made any significant revisions to its listing regulations in the past two years. However, given the stated goal of the government to develop Korea as a northeast Asian financial hub, attracting foreign listings is a key goal of the Korea Stock Exchange in addition to achieving its own self-listing. To achieve these goals, the exchange has adopted a three-year plan to increase corporate disclosure and improve surveillance. Whether the exchange will use its own listing to promote higher CG standards for listed companies and whether it ensures the independence of market surveillance from commercial activities will be important indicators of meaningful change for the better.

Accounting and auditing

Korean accounts not consolidated and uses cost rather than fair value

Korean accounting standards differ significantly from IGAAP and contribute to a weak score in this CG Watch section. Major differences relate to disclosure (Korean standards are based on individual rather than consolidated accounts), valuation (Korea uses cost rather than fair value concepts) and legal/policy-driven (Korea provides for special accounting treatment in certain circumstances).

Task force undertaking convergence since 1999

Changes to conform to IGAAP are under way, but moving slowly. The KAI/KASB IFRS Adoption Task Force has a detailed roadmap to achieve full compliance with IAS/IFRS for all listed Korean companies on a staggered timetable with full compliance expected in 2013. The taskforce has been undertaking convergence since 1999 and, as of March 2007, had issued 23 SKASs (Statement of Korean Accounting Standards).

Progress is slow

Although progress is slow, it should be noted that some large Korean companies, notably many banking institutions, and foreign-listed companies, already publish IGAAP-compliant accounts, or provide full reconciliations.

Judiciary and prosecutors

Errant directors generally given suspended sentences

While prosecutors have started prosecuting errant directors and senior management more vigorously in the last two years, even from the chaebols, they have until recently been given suspended sentences, avoiding jail. Even when custodial sentences are handed out, they are often light. As stated earlier, Hyundai Motor's Chairman Chung Mong-Koo was given a three-year suspended prison sentence this year, rather than the original six years sought by prosecutors. In addition to Hyundai Motor, high-profile cases were successfully brought against Samsung Everland and Doosan.

Indictments must be handled by Prosecutor's Office

Despite these successes, commentators note that cases for securities and corporate fraud remain very difficult to prosecute. Whilst the Financial Supervisory Service, the executive arm of Korea's chief financial regulator undertakes most investigations related to securities or corporate fraud, any indictment must be handled by the Prosecutor's Office. This means that a lot of the investigative work is effectively restarted, often by personnel unfamiliar with securities and corporate matters and can lead to weakened cases being brought to court.

Cost-effective access to courts remains a major problem

While Korea's judiciary appears to be more independent and effective than hitherto, the court system remains problematic due to its civil law procedures. Cost-effective access to courts remains a major problem, effectively neutralizing any benefit for plaintiffs from Korea's existing class action litigation since costs are punitive.

* * *

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Corporate CG issues over the past two years

There have been two major corporate-governance episodes in Korea over the past two years.

MK Chung and Hyundai Motor

Hyundai Motor chairman MK Chung remains out on bail pending appeal

In May 2006, prosecutors indicted Hyundai Motor's chairman, Mong-Koo Chung, on charges of embezzling company money to create a slush fund for bribing lobbyists. In late June 2006, the courts permitted Mr Chung to be released on bail. Chung was convicted of embezzlement and breach of fiduciary duty on 5 February 2007 and sentenced to three years in prison. However, on appeal and after a decision to make a 1tn won donation to the Korean public, his sentence has been suspended with the judge taking into account “the potential cost to the economy”. Prosecutors are looking to appeal this decision on the basis that the judge has moved beyond his jurisdiction is allowing such a suspension..

KT&G

In 1Q06 Carl Icahn and Steel Partners acquired 12.2m shares in KT&G from the market for 547bn won. They then approached management with several proposals to increase shareholder value through improved capital management.

Theoretically assured of election of two directors, a sly move by KT&G

Following a public disagreement on capital management strategy, a proxy fight commenced. Icahn and Steel Partners put forward three director nominations during the re-election of six directors out of a board of 12. Two were regular directors and four were audit committee positions. KT&G decided to split the voting into two pools with separate voting and included the three Icahn/Steel Partners candidates in the regular pool with only two possible seats. The four audit committee directors went unchallenged. Thus, under the cumulative voting system for the regular directors Icahn/Steel Partners could only pick up one board seat rather than the two or three possible if voting was for all six directors. Warren Lichtenstein, the founder of Steel Partners was subsequently elected to the KT&G board.

Masterplan includes at least 2.3tn won in dividends and share buybacks to 2008

KT&G undertook a process of evaluating its complete strategy going forward with the assistance of BCG. This resulted in the August release of its medium term Masterplan, which included at least 2.3tn won in dividends and share buybacks to 2008 and an immediate buyback and cancellation of 12m shares, or 8.3% of outstanding shares. This was followed by a further 4m shares purchased in May and June being cancelled on 29 June, whilst dividend payout ratio remained at 50%.

KT&G has lost credibility by buying 197bn won of Shinhan Bank shares

However, more recently, the board and management have sought to protect their positions by purchasing 197bn won of Shinhan Financial shares, which was followed two weeks later by a reciprocal sale of 3m KT&G Treasury shares, diluting existing shareholders by 2%. So, whilst not material in financial terms, the intention of the transaction represents a significant change in management’s relationship with shareholders. KT&G’s long-term and currently largest shareholder, Franklin Mutual Advisors restated its investment stance to active from passive as of 3 July. It was reported to the watchdog a day after KT&G cancelled its treasury shares fund to purchase the Shinhan stake. Franklin has gradually increased its investment in KT&G from 5.04% to 10.41% since the end of 2004.

Clean & Green survey

In Korea, 53 companies (70%) responded to the C&G survey. Of those responding, 19 scored higher than 50%. Reponses of note included the following:

Samsung SDI has a target to reduce emissions by 15% by 2010

Samsung SDI started keeping an inventory of GHG emissions in 2006 and has a target to reduce emissions by 15% from their 2002 level by 2010. Its R&D projects include fuel cells, solar batteries and HEV batteries. The company is also supporting suppliers such as Seoul Semi and Jahwa Electronics to reduce emissions through the Supply Chain Environment Management (SCEM) business.

Posco's emissions were calculated to be 62.1 tonnes of $C0_2$ in 2006

Posco has an Environment & Energy Committee that is responsible for the company's GHG emissions. In February 2002, the company completed its development of an enterprise-wide life cycle assessment to monitor and provide an inventory of GHG emissions. Independent firms, Ernest & Young Australia (2004) and KPMG (2005 & 2006), verified the Posco sustainability report in which Posco GHG emissions data were included. The company quantified annual emissions as 60.8 tonnes of $C0_2$ in 2005 and 62.1 tonnes of $C0_2$ in 2006. For the GHG emissions, the target is to lower emission to 6.9% below 2003 levels (15.07m TOE) by 2008.

Two small-scale hydroelectric power plants with a power generation target of 320kW are being installed at the Gwangyang Works and became operational in May 2007. Posco signed a strategic partnership in September 2004 with Fuel Cell Energy for co-development of technology. And Posco will build Korea's first fuel cell plant for power generation in Pohang in 2008.

Posco's proprietary Finex technology enables significant $C0_2$ reduction

Posco's proprietary Finex technology enables a significant reduction of carbon dioxide emissions since pre-treatment processes of sinter & coke-making are not required. Strip-casting simplifies the existing process from continuous casting, heating, roughing mill, to finishing mill into one and produces hot-rolled coils directly from molten iron. Therefore, energy consumption of strip-casting is significantly lower than conventional processes.

Hyundai Motor is investing in developing "clean and green" cars

Hyundai Motor is investing in the development of bio-fuel cars, hydro-powered cars and hybrid cars. Some of its plants use renewable energy, such as wind power. The company has also established green partnerships with 27 suppliers.

Kia Motor has made Gwan-Su Shin head of the Environment Management Team, which is responsible for the company's GHG emissions. The company has quantified its annual CO_2 emissions at 755,817 tonnes (789.5 kg/equipment) in 2005 and 767,438 tonnes (766.5 kg/equipment) in 2006.

Kumho Tire has teamed up a climate change response taskforce, running since August 2006. A GHG emission report is included in the energy report to the CEO on a monthly basis. The company plans to establish GHG inventory and have third-party authentication (to be completed by March 2008).

Samsung Electronics has set a target to reduce emissions by 45%

Samsung Electronics has a committee called the Clean Production Committee which estimates companywide GHG emissions. CO_2 emissions in 2006 were 7,096,771 tonnes, and management has set a target to reduce emissions by 45% from the 2001 level by 2010. An Environmental & Social Report published in 2006 includes details of emissions.

LG Philips LCD Vice-president Dong-Shik Kim is responsible for the company's environmental issues. The company calculates GHG emissions according to IPCC Guidelines and is in the process of establishing an inventory system. It plans to obtain third-party verification in 2008. CO_2 emissions (excluding PFCs) in 2006 were 1,418,000 tonnes.

Hynix has a taskforce team focusing on lower PFC emissions. Vice-president Sue-Byun is responsible for this. It quantifies annual CO_2 emissions each January. Hynix is planning to reduce its PFC emissions by 10% of from the 1997 level.

Figure 3

Clean & Green scores

	(%)
Samsung SDI	100
POSCO	95
Hynix Semiconductor	90
Kia Motor	85
Kumho Tire	85
Samsung Electronics	75
Hyundai Motor	75
LG Philips LCD	65
KT	65
Semco	65
GS Holdings	60
CJ	60
S-Oil	60
Kogas	55
Hankook Tire	50
LG H&H	50
SK Telecom	50
AmorePacific	50
Lotte Shopping	50
Industrial Bank of Korea	40
Hanwha	35
DSME	35
Honam Petrochemical	35
Hyundai Heavy Industries	35
Hyundai Mipo Dockyard	35
Halla Climate	35
LG Petrochemical	35
Daelim Industrial	25
LG Electronics	25
Samsung	25
Seoul Semi	25
Hyundai Steel	20
Kangwon Land	20
Daewoon E&C	15
Doosan Heavy Industries	15
GS E&C	10
Doosan Infracore	10
Hyundai Development	5
Shinsegae Company	5
Dongkuk	5
Orion	5

Source: CLSA Asia-Pacific Markets

Voting by poll

Many Korean companies are confused by the issue of voting by poll

Many Korean companies are confused by the issue of voting by poll. A typical response on this question is the following:

> Shareholders express opposition by a show of hands. If there is no show of hands, the company moves on to next resolution. If there is a show of hands, the resolution is voted by poll. In the case a poll is conducted, if there is no specific request from shareholders, the company counts the votes. However, there is a notary that participates in the count.

Few Korean companies understand best-practice voting

As far as we can tell, this is as close as Korea gets to best practice. The response above scores a "no" to our question on voting by poll as it does not meet the following criteria:

- All votes are counted properly, including electronic and proxy votes;
- An independent auditor counts the votes;
- A detailed breakdown of the votes by resolution is provided the following day, and available on the company's website and/or in the filings;
- The company always does this whether or not there is opposition.

Companies should vote by poll as a matter of course,

We found no companies who met all four criteria to pass question 38

We could find no company that met these criteria, so all 76 companies in the survey scored negatively on question 38. Many companies said they vote by poll on controversial issues or when there is opposition, but this does not meet the best practice standard as voting by poll should be carried out as a matter of course.

Directors' remuneration

Smaller companies pay the most to their directors relative to net profit

The average percentage of directors' total remuneration to net profit for CLSA coverage companies in Korea is 0.96%. The 10 companies with the highest remuneration to net profit are smaller companies with an average market cap of 1.2tn won, and are mostly companies in the tech and internet sectors, which have lagged the market in the last five years. The 10 companies with the lowest remuneration to net profit are larger companies with an average market cap of 9.7tn won, and are companies in the heavy, construction sectors, which have been the strongest performers in the past five years.

Some smaller companies have lifted directors' pay faster than profit growth

Figure 4

Companies whose directors' remuneration is highest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit last 5 years?
Kumho Tire	14.0	No
CDNetworks	6.0	No
Cheil Communications	5.6	Yes
Kumho Electric	5.1	Yes
Samsung SDI	4.5	No
Halla Climate	4.4	Yes
Seoul Semi	3.9	Yes
NCsoft	3.5	No
Megastudy	3.0	Yes
Nongshim	2.1	No

Source: CLSA Asia-Pacific Markets, company reports

Board compensation not registered as share of profit at some large firms

Figure 5

Companies whose directors' remuneration is lowest share of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit last 5 years?
Hyundai Mipo Dockyard	0.0	Yes
Daewoo E&C	0.0	Yes
DSME	0.0	No
Samsung Heavy Industry	0.0	Yes
Daelim Industrial	0.0	Yes
Hynix Semiconductor	0.0	Yes
Hyundai Development	0.0	Yes
Shinsegae	0.0	Yes
Woori Financial	0.0	Yes
LG Card	0.0	Yes

Source: CLSA Asia-Pacific Markets, company reports

Changes in CG scores

The table below highlights six major movers in our CG rankings: two companies which have moved up and four companies which have moved down.

Woori Financial moved from the third to the second tier

Figure 6

Notable movers

	CG quartile 2005	CG quartile 2007	Direction
GS Holdings	3	1	Up
Woori Financial	3	1	Up
Amore Pacific	2	3	Down
Kogas	2	3	Down
Kumho Tire	3	4	Down

Source: CLSA Asia-Pacific Markets

GS Holdings' results are now reported through a press release

GS Holdings has had a noticeable improvement in CG over the past two years, especially in relation to disclosure and communication. Results are now reported through a press release with good segmentation. It also now has a well-developed and updated English website that was not available at the time of our last survey. Communication with investors has improved significantly through more roadshows, presentations, good management access and transparency.

Woori now has a new chairman and CEO. The chairman has called for all senior executives to buy group stock and shift from an employee to an owner mindset. It remains early days; however, we are very encouraged by the changes. Management has disclosed profitability targets and articulated a detailed business plan. The simplest change is that the legacy of mergers related to the insolvency of the various banks that KDIC brought together to form Woori is now outside our five-year window of consideration.

Amore Pacific adopted a holding company structure in 2006; however, we have found key management members are seldom available for IR meetings, although materials and IR staff have been available all the time. Changed shareholding and management structures are raising questions. With Mr Seo as CEO of both the operating entity and the holding company Pacific Corp, we see little financial benefit in forming a holding structure given that Pacific Corp did not have any significant non-core investment that was either undervalued or retarding the valuation of Amore Pacific. Still, the Seo family holds 13.5% of Amore Pacific in addition to Pacific Corp's 35.3%, whilst the family holds over 56.7% of Pacific Corp.

Kogas has been more investor friendly on committees relating to the board of directors, so now they have a remuneration committee and an audit committee.

Kumho Tire participated in the Kumho Group bid for Daewoo E&C

Kumho Tire scores strongly on access to management and communication to investors, with a strong IR team. However, their financial reporting has become more confusing with the inclusion of Chinese tires made in China in their Korean revenue figures. The flip side of this is that they are not disclosing enough information on China operations to determine the consolidated income for these tires on a quarterly basis. Also, Kumho Tire participated in the Kumho Group bid for Daewoo E&C, spending 500bn won. While the returns on this may prove reasonable, we believe this is not the kind of move an independent tyre company would have made.

Our Qarp picks were mostly low-beta stocks that have underperformed

Qarp stocks 2005

Our Qarp picks for 2005 lagged slightly, providing a two-year return of 62%, versus 68% for the market. This apparent marginal lag, however, would have been much worse were it not for the performance of Posco, which returned 156%; the other four picks underperformed.

High corporate governance can be a proxy for low-beta stocks

As has been noted in previous corporate-governance reports, high corporate governance can be a proxy for low-beta stocks. This was arguably the case in 2005, with Kogas, KT&G and SKT typically expected to lag during bull markets.

Figure 7

Qarp stock picks 2005

Company	CG quartile	ROE 04-05 (%)	Share price Jun 05 (won)	Share price Sep 07 (won)	Performance (%)
KT&G	1	17.7	40,500	67,800	67.4
Posco	1	13.8	182,500	467,000	155.9
Samsung Electronics	1	24.2	494,000	571,000	15.6
SKT	2	20.6	42,000	44,050	4.9
Kogas	2	6.6	29,650	49,450	66.8
Average return of Qarp stocks					62.1
MSCI Korea two-year return					68.3

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

Qarp picks 2007

This year, our Qarp picks are dominated by banks

This year, we have five Qarp picks, which are companies with ROE above COE, at least 10% upside to theoretical PB value (calculated using a simple Gordon growth model) and scoring in the top two CG quartiles. Our Qarp picks include four banks, which score highly due to their high ROE relative to the ROE reflected in PB valuations. (See our recent bank sector report *Theories of Relativity* for more on this).

Cost of equity for Korea is 11%

The other Qarp pick is Posco. As with the banks, the PB ratio of this company implies the markets believe recent return on equity is not sustainable. We use an 11% cost of equity for Korea, based on a 6% risk free rate and 5% equity risk premium.

Figure 8

Qarp picks 2007

Company	CG quartile (1-4)	Avg ROE FY07-08 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Korean Exchange Bank	2	23.4	11.6	4.0	2.6	1.5	73.6
Woori Financial	1	21.0	11.6	5.0	2.4	1.4	69.1
Hana Financial	1	14.4	10.7	5.0	1.6	1.1	50.9
Daegu Bank	1	18.1	12.6	5.0	1.7	1.5	17.0
Posco	1	15.9	11.0	2.0	1.5	1.4	13.3

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Malaysia - Transmile testing the market

Market hit major pot hole with Transmile's accounting debacle

On the surface, Malaysia's corporate-governance environment has generally been on an improving trend, as evidenced by favourable remarks made by the World Bank regarding protection of investors in early 2007. However, we have not noticed a significant step-change and the market hit some serious pot holes when Transmile's accounting irregularities came to the fore earlier this year. ACGA's country rating for Malaysia slipped to 49%, compared with 56% in 2005. But this is largely a reflection of a more rigorous evaluation process this time around, including more criteria in the country rankings regionally. ACGA also stressed that after a strong start in the first half of this decade, the regulatory reform process seems to have lost its sense of urgency: new policy developments over the past two years have been fairly superficial, while promised amendments to the Companies Act are happening only slowly and in a piecemeal fashion.

Major changes in regulation have yet to materialise on the back of Transmile's troubles, but the media has increasingly been highlighting the government's tough talk regarding CG misadventures, and there is increasing debate about the role and structure of internal audit committees. The media is increasingly concerned about the "independence" of independent directors and the need for Bursa to run test samples amongst smaller companies.

Clean & Green is a growing focus, but off a low base

The top CG companies, according to our ranking, are Public Bank, Tanjong, Zelan, Top Glove and Genting. Interestingly, there is a sizeable overlap as far as Clean & Green (C&G) is concerned.

Pressure from EU-based NGOs

The C&G issue is growing in Malaysia, but from a low base. A big push has come from the palm oil industry's need to prove that it is sustainable, in view of the intensifying campaign by environmental groups in Europe. The issue of full traceability is raising the issue of C&G to the fore amongst plantations. The issue of $C0_2$ emissions is at the heart of this, with NGOs alleging that plantation expansion is achieved through burning, generating CO_2 emissions, with peat draining further boosting methane emissions. This issue, in turn, is very slowly starting to generate a two-tier palm oil market, and those than can get certified (eg via Proforest) can sell part of their production at a premium. Those that are well distanced from the industry's palm oil estate expansion in Indonesia, or have taken active steps to act in a sustainable fasion there, should also benefit (as Indonesian expansion is being seen as the major culprit). Meanwhile, a few niche companies are capitalizing on the prospect of generating carbon emission credits.

Elsewhere, the C&G issue has not generated much traction yet in both corporate and political Malaysia. But it is early days yet. The trajectory will be sharply up given the commercial prospects for carbon emission trading.

Qarp picks from 2005 returned an average 42% from past two years

Qarp picks from 2005 had a mixed performance. The average for the four stocks was a return of 42% for the two years to mid-2007 versus the 51% return for the MSCI Malaysia. Perhaps not surprising, low-beta plays BAT and Guinness performed accordingly amid the upturn in the stock market. But Qarp picks IJM and SP Setia generated spectacular returns of 55% and 110%, respectively, given the sharp upturn in property and construction prospects. Current-year Qarp picks are Tanjong, Zelan, WCT Engineering, Bumiputra-Commerce, Naim Cendera, Maybank, Media Prima and BAT Malaysia.

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Country CG score

Malaysia has slipped in our survey from 4th in 2005 to equal 6th this year for a number of reasons. Rules and guidelines on corporate governance are aplenty in the country, but so are accounting scandals (Transmile and Megan Media, to name just two), indifferent implementation of best practices by listed companies, and patchy enforcement. Corporate governance may be talked about a great deal in Malaysia, but the extent to which it has penetrated the country's business culture remains limited. And after a strong start in the first half of this decade, the regulatory reform process seems to have lost its sense of urgency: new policy developments over the past two years have been largely superficial, while promised amendments to the Companies Act are happening only slowly and in a piecemeal fashion.

Figure 1

Malaysia ratings for maco-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	44	59	Plenty of regulations
Enforcement	35	49	Patchy by ACGA's criteria
Political & regulatory environment	56	60	Sense of urgency lost in reforms
Adoption of international accounting/auditing standards	78	75	Progress has been made on this front
Culture	33	38	Relatively low penetration
Overall score	**49**	**56**	Drop partly due to a more rigorous survey procedure

Source: ACGA, CLSA Asia-Pacific Markets

Tweaking the Companies Act

Improvements to company law have been slow in coming

On 23 May 2007, the Companies (Amendment) Act 2007, intended to enhance the country's corporate-governance framework, was passed by parliament (and is still awaiting royal assent before it takes effect). Some of its key amendments include:

- Allowing companies to use more than one venue for their shareholder meetings, so as to enable all members a reasonable opportunity to participate. Companies may also utilise any technology to conduct their meetings.
- Requiring AGM notices to be sent out at least 21 days before meetings (the current rule is 14 days).
- Obliging an auditor of a public company to report to the Registrar of Companies any serious offence involving fraud or dishonesty that he/she believes has been committed by any officer or employee against the firm.
- Protecting any officer of a company who exposes breaches of the Companies Act from discrimination by their employer.

This is not quite what was envisioned in 2003 when the Companies Commission of Malaysia (CCM) established the Corporate Law Reform Committee to undertake a comprehensive review of the Companies Act 1965 and make it relevant in today's corporate environment. The committee set up four working groups, each comprised of one committee member and people from a wide variety of fields, including academia, industry and professionals. Group A dealt with company formation and the alternative forms of business vehicles; group B with capital raising and maintenance rules; group C with corporate governance and shareholders' rights; and group D with insolvency and corporate securities. Taking into account law reform initiatives being conducted elsewhere, particularly the UK Company Law Review, the working groups were to publish consultation documents containing:

- A comparison of the existing Malaysian law and other jurisdictions;
- Questions that require public comment;
- Recommendations on the respective issues;
- Draft legislative texts.

These were to be posted on the CCM website for public feedback. Nine documents have so far been issued, four this year alone. But given the generally slow pace of follow-through, many practitioners and observers have begun to question how long the exercise will last.

Over in the capital markets

Some streamlining of securities laws

In May 2007, parliament also passed the Capital Markets and Services Act (CMSA), which combines the Securities Industry Act 1983 and the Futures Industry Act 1983 into one piece of legislation. It is scheduled to come into force in September 2007.

According to the Securities Commission (SC), the CMSA will:

- Enhance investor protection in the areas of market misconduct and fund raising;
- Establish a framework for regulation of self-regulatory organisations within capital markets;
- Enhance the framework for fund raising by providing greater clarity.

The act comes in the final phase of the SC's 10-year Capital Market Master Plan, which covers the period 2000-2010. However, regulatory officials admit that there is little that is new in the act and it is more of a streamlining exercise.

Meanwhile, in November 2005, Bursa Malaysia amended its listing rules with regards to related-party transactions and the issuance of new shares. Key additions included:

- Where the percentage ratio for a related-party transaction is equal to or exceeds 5% or 25%, the appointed independent adviser has to advise the minority shareholders on whether they should vote in favour of the transaction;
- In the case of new issues of securities, the chief executive of a listed issuer or a holding company of the listed issuer was added to the list of people that were not allowed to buy these shares unless shareholders approved the sale in a general meeting;
- The chief executive also has to ensure that people with relations to the chief exectitive's office abstain from voting on the resolution approving a sale of new shares to the chief executive.

Accounting convergence

Resistance to some international accounting standards is appearing

While Malaysia claims convergence with international financial-reporting standards, full convergence has not yet been achieved. This year has seen some pushback, particularly with the financial-instrument standard IAS 39 and the agriculture standard IAS 41, both of which require fair-value application.

IAS 41 is only an exposure draft, but two issues have come to the fore so far: do Malaysian accountants have the expertise to deal with this standard? And will the layman understand the information? IAS 39, on the other hand, was issued as a standard, but the effective date was postponed twice before being deferred indefinitely. Some people are starting to question the need for globalisation and greater transparency in Malaysia.

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Corporate CG issues over the past two years

Transmile steals the limelight

The top CG disaster over the past two years is undoubtedly **Transmile**, a rapidly growing air freight forwarder. This overshadowed most other events, but other issues have surfaced at Megan Media, Nasioncom and Welli Multi in 2007. Another notable transgression involves GP Ocean's bid for listing on Bursa in 2006 that contained erroneous information (subsequently called off). The SC has been conducting investigations into Transmile, Megan and Welli Multi. Earlier this year, it 'preferred criminal charges against three individuals for abetting Transmile in making a statement that is misleading in a material particular relating to TGB's revenue in the company's Quarterly Report on Unaudited Consolidated Results for the Financial Year ended 31 December 2006.' They are the former CEO, former CFO and an executive director.

With receivable discrepancies, Transmile's accounts had been substantially overstated. The troubles first surfaced in May 2007 when the company failed to get an extension of the filing of audited accounts and the auditors did not approve the accounts due to a lack of backing for some trade receivables. The board, led by major shareholder the Kuok group, called for a special audit. Released in July 2007, the audit suggested transactions had been 'fabricated to transfer trade receivables to asset accounts' (quoted in *The Star*).

After the special audit investigation, the audited numbers indicated the following changes relative to the unaudited results for FY06 and FY05, respectively: 1) reduction in revenues by RM333m and RM194m to RM656m and RM356m; 2) reduction of net profit by RM284m and RM445m to a loss of RM126m and a loss of RM370m; and 3) reduction in property, plant and equipment valuation by RM573m and RM586m to RM975m and RM979m. In fact, loss estimates have been mounting between Moores, Rowland's first special audit and the final one.

Transmile sent shockwaves through the market . . .

. . . but general confidence has not been significantly dented

This sent shockwaves through the market as Transmile is not a small cap. It had a market cap of more than US$1bn at its peak, with significant foreign shareholding and analyst coverage. Target prices on this stock were hovering well above RM10 in the run-up to the problems, in contrast to the RM5 level currently. Indeed, Transmile was long seen as one of Malaysia's more interesting growth stories. The perceived pressure to live up to market expectations resulted in concerns over other top-performing stocks. Fortunately, nothing has materialised on other institutional investor favourites.

Also cases at smaller companies Megan, Welli and Nasioncom

However, troubles also surfaced at **Megan Media**, a maker of optical discs. Investigative accountants Ferrier Hodgson said earlier in 2007 that 'certain trades in the company's accounts last year were fraudulent' (quoted in *The Star*). The final report has yet to come out at the time of writing, but, for FY4/07, Megan reported a RM1.3bn loss and in early July defaulted on RM0.9bn worth of bank loans (after having defaulted on RM47m worth of trade loans in May, at the time when its problems started coming to the surface). In June, the SC launched an investigation into the company. Although the numbers are large, Megan has received less attention given its low profile in the equity market.

Public Bank No.1 on CG, followed by Tanjong, Zelan, Top Glove, Genting

Figure 2

Companies in the top-two CG quartiles for Malaysia (CLSA coverage)

Top quartile	Second quartile
Public Bank	AMMB
Bumiputra-Commerce	BAT Malaysia
Genting	EON Capital
IJM	Gamuda
Lafarge MC	IOI
Naim Cendera	Kuala Lumpur Kepong
Tanjong	Malayan Banking
Top Glove	Media Prima
WCT	Resorts World
Zelan	SP Setia

Source: CLSA Asia-Pacific Markets

Elsewhere, **Welli Multi** at the end of June 2007 was requested by the SC to withhold the issuance of quarterly reports for December 2006 and March 2007 given an issue regarding the 'authenticity and/or recoverability' of trade receivables of RM113m. Meanwhile, the request by Mesdaq-listed telecom firm Nasioncom to extend the time for presentation of annual audited accounts for FY12/06 was rejected by Bursa Malaysia. The SC's website indicated that it recently charged three people at Nasioncom for submission of false information to the SC, both in relation to the December 2005 accounts and the IPO prospects.

These issues have not rocked confidence in the market in a noticeable way, in our view. A common view is that issues like this are happening all over the world, not just Malaysia. China Aviation Oil's 2005 collapse in Singapore was of a larger scale. These do not appear to be systemic or peculiar to Malaysia.

Rules are there . . . key is enforcement

The market will nevertheless pay close attention to how the authorities ultimately handle these situations. Whilst the rules are in place, investors want to see tougher enforcement and penalties. Not surprisingly, we are seeing more attention being paid by the political powers to this issue as foreign confidence in the Malaysian market, although on a far stronger footing than post the Asian Crisis, still has some way to go.

Some focus on M&A proceedings as well

On a more general note, the market's aggressive M&A wave has seen some concerns raised over the way that major shareholders are taking over companies in Malaysia. Examples include Malakoff (by MMC), Maxis (by the major shareholder) and the merger of Sime Darby, Kumpulan Guthrie and Golden Hope. Everything has been above board and in line with regulations. But with major shareholders able to: leverage on the threat of delisting; and structure buyouts within the asset and liability buyout model to leave a lower threshold of required minority approval, questions have been raised about fair valuations.

The former issue relates to the 25% hurdle for a free float. If an acquiree gets more than 75% of the company's shares outstanding, it will then be up to Bursa to call for delisting. If one is a minority shareholder, the prospect of delisting is not attractive, leaving the investor pressured towards accepting offers where the major shareholder is perceived to have enough backing.

Point number two relates to the structure of takeovers. If the equity is taken over, the acquiree needs more than 75% of the unrelated parties vote. However, if the assets and liabilities are sold to another vehicle, only 50% is needed. This model was used in MMC's take-over of Malakoff, announced in 1H 2006.

At the end of the day, enterprising companies will do what they can within the rules of the market and investors will need to ensure their votes are recorded appropriately at EGMs - hence this is an area that ACGA has emphasized for improvement across the region. A positive event in this regard took place in early July when institutional shareholders managed to squeeze out a higher price for Linde's takeover of Malaysian Oxygen, after consultation with Linde.

Clean & Green survey

We had expected a lower rate of response

In Malaysia, the survey was sent out to 38 companies. Out of these, 33 responded with either surveys filled in or an outright decline in participation. Out of the total, 22 companies (58%) sent the survey form back to us. Out of these 22 companies, 20 had positive scores (ie, not zero). Generally, there is still a view that this issue is not directly relevant to companies and their business models; we had anticipated a higher rate of coporations with zero scores.

The high scorers were IJM, YTL Power, Resorts World, Tanjong, Plus, Genting, WCT and Lafarge. We saw decent representation by construction-related companies and those with emission issues, eg transportation, power plants and plantations. Some of those that scored high on CG, however, did poorly on C&G, for example Public Bank.

YTL Power came in with a C&G score of 55%. Out of its businesses, UK's Wessex Water appears to have been the most proactive on this front. We also note that the group is in the process of obtaining IS0 14001 certification for its power stations in Paka and Pasir Gudang in Malaysia and mechanisms are being implemented for the management of power plant gaseous emissions, waste effluent, discharge cooling water and industrial scheduled waste.

Lafarge Malayan Cement scored highly at 55% and would have had the highest marks if not for the individual/committee responsible for the company's GHG emissions not reporting directly to the board but to the CEO. Being a cement maker within a global group, environmental issues appear at the top of their agenda. According to Lafarge Malayan Cement (LMC), there are no government regulations on CO_2 emissions in Malaysia, but LMC follows international standards for greenhouse gas emissions set by Lafarge which are more stringent than regulations in Malaysia. LMC's target is to reduce emissions by 20% in 2010 from 1990 levels.

IJM scored a respectable 50% for C&G. The company is ISO 14000 accredited. Key measures and focus has been at IJM Plantations. This subsidiary quantified annual carbon sequestration in its 2006annual report.

Figure 3

C&G scores

	(%)
YTL Power	55
Lafarge MC	55
IJM	50
Resorts World	45
Genting	45
WCT	45
Tanjong	40
Plus Expressways	40
Kuala Lumpur Kepong	35
Zelan	35
Malaysia Airlines	30
Star Cruise	30
Top Glove	30
IOI	25
Bumiputra-Commerce	15
Gamuda	15
Naim Cendera	10
Malayan Banking	5
SP Setia	5
Media Prima	5

Source: CLSA Asia-Pacific Markets

Voting by poll

Very rarely do we hear of voting by poll

In Malaysia, almost all voting is done via a show of hands. That is why there was a "no" result throughout the surveyed universe on whether the company had voting by poll. Some companies have rules that vary depending on what the voting threshold is (eg 50% or 75%), but most of the time a poll is not used. As for AGMs and EGMs in Malaysia, in the past, it was popularly seen that most small retail investors would primarily show up for the food and freebies, but we hear anecdotes of this now changing with more challenging questions asked to management/boards. This is probably a lingering effect of the Asian Crisis, following which many investors have been licking their wounds from corporate failures.

Directors' remuneration

Positive correlation

The average director's total remuneration as a share of net profit for firms we cover is 2.1% (excluding outlyers due to losses or extremely small net profit for 2006). In Malaysia, the correlation between directors' remuneration, the share price and earnings is reasonably high. Typically, we find the higher the renumeration as a proprtion of net profit, the better the company performs.

SP Setia, Naim Cendera, Resorts and Zelan directors get 5-7%

Figure 4

Companies with directors' remuneration at highest % of net profit

	Directors' remuneration as % of net profit	Has director's remuneration risen faster than net profit over the past five years?
SP Setia	6.92	No
Naim Cendera	5.90	Yes
Resorts World	5.29	No
Zelan	5.18	No
Genting	4.52	No
WCT	4.40	Yes
Media Prima	4.00	No
Berjaya Sports Toto	3.86	No
Ta Ann	3.50	No
IJM	3.34	No

Source: CLSA Asia-Pacific Markets, company reports

Telekom, Tenaga, MISC get only 0.1% of earnings . . .

. . . while directors at Maybank and Bumiputra receive about 0.5%

Figure 5

Companies with directors' remuneration at lowest % of net profit

	Directors' remuneration as % of net profit	Has director's remuneration risen faster than net profit over the past five years?
Digi	0.03	No
Telekom Malaysia	0.10	No
Tenaga Nasional	0.10	No
KLCC Props	0.10	No
MISC	0.12	No
Plus Expressways	0.14	No
Sime Darby	0.20	Yes
Tanjong	0.39	No
Malayan Banking	0.41	No
Bumiputra-Commerce	0.58	No

Source: CLSA Asia-Pacific Markets, company reports

Changes in CG scores

Transmile the biggest change, by a wide margin

The biggest single drop in CG score was Transmile, whose troubles have been discussed in the section above. Formerly in the second quartile, the company has dropped to the bottom of the list.

Positively, we note general improvements at the GLCs, a function of GLC reforms and greater openness. For example, Tenaga's rating benefited from the publication of return on capital estimates and a shift in terms of perceived government interference. MAS benefited from a more effective board and from the turnaround effected under the new top management. At Bumiputra-Commerce, the improvement in score came about as the group has disclosed ROE targets, raised the number of independent directors and increased the effectiveness of the board, in line with Khazanah's increase in shareholding. EON Capital benefited from now having an independent director as chairman, increased number of independent directors and a more effective board, in our view. Berjaya Sports Toto also deserves mention with an improvement in score after a long history of being seen as weak on corporate governance (eg, there was a history of inter-group lending). There has also been an improvement in our view of board effectiveness.

Figure 6

Companies with notable changes in CG scores: 2005-07

	Chg in CG score (ppt)	2005 quartile ranking
Berjaya Sports Toto	18.9	4
Bumiputra-Commerce	9.9	1
EON Capital	16.2	2
Malaysia Airlines	19.3	4
Tenaga Nasional	18.2	4
Transmile Group	(40.9)	2

Source: CLSA Asia-Pacific Markets

Qarp stocks 2005

Qarp picks 2005 a mixed bag

Qarp picks in 2005 performed positively in terms of absolute return from mid-2005 to 2007. But on a relative basis, the average for the four stocks was a return of 42% versus the 51% return for the MSCI Malaysia. This is largely a function of the stock and its sector. Construction and property play IJM and SP Setia outperformed, in line with the strong recovery in their business cycles. IJM and SP Setia generated spectacular returns of 55% and 110%, respectively. However, low-beta stocks BAT (+1%) and Guinness (+4%) underperformed.

Figure 7

Performance of 2005 Malaysian Qarp picks

Company	CG quartile	ROE 04-05 (%)	Share price Jun 05 (RM)	Share price Sep 07 (RM)	Performance (%)
IJM	2	9.1	4.92	7.65	55.5
SP Setia	2	13.7	3.84	8.05	109.9
BAT	1	111.7	41.75	42.00	0.6
Guinness	1	33.1	5.65	5.85	3.5
Average return					42.0
MSCI Malaysia two-year return					51.0

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets, Bloomberg

Qarp picks 2007

Eight Qarp picks for 2007

Our 2007 Qarp picks are outlined in the table below, based on criteria outlined at the beginning of this report. The valuations differ from our target price for various reasons, e.g. NAV-based valuation, PE-based valuation, etc. We have equalised the long-term growth rate for all to make it more comparable given less moving parts. The cost of equity used for Malaysia is 10%, of which the risk free rate we use is 4.3% and the equity risk premium is 5.7%.

Figure 8

Qarp list: September 2007 valuations

Company	CG quartile (1-4)	Avg ROE 07-08 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Zelan	1	23.6	10	5	3.71	2.8	32.7
Bumiputra-Commerce	1	20.0	10	5	3.01	2.4	25.2
BAT Malaysia	2	121.4	10	5	23.27	19.0	22.5
Media Prima	2	32.8	10	5	5.57	4.6	21.0
WCT	1	17.0	10	5	2.41	2.0	20.4
Naim Cendera	1	19.5	10	5	2.91	2.4	19.4
Malayan Banking	2	20.0	10	5	3.00	2.5	18.9
Tanjong	1	16.2	10	5	2.24	2.0	14.6

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Philippines - Awareness, but progress?

Overall, there were no surprises in the CG scores of the 22 companies participating in our CG and Clean & Green surveys. As expected, the Ayala group (Ayala Corporation, Ayala Land, Bank of the Philippine Islands, Globe Telecom and Manila Water) landed at the top, along with telecom giant PLDT.

Ayala Group continues to lead the way

As compared to two years ago, awareness of CG and C&G has risen amongst the government and companies in the Philippines. Note that the government recently implemented the Biofuels Act of 2006, also known as the Clean Air Act of 2006 last May 2007, which requires a 1% blend of biodiesel to all diesel fuel sold in the country. The act also provides a provision for the possibility of increasing the mandatory diesel blend level to 2% within two years from approval. The law further stipulates that refiners must maintain a 5% minimum ethanol blend to petrol. There is the further possibility to increase the ethanol blend to 10% in the fourth year after the law's enactment.

Government recently implement the Biofuels Act of 2006

Awareness has also increased amongst corporations. 73% of the companies responded to the C&G survey and five (23%) have a score above 50%. In particular, First Gen, First Philippine Holdings, Ayala Land and Ayala Corporation are worth noting for their C&G scores.

Two-thirds of the corporates participated in the C&G survey

In 2005, Manila Water represented our sole Qarp pick. Since then, the share price has rocketed from P6.30 per share to P14.30, up 127% against MSCI-country two-year return of 88%. For 2007, however, we do not have any Qarp picks. The high-CG stocksat around theoretical valuations are Globe and First Gen.

No Qarp picks in 2007

* * *

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Country CG score

Overall, amongst the 11 markets surveyed, the Philippines scored the second-lowest, coming just ahead of Indonesia and slipping one place behind China from its position in the *CG Watch* survey in 2005.

Like Indonesia, the Philippines scores poorly in most categories (see table below). "CG Rules & Practices", "Enforcement" and "Political and Regulatory Environment" represent the lowest-scoring areas. Also, like its larger neighbour, the country suffers from similar problems of corruption, political interference and a lack of financial resources. Unlike Indonesia, however, and despite slipping a place in the rankings, there are early signs that matters in the Philippines may be set to improve in the years ahead.

Corruption, political interference and lack of financial resources

Despite a challenging political environment, the administration of President Gloria Macapagal Arroyo has surprised everyone by turning around the government's finances in recent years with a strong shot at balancing the budget in 2008. A major contributing factor has been the government's campaign to pursue and prosecute corrupt public officials, notably in the Customs and the Bureau of Internal Revenue, suggesting that it is serious about tackling the rampant corruption that still is an issue for the economy.

Arroyo is busy fixing the fiscal situation

That said, political interference in the securities market remains strong: while the chief market regulator, the Securities Exchange Commission (SEC) is separately constituted and operates independently of the Department of Finance, all SEC commissioners are appointed by the President for a fixed term of seven years, leading to clear political influence.

The Philippines has the second-worst score

Figure 1

Philippine ratings for macro-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	39	53	Score has slipped on tighter criteria; SEC and PSE suffering lack of resources.
Enforcement	19	22	Slightly lower; poor score.
Political & regulatory environment	38	50	Political influence remains apparent.
Adoption of international accounting/auditing standards	75	82	Philippines has achieved full compliance with accounting and auditing standards since 2005. Relatively high score.
Culture	36	31	Overall improvement in CG awareness amongst Philippine corporates.
Overall score	**41**	**46**	Score reduced; in the region slipped one rank, now just above Indonesia

Source: ACGA, CLSA Asia-Pacific Markets

Enforcement remains weak

Still the government is beginning to make the right noises towards improving CG standards and has adopted Organisation for Economic Cooperation and Development (OECD) CG principles in its market CG code. However, the government's long-term commitment to the cause remains questionable due to some weak rules, very weak enforcement and a continued chronic lack of resources. With an improved fiscal position, it is to be hoped that more resources can be efficiently channelled to the SEC and the stock exchange to improve the current woeful surveillance and enforcement activities.

There is generally no split between chairman and CEO

Filipino companies score poorly in many aspects of CG. With many large conglomerates and groups controlled by dynastic families and tycoons, there is generally no split of the roles of chairman and CEO. Voting by poll at company meetings is done by only a few companies.

CG Code of Philippine companies falls materially short

While there is a CG code that companies generally follow, it falls materially short of international best practice. Requirements on board governance and independence, especially of key committees, do not follow international best practice and while there is a provision in the code that all shareholders shall have pre-emption rights, it is qualified by any provisions of a company's articles of incorporation that may deny such rights, effectively leaving the matter to the discretion of the board. Since the definition of 'independent director' in the CG Code does not explicitly refer to the need for an independent non-executive director (INED) to be independent of any controlling shareholder, it is relatively easy for a controlling shareholder to also control the board.

A few corporations understand the importance of CG

Many of these CG shortcomings emanate from a lack of credible rules, yet there is no meaningful evidence that the average listed company sees CG as anything more than a regulatory requirement. True, a number of leading Filipino companies (eg SM Group and the Ayala group) understand the importance of CG as a useful marketing tool and do follow meaningfully higher standards than required, but these are generally the larger companies and even these fail to follow international best practice in all respects. In contrast, corporate communications processes in the Philippines, particularly among large cap stocks, are well understood. Online data are plentiful and up-to-date among the better-run companies. These stocks tend to be well covered by analysts and understand the importance of briefing shareholders and the market regularly.

In full compliance with international standards

The Philippines has already achieved full compliance with international accounting and auditing standards since 2005 and consequently scored highly in this category of our survey. Generally, regulations relating to accounting are also good, with auditor independence and rotation standard. Corporate financial disclosure is also generally sound with quarterly accounting and non-financial reporting of a decent standard, principally among the larger companies.

Despite this, a survey by the SEC of the audited financial statements of the 100 largest Filipino companies found 19 areas of non-compliance with accounting and auditing standards, suggesting that while accounting regulations meet best practice, compliance does not.

There is little evidence of institutional activism

Similar to Indonesia, there is little or no evidence of institutional activism to promote better CG in the Philippines, either among international or domestic investors. There are no CG activist funds in the Philippines; development of investment institutions is at an early stage in the Philippines and any private body promoting CG on behalf of institutional investors is likely to be years' away. Even non-government organisations (NGOs) promoting better CG appear non-existent.

Disgruntled minorities have little recourse

Institutional investors generally do not vote their shares at company meetings and do not vote against management. Like the institutional market, the retail investor base is still very shallow and underdeveloped, lacking cohesion. Disgruntled minority shareholders have little recourse: class action legislation is possible in theory in the Philippines but a tortuously complicated and costly legal system prevents such litigation in practice.

Regulatory overview

Regulatory system is modelled on that of the United States

The Philippines' securities regulatory system is modelled on that of the US and as such, the SEC in theory has strong powers of rule-setting, regulation and enforcement. In practice however, the SEC is a semi-political animal with weak financial and human resources and a poor track record of enforcement. Insider trading and market manipulation are commonplace in the market, especially given thin volumes. While securities laws appear robust, weak enforcement means there is little deterrent. Very few insider trading or other market manipulation cases have ever gone to trial. Even if they get there, the legal system tends to tie up such cases for years.

The PSE also suffers from lack of resources

The Philippine Stock Exchange (PSE) also suffers from a lack of resources, especially with regard to enforcement. Moreover, the PSE's powers of sanction are unclear, although there is a prosecution and enforcement division. Primary responsibility for enforcement rests with the SEC.

Enforcement remains the key issue

The government has made efforts in the past year to improve and update securities laws and regulations, but there is still plenty to do. While there is little evidence of new listing regulations from the PSE, the SEC, which sets the principal ongoing rules relating to disclosure etc, has revised its rules substantially over the last few years. Rules are fine — enforcement remains the key issue.

Accounting and auditing

As mentioned earlier, the Philippines scores highly with its accounting standards, which are already fully compliant with international best practices. Oversight of the accounting profession is undertaken by the Accountancy Board of the Professional Regulation Commission. Adequacy of resource is as usual a key issue but the government has done surprisingly well in the past at pushing reform of local standards towards international accounting standards (IAS) so it is to be expected that local standards will remain up-to-date.

Judiciary and prosecutors

The Philippine scores poorly on its judicial system

The Philippines scores poorly on its judicial system, which is widely regarded as administratively burdensome, politically influenced, costly and corrupt. Minority shareholders have little recourse against errant companies and management as cases can take years to resolve. Witness the government's own case against owners of sequestered shares of San Miguel, which has been ongoing since 1986 and remains unresolved to the present day. As few cases reach the court's docket, the judiciary also suffers from inexperience with regard to securities law.

* * *

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Corporate CG issues over the past two years

The Ayala group, spearheaded by Ayala Corporation (AC) and including Ayala Land (ALI), Globe Telecom (Globe), Bank of the Philippine Islands (BPI), and Manila Water are at the top of our CG rankings, underscoring the group's excellent reputation and deep commitment to CG practices. In FY2005, all of these companies with the exception of Manila Water were also in the top quartile of our CG survey. Note though that Manila Water was in quartile two in 2005. PLDT also made it to the top quartile in our survey this year, rising from quartile two in previous rankings.

Second stringers

Maintaining their positions in quartile two are Banco De Oro and ABS-CBN. Moreover, newly covered stocks namely SM Investments, First Gen, Rizal Commercial Banking and Megaworld also made it into the second quartile.

Disappointments include San Miguel, Jollibee and Metrobank

The major CG disappointments in our view include San Miguel, Jollibee Foods and Metrobank as we find their disclosure standards sub-par when compared to other large cap companies in the Philippines. In recent quarters, we found management at these companies to be inaccessible following results announcements or meaningful newsflow.

Figure 2

Companies in the top-two CG quartile for the Philippines (CLSA coverage)

Top quartile	Second quartile
Ayala Corp	ABS-CBN
Ayala Land	Banco de Oro
Bank of the Phil. Islands	First Gen
Globe Telecom	Megaworld
Manila Water	RCBC
Philippine Long Distance Telephone	SM Investments

Source: CLSA Asia-Pacific Markets

Clean & Green survey

Two-thirds of the corporates participated in the C&G survey

Environmental awareness has grown, with 68% (15 of the 22 respondents) receiving high scores in our C&G survey. In particular, First Gen, First Philippine, Ayala Land and Ayala Corp are worth noting for their strong placing. Further, PNOC-EDC also did well, ranking a strong number five.

No surprises for Fist Gen and First Philippine

First Gen and its parent First Philippine Holdings each score 75% on the C&G survey. This should come as no surprise, given that their major business is power, an industry more impacted by greenhouse gas (GHG) emissions and climate change issues. Moreover, the group uses renewable energy sources via water, solar and wind technology. Furthermore, multinational partner British Gas ensures that the group is aware of current and emerging trends in environmental protection and complies with the standards of local and global regulatory bodies.

Figure 3

Clean & Green score

Company	(%)
First Philippine	75
First Gen	75
Ayala	65
Ayala Land	65
PNOC-EDC	55
Manila Water	35
Petron	30
Meralco	20
Banco de Oro	10
ABS-CBN	10
Filinvest Land	10
Megaworld	10

Source: CLSA Asia-Pacific Markets

Ayala Land and Ayala also did very well

Ayala and Ayala Land also scored well on our C&G survey. The group observes current government regulations on emissions and has assigned a committee to manage GHG emissions and/or climate change controls. Ayala and Ayala Land's initiatives on environmental protection are testimony to the group's good governance. Both companies enjoy better CG and C&G credibility versus other conglomerates and property companies, which may help explain their premium valuations versus peers.

PNOC-EDC also did well

Philippine geothermal giant PNOC-EDC also did well in the C&G survey. Like in the case of First Gen, awareness of environmental issues is due to the company's industry. Note that PNOC-EDC has assigned a position responsible for its overall compliance with the UN Framework Convention on Climate Change, which the Philippine government joined in 1992.

Banks generally fared poorly in the C&G survey

Three banks under our coverage responded to the C&G survey (Rizal Commercial Banking, Bank of the Philippine Islands and Metrobank) and received relatively low scores. Banks in the Philippines, and most other emerging markets, do not yet see climate change as a directly concerning issue. Yet, we expect scores to improve, as they follow the lead of global banks. For example, HSBC (95% C&G score) has appointed a special advisor to the chairman on environmental issues and introduced lending guidelines across the group that include environmental impact.

Voting by poll

Only a few companies in the Philippines vote via polling

Of the 22 companies who took our survey, only four (18%) vote by poll. Annual general meetings (AGMs) are typically held in April-July of the year. These meetings are well attended by local institutional and retail investors, media and investment analysts. Typically, there is a good exchange of ideas between management and the other attendees. We note though that there are relatively few foreign institutional investors attending these annual general meetings. After some of the meetings, there are separate sessions for media and investment analysts.

Figure 4

Companies that vote by poll

Company	CG quartile
SM Investments	2
PNOC-EDC	3
Petron	4
SM Prime	4

Source: CLSA Asia-Pacific Markets

Directors' remuneration

Directors' remuneration as a percentage of profits is not really that much

Directors' remuneration as a percent of net profit for companies surveyed averages just 1.2%. Sixteen companies specifically indicated that directors' remuneration as a percentage of their profits has lagged net profit growth. The other six companies did not answer the question specifically. Overall though, it is obvious that Philippine companies do not pay the board a hefty sum *vis-à-vis* profits.

Philex paid the most directors' fess as a share of net profit

The four companies that paid the most in directors' fees as a percentage of net profits are Philex at 3.4%, followed by Rizal Commercial Banking (2.5%), SM Investments (2.5%) and San Miguel (2.2%). The four companies that paid the least in directors' fees as a percentage of net profits are ABS-CBN, Jollibee, Meralco, and Ayala Land, all at around 0.1%.

Figure 5

Companies with directors' remuneration at highest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years[1]?
Philex	3.4	Yes
Rizal Commercial Banking	2.5	No
SM Investments	2.5	No
San Miguel	2.2	Yes
Globe	2.0	No
PNOC-EDC	2.0	No
Petron	1.7	No
PLDT	1.5	No
Metrobank	1.2	No
First Philippine Holdings	1.1	Yes
Ayala Corporation	1.0	No
Filinvest Land	1.0	No

Figure 6

Companies with directors' remuneration at lowest % of net profit

	Directors' remuneration as % of profit	Has directors' remuneration risen faster than net profit over the past five years[1]?
ABS-CBN	0.03	No
Jollibee	0.06	Yes
Meralco	0.10	No
Ayala Land	0.14	No
First Gen	0.18	No
Bank of the Philippine Islands	0.22	No
Banco De Oro	0.33	No
Manila Water	0.50	No

[1] Also means that company did not respond specifically to the question, Source: CLSA Asia-Pacific Markets

Changes in CG scores

Some changes in the scores

The scores of most Philippine companies have not altered much since 2005 with only a few exceptions. San Miguel's score fell by 9.6%, Meralco's rose by

9.4%, SM Prime increased by 9.7% and Petron jumped by 11.7%. We were most impressed by real improvements in corporate governance for Meralco, while San Miguel has disappointed.

Meralco's score rises 9.4%

Meralco's total score increased by 9.4% mainly due to the higher score due to strong results in the independence and transparency sections of the survey. Specifically, the company scored well on issues such as fairness of board/senior management decisions; the existence of an audit committee chaired by an independent director with financial expertise; creation of a remuneration committee; and the absence of any large creditors on the board who would favour creditors over shareholders.

San Miguel's score reduced by 9.6%

At the other end of the scale, San Miguel's score decreased by 9.6% mainly due to its lower scores in the independence and accountability sections of the survey. Specifically, we noticed poor results on issues such as questions/controversy of board decisions/senior management and chairman bias. Similarly, we move to negative territory when considering the independence of the board, free flow of information between analysts and the board and nomination of external auditors by the audit committee.

SM Prime and Petron also improve

Figure 7

Companies with changes in CG scores (2005-07)

	Chg in CG score (ppt)	2005 quartile ranking
San Miguel	(9.6)	4
Meralco	9.4	4
SM Prime	9.7	4
Petron	11.7	4

Source: CLSA Asia-Pacific Markets

Qarp stocks 2005

Manila Water validates our choice in 2005

Manila Water represented our Qarp pick in 2005. Since then, the stock price has rocketed from P6.30 per share to P14.30 per share, up 127% against MSCI-country two-year return of 88%.

Figure 8

Performance of Qarp picks

Company	CG quartile	ROE 04-05 (%)	Share price Jun 05 (P)	Share price Sep 07 (P)	Performance (%)
Manila Water	1	15.0	6.30	14.30	127

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

Qarp picks 2007 - None

No Qarp picks for 2007

For 2007, we do not have any Qarp picks. Using a risk-free rate of 5%, ERP of 4% and MRP of 3%, we do not see any stock offering the hurdle 10% upside to theoretical PB value. However, Globe and First Gen are among the companies in the upper half of our CG rankings, which are around the estimated theoretical value. Note that the lack of companies making the Qarp criteria might suggest that the implied cost of equity in market valuations is lower than what we have used (12%) for this exercise – or that the market has become over-priced at least with regard to higher quality stocks.

Figure 9

Qarp list: September 2007 valuations

Company	CG quartile (1-4)	Avg ROE 07-08 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Globe Telecom	1	24.7	12	5	2.81	2.8	0.7
First Gen	2	17.8	12	5	1.83	1.9	(1.1)

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Singapore - Focusing on execution

CG new developments - Procedural issues and implementation

The general level of corporate governance awareness and practice in Singapore remains high. Regulator, Ministry of Finance (MoF), is constantly looking at ways to further tighten and strengthen the framework of its Code of Corporate Governance. The Clean and Green environment is Singapore is supported by a stringent regulatory environment, high accounting and auditing standards and high mandatory disclosure levels for corporations. The regulator's focus over the past year has been on procedural issues for practical implementation to achieve the standards set by this code.

Findings of large study on state of CG released

Findings of a first ever comprehensive study jointly commissioned by the Monetary Authority of Singapore (MAS) and Singapore Exchange (SGX) on the state of corporate governance practices of SGX-listed companies were released in June 2007. Key areas recommended for action were in tightening procedures in the areas of enforcing letter and spirit of the "'comply or explain" requirement for material deviations from the code, enhancing independence, effectiveness and pool of independent directors, improving remuneration disclosures and policies, enhancing expertise and mix of audit committees and increasing internal controls and risk management procedures particularly for SMEs. The study also found that the pool of independent directors in Singapore was relatively small - 6.5% of directors were sitting on boards of more than four SGX-listed companies and around 10% had served on their boards for more than nine years. The study highlighted that training of directors was an area where Singapore lagged most developed markets.

Director training -Early initiative being considered

MAS and SGX are currently studying the report findings and also exploring two immediate initiatives on director training and providing practical professional guidance to audit committees. Singapore already has a high level of independence on corporate boards and fairly widespread CG awareness, which will only be further enhanced by these measures.

Ranking lowered on tighter ACGA criteria

On the tighter criteria by ACGA, the macro CG score for Singapore reduced somewhat and its ranking slips to second, just below Hong Kong, for the first time since we conducted this survey in 2001. Singapore scores higher than Hong Kong on rules and practices as well as on accounting and auditing standards, but has a lower score on CG culture, enforcement and political/regulatory environment. The net difference is a relatively minor 2-points in the overall macro CG scoring between the top two markets that we survey in Asia.

Company CG scores

Avg score for Singapore coverage companies increased 1.1ppt

The aggregate net change in CG scores for Singapore covered companies in 2007 on comparable micro determinants of our 2005 survey (additional criteria included this year) increased by 1.1ppt. The spread between the highest score at 76.2ppt and lowest at 37.6ppt remained approximately the same as our 2005 study.

SingTel retains pole position in overall score

Overall top five scorers in our survey coverage list are SingTel, maintaining pole position from our 2005 survey, ST Engineering, Singapore Exchange, MobileOne and Olam. The first three are Temasek-linked companies (TLCs). TLC's have generally done well in the CG survey with most falling within the top two ranking quartiles, a noticeable difference from the early part of the decade where many of these companies were perceived to be expanding in overseas markets at Temasek's behest. Today this misperception among minority investors has largely dissipated - in part as many of the overseas acquisitions do not look expensive in hindsight and in part because Temasek has demonstrated that its actions are quite independent of TLCs - it has been directly active in overseas expansion in recent years without involving the TLCs and, in instances actually competing with them.

SembCorp and CapitaLand lead our Clean and Green survey scores

The top five scorers in the "Clean and Green" section aimed at evaluating corporate awareness of and responsibility towards environmental issues and climate change are SembCorp Industries, CapitaLand, SingTel, SembCorp Marine and City Developments. But we sense that the overall level of awareness and proactive engagement by corporations towards these issues is still quite low - our survey had a relatively low response rate despite reminders and the general tendency of many firms is to dismiss (often wrongly, in our view) environmental issues as not being pertinent to the industry or sector they are involved in.

2005 Qarp picks basket underperforms STI and MSCI Singapore

The Straits Times Index (STI) appreciated 60.6% and MSCI Singapore benchmark index 65.5% (excluding dividends) over the two year period June 2005 to June 2007. In contrast, our 10 Qarp picks of 2005 gave an average return of 54.3% (or ~51% on market weighted basis). The underperformance was mainly due to the absence of any property stock picks in this basket as the property sector subsequently appreciated a whopping 191%.

*   *   *

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Country CG score

Singapore has slipped into second place in our CG Watch this year and for the first time since the survey began in 2000. It is two percentage points behind Hong Kong and five percentage points below its score in our 2005 survey. Why the change? The first point to make is that this year's scores do not reflect a decline in corporate governance standards in Singapore. As noted in our regional overview, the lower scores for most markets are a byproduct of our tighter scoring system and more detailed survey.

Slipped 5ppt from tighter scoring and more detailed survey relative to 2005

Figure 1

Singapore ratings for macro-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	70	74	Similar score despite tighter criteria
Enforcement	50	56	Lowered score on tighter criteria
Political & regulatory environment	65	73	Lowered score
Adoption of international accounting/auditing standards	88	95	Slight decline
Culture	53	57	Also reduced on tighter criteria
Overall score	**65**	**70**	

Source: ACGA, CLSA Asia-Pacific Markets

Most listed companies did not vote by poll

The lower scores do, however, indicate some relative weaknesses in Singapore's corporate-governance regime. One issue is that while Singapore has many world-class rules on corporate governance - as reflected in its 70% score in the "CG Rules & Practices" category - it has shown some resistance to improving further its regime for shareholder rights. Listed companies, for example, have been reluctant to embrace best practices in the organisation of shareholder meetings, including sending out detailed meeting agendas early and voting by poll rather than a show of hands. Its listing rules are also weaker than Hong Kong's in terms of certain protections offered to minorities (eg, rules governing shareholder approval for voluntary delisting).

Reluctance to improve standards unless given guidance by govt or GLC

This leads to a second issue: most of the smaller and medium-sized listed companies in Singapore, as well as many of the larger ones, seem unwilling to improve their governance standards unless given guidance by the government or a major government-linked company (GLC). Companies say this of themselves, even some of the smaller GLCs, and the point is echoed by market practitioners and investors. To take again the example of voting by poll: listed companies in Singapore will not do this voluntarily until SGX or a market leader like SingTel do so or the rules are changed to mandate it. While some of the bigger companies are starting to respond to market pressures (eg, in lowering their requested mandates for the issuance of new shares through private placements, which exclude almost all existing shareholders), the track record of listed companies in taking voluntary action to strengthen protection for their shareholders is far more limited than in Hong Kong.

Improving the audit environment

Singapore ahead on improving quality of external auditors

One area where Singapore is ahead of the regional curve is the work it is doing to try to improve the quality of external auditors. In July 2007, the Accounting & Corporate Regulatory Authority (ACRA), which regulates public accountants (ie, auditors) and enforces the company law, published an enlightening report on the quality of CPA firms in Singapore. Undertaken as part of its Practice Monitoring Programme (PMP), the review covered 110 audit firms, including the Big 4 as well as small- and medium-sized entities (SMEs), from April 2005 to March 2007. As ACRA explained in the report, since its aim is to promote market confidence, it focussed its resources on 'reviewing public accountants and accounting entities that audit public interest entities' (eg, listed companies, companies planning to list, companies in regulated industries such as banking and insurance, charities).

ACRA report indicates 32% of auditors need to undergo remedial action

What the results show is that the audit environment in Singapore has room for improvement. Only 32% of the firms surveyed were rated as "good", while 31% were felt to be "satisfactory". Another 32% need to undergo some remedial action, while the remaining 5% have had their registrations suspended or cancelled. Although ACRA has been playing down the significance of these findings - saying publicly that the standards of audit reports are not in question at present - it deserves credit for publishing the results at all. Part of the problem, it would appear, is a shortage of qualified and experienced auditors in Singapore, described recently by the *Business Times* as a 'labour crunch of accountants' caused by people going overseas to work (BT, 14-15 July 2007).

ACRA, meanwhile, recently launched a series of public consultations on three areas: its regulatory strategy for auditing and corporate reporting; a Code of Professional Conduct and Ethics for Public Accountants; and the registration framework for public accountants. The latter paper, called the "Path to Becoming a Public Accountant", seems particularly relevant in the current environment. It invites comments on questions relating to, among other things, the entry of international auditors, former public accountants and mid-career entrants into the audit profession, and ideas on 'alternative pathways for becoming a public accountant'.

MAS action

Proposed SFA amendments

The Monetary Authority of Singapore (MAS) is working on a series of proposed amendments to the Securities and Futures Act (SFA) that, if implemented, would help to improve the corporate governance regime in Singapore. In December 2006, it released a consultation document that, among other things, included proposals on enhancing the enforcement framework for market misconduct and streamlining the way in which substantial shareholders (with stakes of 5% or more) report changes in their shareholdings.

Liabilities for financial intermediaries that fail to prevent employees' illegal activities

On market misconduct, for example, MAS proposes to extend liability to those that fail to take measures to prevent their employees from engaging in illegal activities such as insider trading, false trading or market manipulation. Under the current SFA provisions, a company 'may not be liable for market misconduct committed by its employees whilst trading on the company's behalf', according to the consultation paper, 'unless management is involved in the misconduct'. However, it would appear to be relatively easy for management to argue that it is not involved, by delegating trading decisions to employees. In this way, it could 'reap the benefits of an employee's market misconduct without the risk of liability', the paper notes. MAS propose to make companies liable only when they fail to take "reasonable steps" to prevent the misconduct. It is not proposing 'strict liability for all the wrong doings of their employees', as this could be unfair to companies.

Streamlining reporting of substantial shareholdings

On the reporting of substantial shareholdings, MAS proposes to streamline the current system and move the relevant legal provisions from the companies act to the SFA. The current system is somewhat inefficient in that substantial shareholders must notify both the listed company and the SGX of changes in their holdings, while the listed company is then bound by the listing rules to make an announcement to the market via SGXNET. The new proposal would require substantial shareholders to report changes only to the listed company, which would then have to announce them to the market via SGXNET. This would remove one step in the process for substantial shareholders. It would also strengthen the disclosure obligation on listed companies, since the announcement rule would become a legal requirement under the SFA (and no longer a listing rule). MAS, as the main securities regulator, could then enforce these provisions.

Brave new board

Sesdaq to transform into "sponsored supervised" market for growth firms

In May 2007, the Singapore Exchange (SGX) announced ambitious plans to change the rules of its main board to attract larger listed companies and to transform its small-company board, Sesdaq, into a "sponsored supervised" market for growth companies, much like AIM in the UK. This is an interesting and somewhat controversial development, since there is quite widespread skepticism in the market as to whether Singapore can emulate London's AIM. Some concerns focus on the transferring of responsibility for supervision of listed companies from the exchange to local sponsors (eg, investment banks). There are also doubts as to whether the "new board" can attract companies of sufficient size and quality to be of interest to major investors. Nevertheless, SGX believes that the market is ready, that sponsors can do the job, and that this is a natural evolution for its market. The development of this board will be worth watching, particularly since Hong Kong has rejected a similar plan. It believes that its market is not yet mature enough.

SGX announced amendments to Listing Manual

Earlier in the same month, SGX announced various amendments to its Listing Manual. From a corporate governance perspective, one of the more interesting features was a proposal to enhance the transparency of share option grants. SGX is proposing a new rule that would require companies to announce immediately any grant of options and to give details covering date, exercise price, number, and any options granted to directors and controlling shareholders. Another notable new rule will require any change of auditors to be approved by shareholders in a general meeting.

Duties transferred to MAS, SGX and a new council

Council closes

From 1 September 2007, Singapore's Council on Corporate Disclosure and Governance (CCDG) will be dissolved and its duties transferred to other bodies. MAS and SGX will take over the review of the Code of Corporate Governance (although the regulators do not plan any further changes at this stage), while CCDG's responsibility for setting accounting standards will be taken up by a new council in the near future.

MAS and SGX to review how to enhance director training

A practical turn of mind

MAS and SGX also recently announced, in June 2007, the results of a review of the corporate governance practices of listed companies. Undertaken by Mak Yuen Teen, Associate Professor, National University of Singapore, the study analysed the annual reports of 659 companies to see how well they disclosed and implemented the best practices in Singapore "comply-or-explain" Code of Corporate Governance. The report makes a series of recommendations as to how companies could strengthen their internal governance standards. And it places a large part of the burden for this on the shoulders of retail and institutional investors, suggesting they could be doing more to hold companies accountable. MAS and SGX, meanwhile, will initiate two projects flowing from the study: one is a review of how to enhance director training in Singapore, while the second will be the production of practical guidance manuals for companies on audit committees and so on.

* * *

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Corporate CG issues over the past two years

After the spree of CG issues ranging from mismanagement to misappropriation in 2003-04 involving four errant companies ACCS, Citiraya, China Aviation Oil and Informatics, Singapore's corporate sector has not witnessed developments of similar magnitude. Since 2005, a couple of stray events that transpired warranted moderate eyebrow-raising are:

- A proposed investment in 2005 by SingPost in ACCS, which did not eventuate. Apart from market scepticism about the fit between the two, the deal also raised questions about objectivity as some directors of SingPost were also shareholders of the investment target company.

Fewer CG incidents to report than in previous study

- Local press reports in 2006 on Bio-Treat stated that its chairman, Wing Hak Man, had lodged a police report about a falsified resignation letter, two weeks after the board announced his retirement. Wing said he had not been asked to attend a single board meeting in 2006. Bio-treat announced that Wing sold 50 million shares for US$1.08 each on the open market but Wing claimed to know nothing about the share sale. The company then issued a statement it would investigate and informed shareholders that given Wing's prolonged absence from board meetings, directors resolved that his office as director be vacated. In an unrelated development Bio-Treat's FY06 net profit declined by 42% YoY, which the company blamed on heavy rain (overall, a confusing and messy picture).

SingTel, Singapore Exchange and ST Eng in top quartile

Our Singapore universe of covered stocks has increased significantly (by around 90%) from 31 companies in 2005 to 59 companies in 2007. By virtue of this factor alone, relative rankings for a large number of companies have changed although in many instances, the absolute CG scores may have witnessed only marginal movements. 2005 top quartile scorers, SingTel, Singapore Exchange and ST Engineering are the common names to feature in the 2007 top quartile while SingPost noticeably drops out of the top two quartiles from loss of points related to the proposed ACCS transaction.

Figure 2

Companies in the top-two CG quartiles for Singapore (CLSA coverage)

Top quartile	Second quartile
Cambridge Industrial Trust	Ascendas Reit
Capitaland	CapitaCommercial Trust
Chartered Semi	CapitaMall Trust
Comfort Delgro	City Developments
Keppel Corp	ComfortDelGro
Keppel Land	CSE Global
MobileOne	DBS Group
Olam	Elec & Eltek
Petra Foods	HTL Intl
Singapore Exchange	OCBC
SingTel	SembCorp Marine
SMRT Corp	SembCorp Industries
ST Engineering	Singapore Press
UTAC	Starhub

Source: CLSA Asia-Pacific Markets

Much larger sample size partially responsible for changes in rankings

First time included, Olam, UTAC and Cambridge Ind make top quartile

Large-cap companies and ones with a moderately long listing history usually feature prominently in the top quartile of scores given these firms provide high disclosure and have longer track record for us to better gauge some of the micro-determinants of evaluation. That said Olam, UTAC and Cambridge Industrial Trust are three fairly new listings which make the top quartile on their maiden inclusion this year.

Clean & Green survey

Singapore corporates lag developed markets in environmental awareness

The Clean & Green survey - a new addition in overall CG evaluation - is the main area where we believe Singapore lags other developed markets. Just 54% of the universe responded to the survey despite follow-ups compared to 58% response rate for our overall Asia sample. Even within this respondent group, we estimate only a fraction actually have a strong grasp of how their business impacts the environment and are proactive about it. A few interesting points from our survey on the level of awareness or lack thereof on this topic are:

- Only 25% of companies believed that our survey was relevant to their business.
- Only 18% of companies responded that they were aware of current Government regulation on monitoring or reducing emissions, increasing energy efficiency, using renewable energy etc.
- Only 10% of companies have a specific individual or committee responsible for GHG emissions and/or climate change controls.
- Only six or 10% of companies in our Singapore sample scored 50% or higher on our very broad-based survey questionnaire.
- Often respondents from the same industry and sector had very different perspectives on how their business affects the environment, ie, one company may have a structured carbon disclosure framework while others in the same sector believe their business has no impact on the environment.

SembCorp group, large property developers, Comfort Delgro, SingTel score high in C&G

The top two scorers and the only ones to garner over 70% in the C&G survey are SembCorp Industries and CapitaLand. Generally we observe that the property sector is giving this area consideration with developers indicating they have environmental management and tracking systems as well as some focus on recycling/using recycled materials - the three large developers CapitaLand, City Developments and Keppel Land rank in the top-10 Clean & Green scorers. Other names to highlight among high scorers are Comfort Delgro, one of the leading domestic transport companies and SingTel, the largest telecom service provider domestically.

Figure 3

Clean & Green scores

	(%)
SembCorp Industries	75
Capitaland	75
SingTel	60
SembCorp Marine	60
City Developments	50
Comfort Delgro	50
Jaya	40
Keppel Land	40
Singapore Press	35
Chartered Semi	30
STATS-ChipPac	30
Ezra Holdings	30
Celestial Nutrifoods	25
ST Engineering	15
UTAC	15
Great Eastern	5
Suntec Reit	5
Ascott Residence Trust	5
Pine Agritech	5

Source: CLSA Asia-Pacific Markets

Proactive approach to C&G is central to SCI's core business

SembCorp Industries (subsidiary SembCorp Marine also ranks well in the survey) with the lion's share of its business in energy and utilities, tops our C&G survey and is the only respondent that views increased regulation from climate change as a possible area to benefit from. SCI is involved with building and operating renewable energy power plants in the UK which allow it to monetise the various incentives provided under the country's "green energy" initiatives - it currently trades carbon credits under the European regulatory mechanism. The company is also a major regional player in water and wastewater treatment, recycling and waste-to-resource projects.

Being in the power generation business, clean air and climate change is a key concern area for the company and it strives to limit and manage the environmental impact of its operations through improving efficiency and environmental friendliness of its plants, feedstock, emissions and energy use. SCI has policy statements on Environment, Heath and Safety (EHS) policy which is incorporated into the approach of how it conducts its business which is based on four principles: investment in green business lines, implementation of sound internationally recognised EHS systems, integration of EHS measures into business processes and coordination with business partners and suppliers on EHS improvements. Various business lines of SCI have achieved certification under ISO9001, ISO14001 and OHSAS18001.

CapitaLand - Aiming to be the green building developer in the region

As a real-estate developer, CapitaLand has been playing its part as an environmentally sustainable company, as evidenced by the local and foreign accolades won by its properties for their environment-friendly designs and features. To step up their C&G initiatives, in 2006, CapitaLand established a green committee to spearhead environmental initiatives across the group, both in Singapore and overseas guided by a steering committee comprising the SBU CEOs and chaired by the group president and CEO, which demonstrates management commitment to this area. The group has developed its own Green Buildings Guidelines which serve to advocate best practices among design, project, building and asset managers to consider injecting green features and adopting green practices into the group's developments throughout the various stages in the life-cycle; feasibility, design, procurement, construction, and operation. It has also developed an environmental tracking system.

Staff activities have been organised to heighten awareness and encourage activism in promoting Green initiatives within the group. These include training sessions on the new Green Building Guidelines by inhouse speakers; seminars by external speakers on specialised Green Building topics; and a private screening of *An inconvenient truth*, Al Gore's Academy Award-winning documentary about climate change and global warming. ISO14000 certification (for environmental management) work is underway and it aims to achieve this for the group's entire operations by 2008. Various awards have been conferred on some of the group's buildings for achievements in environmental conservation, such as The Seafront at Meyer, ION Orchard and The Orchard Residences.

SingTel's core business has relatively low environmental impact

SingTel's responses lead us to believe that it is among the most environmentally aware firms in Singapore even though its core business does not directly involve GHG emissions, is not energy intensive like manufacturing or holds significant recycling scope. While monitoring or reducing emissions is not a regulatory requirement for its business, the company has been publicly reporting this for the past three years. It takes renewable energy initiatives with solar panels for some remote locations to power infrastructure, looks for areas where energy efficient lighting and air-conditioning can be used and engages green power service and equipment vendors wherever practical. SingTel also provides data to the Carbon Disclosure Project separately for its Singapore and Australia operations and has a target of being 50% carbon neutral for its corporate portfolio by November 2007.

Voting by poll

Voting by poll not a very common feature

Less than 5% of companies surveyed strictly vote by poll in general meetings, although a few more that employ a combination of both show of hands and voting by poll. In such companies, typically show of hands is used for regular matters, and vote by poll for special resolutions, or if a shareholder requests for a vote by poll. Anecdotally, around 15-20% of companies that do not strictly vote by poll indicated that the issue has been a point of discussion internally and would likey be more prevalent going forward. Interestingly, all the companies that stated they strictly vote by poll fall in the real-estate investment-trust sectors.

Figure 4

Companies that vote by poll

	CG quartile
Cambridge Industrial Trust	1
CapitaCommercial Trust	2
CapitaMall Trust	2

Source: CLSA Asia-Pacific Markets

Directors' remuneration

Directors' fees among the lowest in the region

Directors' fees averaged 0.7% of last reported net profit, generally among the lowest in the region on this metric. The spread between the companies that have highest and the lowest estimated total directors fees to net profit is quite large and lies between 3.1% and a mere 0.02%. Most of the 10 companies that pay their directors the highest percentage of net profit have seen this remuneration rise at par or slower than net profit growth in the past five years (but note that a number are new listings without history for five year comparison). Conversely, the 10 companies that pay their directors the lowest percentage of net profit have seen this remuneration rise faster than net profit growth over the same time frame, largely we suspect because of earlier low base and moves by the companies towards competitive benchmarking against peer groups. A point to note is that directors remuneration for the real-estate investment trusts are generally borne by the trustee manager and not the trust itself; hence any increase in directors fees does not affect minority shareholders of the trust, unless there is any upward revision to the trust management fee structure.

Many with high director fees to net profit are relatively new listings

Figure 5

Companies with directors' remuneration at highest % of net profit

	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
Jardine Cycle & Carriage	3.1	No
Thomson Medical	1.5	No
Ascott Residence Trust	1.3	na (new listing)
K-Reit Asia	1.3	na (new listing)
CapitaCommercial Trust	1.3	na (new listing)
Ascendas Reit	1.3	No
Suntec Reit	1.2	na (new listing)
CapitaMall Trust	1.2	No
Raffles Education	1.1	na
Sarin Technologies	1.1	na (new listing)

These firms should have seen faster fee growth due to earlier low base

Figure 6

Companies with directors' remuneration at lowest % of net profit

	Directors' remuneration as % of net profit	Has director remuneration risen faster than net profit past 5 years?
CapitaLand	0.02	Yes
Allgreen Properties	0.02	Yes
United Overseas Bank	0.02	Yes
City Developments	0.04	Yes
OCBC	0.04	Yes
DBS Group	0.06	Yes
UOL Group	0.09	Yes
STX Pan Ocean	0.10	na (new listing)
Labroy Marine	0.10	Yes
Great Eastern	0.20	Yes

Source: CLSA Asia-Pacific Markets, Company reports

Changes in CG scores

Property sector has shown most improvement in 2007 survey

On a comparable basis between 2005 and 2007, significant improvement of CG practice and disclosure levels in the property sector is the most noticeable change. In 2005, most of the property companies had lesser granularity on board composition and guidance, board performance and remuneration matters. Other areas that have also improved are the level of detail in shareholder communication, disclosure and management access. In our view, apart from more proactive management, some of the triggers for this improvement could partially lie in a strong operational rebound and solid stock performance that has driven up interest as well as information demands from analysts, institutional investors, property funds, private equity etc. UOB and SingPost have seen the largest material negative changes in CG score, mainly driven by factors of related party property transactions for the former and proposed ACCS acquisition for the latter.

Figure 7

Companies with large changes in CG scores: 2005-07

	Chg in CG score (ppt)	2007 quartile ranking
CapitaLand	22.7	1
Keppel Land	18.6	1
Chartered Semi	18.1	1
Allgreen Properties	15.5	3
City Developments	14.1	2
UOL Group	11.0	3
Keppel Corp	10.2	1
United Overseas Bank	(9.3)	4
Singapore Post	(15.6)	4

Source: CLSA Asia-Pacific Markets

Qarp stocks 2005

Our 10 Qarp stock picks in 2005 gave an good average return of 54.3% over the two-year period June 2005 and June 2007 but still underperformed the STI, which appreciated 60.6%%, and the MSCI Singapore benchmark index gain of 65.5% (excluding dividends). One of the main reasons for the underperformance was the absence of any property stocks among our picks as they did not feature prominently in 2005 CG rankings - nonetheless the property sector delivered huge 191% returns over this period.

Qarp picks underperformance from lack of property picks

Performance of the 2005 Qarp picks was also weighed down by the downturn of Jurong Tech from industry specific issues (ie, revenues from an important customer Maxtor was affected after its merger with Seagate) and relatively mediocre performance of stocks like Comfort DelGro, SingTel, SingPost and SPH amid an environment of increasing risk appetite from equity investors for high beta and operating leverage in cyclical offshore and marine and property sectors (hence our Cosco Corp and Keppel picks did very well) instead of the stable returns and cashflow at cheaper valuations that these companies offer.

Figure 8

Performance of 2005 Qarp picks

Company	CG quartile	Avg ROE 04-05 (%)	Share price		Performance (%)
			Jun 05 (S$)	Sep 07 (S$)	
Jurong Tech	1	43.4	1.60	0.91	(43.4)
Comfort DelGro	2	15.4	1.69	2.18	29.0
M1	2	36.2	2.18	2.20	0.8
SingPost	1	34.4	1.00	1.27	27.6
COSCO Corp	2	29.8	0.97	3.74	285.6
SingTel	1	22.9	2.76	3.40	23.2
Keppel Corp	2	16.2	6.07	12.50	106.0
ST Engg	1	27.2	2.42	3.60	48.8
SPH	2	30.6	4.30	4.64	7.9
OCBC	1	10.3	5.80	9.15	57.8
Average return of Qarp stocks					54.3
STI two-year return					60.6
MSCI Singapore two-year return					65.5

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets, Bloomberg

Qarp picks 2007

MobileOne, HTL and Petra hold more than 10% upside to theoretical PB

After the market correction in August 2007, a Qarp screening exercise yielded eight names with more than 10% upside to theoretical price-to-book valuations of which four companies from the small cap space which was particularly affected by the market downturn now hold more than 20% upside. These companies are CSE Global, Elec & Eltek, HTL International, Keppel Corp, MobileOne, Petra Foods, ST Engineering and Sarin Tech.

COE and LTGR estimates adjusted for beta and industry company growth

The key financial inputs for Qarp are return on equity (ROE), cost of equity (COE) and estimated long-term growth rate (LTGR). ROE should be reflective of levels that are sustainable over the long term and somewhat subjective for this exercise, we have used estimated FY07-08 average ROE and adjusted for known exceptional, non-recurring events or for situations where current ROE levels are clearly not reflective of long term sustainable averages (such as companies exposed to cyclical sectors in boom or bust phase etc). COE is derived using a capital asset pricing model where long term risk free rates is assumed at 5%, equity risk premium at 4% and market specific risk premium at 0%. Stock beta is taken on a two-year historical basis from Bloomberg and estimated long-term growth used is generally in the 1-5% range depending on industry, company franchise and business model.

Figure 9

Qarp list: September 2007 valuations

Company	CG quartile (1-4)	Avg ROE 07-08 (%)	COE (%)	long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Sarin Technologies	2	30.0	9.1	3.0	4.4	3.3	33.9
Elec & Eltek	2	14.0	8.6	2.0	3.7	1.4	26.4
CSE Global	2	32.0	8.3	3.0	5.5	4.3	26.3
HTL International	2	12.0	8.2	3.0	1.7	1.4	23.0
Keppel	1	23.0	8.7	5.0	4.9	4.3	13.8
ST Engineering	1	35.0	8.2	4.0	7.4	6.6	12.4
MobileOne	1	42.0	8.2	1.0	5.7	5.1	12.1
Petra Foods	1	18.0	7.8	3.0	3.1	2.8	11.2

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Taiwan - Still watching the government

Corporate governance steadily improving

Corporate governance in the private sector in Taiwan is improving although large cuts to a few companies dragged down the overall score. The primary driver of improved CG is a stock market which has become increasingly fundamental. Equity-based compensation is a large portion of total compensation in Taiwan. If share prices and valuations are low, executives feel it in their back pockets. Even those companies which don't pay bonus shares generally have high levels of family ownership and enough of an incentive to run the business properly. In general the first generation is still in charge and companies remain well run. Taiwan has matured to a slow growth economy where companies pay high dividends and generally eschew diversification.

Better laws and regulations and much better enforcement

The second driver of good corporate governance is the government. We are seeing better laws and regulations such as accounting policies in line with international norms and new laws on independent directors. We are also seeing more regulations from the FSC - for instance Taiwan will have quarterly consolidated accounting from 1Q08. Finally we are seeing a much greater willingness to implement existing laws on insider trading with prosecutors and the judiciary finally achieving some successful prosecutions. The government is both a driver of improved corporate governance and one of the worst offenders when it comes to bending the will of private enterprise to meet political or economic objectives. As a result the ACGA lifted Taiwan's regional ranking one place to fourth in this survey.

Government views the financial sector as a public utility

For instance the government (including the central bank) have long viewed the financial sector as a public utility rather than a group of profit maximising organisations. The central makes a profit equivalent to about 2% of GDP, most of which it pays to the government as a dividend. This is largely made at the expense of the banking system by forcing banks to maintain deposit rates at levels which they would not voluntarily do so. There are no explicit rules on minimum deposit rates but the banks know that if they don't do it, they will be in trouble. The government also encourages the banks to lend more than they otherwise might to some industries, and sometimes refrain from collecting bad loans when they otherwise would try to do so.

The FSC is currently creating new regulations designed to force financial institutions to divest shareholdings in other financial institutions in circumstances where they have not achieved control over a certain period of time. Many see this as aimed at the Koo family where government action against Chinatrust for the attempted takeover of Mega and against KGI for control of CDIB is ongoing.

Banks have the worst CG scores

Frequently we have seen bad behaviour from senior management in the financial sector, particularly in the area of insider trading. Banks make up five of the six worst scoring companies in Taiwan in our CG rating system and the sixth company is BenQ which is experiencing financial difficulties. The best sector in Taiwan is foundry with all three of them in the top five. The shipping sector, which is not known globally for good CG, also does well.

TSMC remains the top scoring company in Taiwan

The top scoring company in Taiwan from a CG perspective is still Taiwan Semiconductor Manufacturing Corporation. Also in the top five are China Steel, UMC, Acer and Vanguard (a TSMC company). The biggest cuts in CG scores from 2005 were in the banking sector. Formosa Group company scores fell somewhat following the increased cross-shareholdings within the group.

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Country CG score

Taiwan has risen one place in our rankings this year to fourth, bypassing Malaysia, which has fallen two notches to equal sixth. There are several factors behind Taiwan's rise over the past two years, including regulatory progress, much tougher public enforcement action, an improved accounting and auditing regime, and a higher score for "CG Culture".

Taiwan shifted up to fourth placed in the region

Figure 1

Taiwan ratings for macro-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	49	53	This will improve next year when Taiwan starts expensing bonus shares
Enforcement	47	49	Lot of insider trading activity prosecuted
Political & regulatory environment	60	65	Less political "protection" in banking
Adoption of international accounting/auditing standards	70	59	This score will improve next year when Taiwan starts expensing bonus shares
Culture	46	33	Still limited in scope
Overall score	**54**	**52**	

Source: ACGA, CLSA Asia-Pacific Markets

We believe that there has been a tangible improvement in the corporate governance environment in Taiwan - unlike some other markets in Asia, the country is moving forward - but it is worth noting that its score in three of the five categories in our survey is actually lower than previously. This is a result of our more rigorous scoring system and extended questionnaire (see Appendix 1), not a reflection of any decline in standards. But the scores do point to ongoing areas of weakness in Taiwan's corporate governance system and, in absolute terms, are low. Overall, Taiwan's score has risen just two percentage points to 54%. The challenge for Taiwan now will be to keep the pace of reform and enforcement going.

Here are some suggestions on further improvements Taiwan could make to enhance transparency and accountability:

Foreign investors find it tough to exercise their voting rights in Taiwan

1. Actively lift shareholder meeting and proxy voting rules up to international standard. Taiwan's record in this area is still woeful and a continuing source of frustration for international investors. It came second last in our inaugural survey of impediments to proxy voting in Asia last year.

Four months is too long for the release of annual results

2. Cut reporting deadlines for audited annual results from the current four months to either 60 or 90 days. (Indeed, the regulators are considering reducing the deadline to 90 days.)
3. Improve the quality and scope of non-financial reporting.
4. Bring disclosure of "substantial shareholder" stakes into line with international norms (ie, 5%). And do the same for share purchase transactions by directors and controlling shareholders (ie, within 3 days).
5. Require disclosure of individual director remuneration. This is a sensitive and somewhat controversial issue, but it is often a useful litmus test as to how seriously a company takes corporate governance. That is, if it is not willing to disclose such information, or if it appears to be overpaying certain directors while profits are suffering, that could be a sign of internal governance weaknesses.

Regulatory overview

Two years of change

On a more positive note, the past two years have brought a large number of significant regulatory changes in Taiwan. Some of the key developments include (in chronological order):

June 2005: The Company Law was amended to enhance the rights of shareholders. For example, shareholders owning 1% or more of a company could now propose resolutions for inclusion in the annual meeting agenda; they could also nominate candidates for election as directors or supervisors. The amendment also permitted voting by mail or electronically (previously shareholders had to attend in person or send a proxy). But note: allowing e-voting and organising it are two different things; Taiwan's nascent e-voting platform has yet to take off and faces a number of serious hurdles.

Audit committees are now compulsory

January 2006: The Securities and Exchange Act (SEA) was amended to provide a legal basis for audit committees and independent directors. Previously, audit committees had only been a recommended best practice, while independent directors were only required for newly listed companies. The amendments still do not make either mandatory, except for certain types of firms. The Securities and Futures Bureau (SFB) mandates independent directors for large listed companies, financial holding companies and banks (they must have at least two or 20% of their board). The requirement for audit committees is similar: listed companies can choose between having an audit committee or appointing the traditional supervisor, but the SFB mandates audit committees also for large companies.

The SEA amendments included several other important changes, such as requiring the chairman, manager and accounting to sign or seal their company's financial statements and to declare that 'the report contains no misrepresentations or nondisclosures' (Article 14).

March 2006: To facilitate the implementation of the SEA amendments, three new sets of regulations were promulgated on: the appointment of independent directors; the exercise of powers by audit committees of public companies; and the proceedings of meetings of the board of directors of public companies. The regulation on independent directors, for example, lays down the minimum professional requirements a person must have to become such a director. It also sets detailed criteria for the "cooling-off period" that former employees, directors and supervisors, shareholders owning more than 1% of the company, and professional advisers would have to serve before they could become independent directors of a company.

A crackdown on the black market for proxy votes

April 2006: Amendments were made to some rules under the SEA with the intriguing title, "Regulations to Encourage the Reporting of Cases of Illegal Use of Proxies for Shareholder Meetings of Public Companies". Market practitioners with an interest in proxy voting will sometimes refer, sotto voce, to the black market for proxy votes in Taiwan - an issue that has become more relevant as contested and contentious director elections become more common. These regulations encourage reporting of such things as 'using a cash payment or other benefit as a condition to obtain a proxy form for a shareholder meeting' and 'using the name of another to obtain a shareholder meeting proxy form'. The authorities offer rewards to informants based on the level of fines imposed.

May 2006: A new regulation to clarify the scope of "material information" as it affects insider trading under the SEA was published. The new regulation provides a detailed list of what material means and is far more specific than previous rules.

Following the amendments to the SEA, the Taiwan Stock Exchange updated its own listing criteria and code of corporate governance during 2006 to give effect to the new regulations.

Not all the new rules are as good as they could be

Without wishing to detract too much from the progress made in improving regulation in Taiwan, it is only fair to mention that some of the new rules have slightly odd features or may not be welcomed by minority shareholders. For example, the new regulation on independent directors states they must meet certain minimum professional qualifications, but then says they only need to have had five years of working experience (which hardly seems sufficient). The rules also allow judges and public prosecutors to become independent directors (which doesn't seem right) and set the "cooling-off period" at only two years (while similar to other markets in Asia, such a rule will likely prove as counterproductive in Taiwan as it has everywhere else). And the January 2006 amendments to the SEA also made private placements easier, which is good for companies wishing to raise capital quickly, but bad for minority shareholders who don't like being diluted.

10 days not enough for foreign investors to get their voting instructions to custodians

Meanwhile, in December 2005, the authorities upgraded the rules governing the content and deadlines for annual meeting notices and agendas. The amendments sought to improve on a perennial problem in Taiwan of companies issuing AGM agendas and then changing them shortly before their meetings, and not providing enough details on the items to be voted on. The amended rule stated that listed companies must publish their detailed "meeting agenda handbook" at least 10 days before their AGM. Unfortunately, this is typically when overseas institutional investors must get their voting instructions to their global custodians, hence such a rule change is of little benefit to them.

Accounting rules converging on international standards

Accounting convergence

The Accounting Research and Development Foundation, which sets accounting rules in Taiwan, has continued to bring its standards closer to international norms. In January 2006, for example, it promulgated two new standards relating to fair value accounting. Of equal significance: in May 2006, the government finally amended the Business Accounting Law to require the expensing of employee bonus shares - a change that had been long awaited. The new rules come into effect from 1 January 2008.

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Corporate CG issues over the past two years

The biggest corporate-governance scandal in Taiwan over the past two years involved **Chinatrust**, whose senior management set up a company in Hong Kong to buy around 5% of Mega FHC, using funds borrowed from Chinatrust. When Chinatrust received permission from the FSC to acquire 10% of Mega, the price of Mega rose substantially, and Hong Kong entity sold the Chinatrust shareholding to at a substantial profit. The profit from this transaction has been returned to Chinatrust. However, the former President of Chinatrust, Jeffrey Koo Jr and his brother-in-law Chester, still face charges relating to the matter and have not returned to Taiwan to face them. As a consequence the number three son in the Koo family has taken over as president of Chinatrust.

CIO of Fubon is out on NT$5m bail

In another case which is serious, but does not involve major shareholders, the CIO of **Fubon FHC** bought shares in Hsinchu Intl Bank just prior to the takeover bid being announced by Standard Chartered. Prosecutors allege he encouraged others to do the same. He has been released on NT$5m bail.

Formosa Group building cross-shareholdings

Taiwan's largest and arguably most successful business is the **Formosa Plastics Group**. There are currently eight listed companies in the group. Over the last year they have bought shares in each other with the apparent intention of building long term blocking shareholdings. This has not had too much of a negative impact on valuation as most group companies have high yields (around 7%) and therefore the funding cost of these shareholdings has much less than the dividends received - ie, the investments have been earnings accretive. As these are low multiple companies anyway, with PEs around 11x, the companies have not been derated. Nevertheless, we see these cross shareholding as a long term negative for the group with capital tied up in passive investments.

Figure 2

Companies in the top-two CG quartiles for Taiwan (CLSA coverage)

Top quartile	Second quartile
Acer Inc	Alpha Network
Asustek Computer	Asia Optical
AU Optronics	Catcher Tech
AV Tech	Chi Cheng
Basso Industry	Compal Electronics
China Steel	Depo Auto Parts
CTCI Corp	D-Link
Cyntec	Everlight Electronics
Delta Electronics	Formosa Plastics
First Steamship	GeoVision
Giant	High Tech Computer
Great Wall	Hotai Motor
Johnson Health Tech	Hung Poo Real Estate Develop
Lite on Technology	Hung Sheng
Merry Electronics	Largan Precision
MiTAC International	President Chain Store
Siliconware Precision	Quanta
Silitech	Sunplus
Sincere Navigation	Synnex Technology International
Taiwan Semiconductor	Taiwan Cement
United Microelectronics	Taiwan Fertilizer
Vanguard Intenational	Tong-Tai Machine & Tool
Wan Hai Lines	Yungtay
Yulon Motor	ZyXEL

Source: CLSA Asia-Pacific Markets

The final issue for Taiwan relates to private equity. The government seems to have decided it does not want large companies taken out of the market and it does not want companies relisting in Hong Kong - where valuations are currently higher than in Taiwan. However, this still leaves plenty of modestly priced mid-cap companies in Taiwan to be taken over and funded with the very low interest rates in Taiwan. In the bids that we have seen so far in this area - Nien Made and Fu Sheng - the premiums offered have been quite modest (less than 10%). In general it seems as if management (which is also the controlling shareholder) is offering itself for sale to the highest bidder. Which ever private equity company offers management the best terms will get the deal. This means that the premium that should go to all shareholders in the company is in fact going to management. This is happening because the independent directors are not properly putting the company up for tender to the highest bidder.

Private equity not good for minority shareholders

Shareholders in Taiwanese companies are in a very difficult position with these private equity offers as there is a rule which says that a company can be de-listed if two-thirds of shareholders are in favour of that. In other words the bidders only have to get to 66% to propose a delisting and essentially force everyone else to sell. With such a poor negotiating position, and management lined up against them, most minority shareholders choose to exit their shareholdings when the offer is announced.

Clean & Green survey

Taiwanese companies are fully aware of environmental issues. For those companies involved in manufacturing, it is both a business opportunity (selling products which reduce fossil fuel consumption) and a risk (of losing business if their foreign customers get bad publicity because of them). They are therefore fully up to speed on all the issues.

Figure 3

Top 40 Clean & Green scores in Taiwan

	(%)		(%)
ZyXEL	95	BenQ	50
China Steel	90	Vanguard	45
United Microelectronics	90	Wan Hai Lines	45
Taiwan Cement	90	Delta Electronics	45
Nanya Plastics	90	Asustek Computer	45
Taiwan Semiconductor	80	Siliconware Precision	40
Nanya Printed Circuit Board	80	AV Tech	40
AU Optronics	75	Formosa Petrochemical Corp	40
Formosa Plastics Corp	75	ASE	40
MiTAC International	65	Fubon Financial	40
Lite on Technology	65	Great Wall	35
Asia Optical	65	CTCI	35
Synnex	65	Hotai Motor	35
Yulon Motor	60	Yang Ming Marine Transport	35
Cyntec	50	Unimicron Technology Corp	35
D-Link	50	King Yuan Electronics	35
President Chain Store	50	Basso Industry Corp	30
GeoVision	50	Catcher Tech	30
Largan Precision	50	Tainan Spinning	30
High Tech Computer	50	Chunghwa Telecom	30

Source: CLSA Asia-Pacific Markets

The Formosa Group has a much better reputation in Taiwan for making money than it does for looking after the environment, yet Nanya Plastics scores 90% on our C&G questionnaire and Formosa Plastics a decent 75%. The Formosa Group is involved in the silicon and carbon-fibre businesses, both of which are major beneficiaries of the higher oil price and the switch away from fossil fuels.

Outside of manufacturing, environmental interest falls away quickly

It was noticeable that outside of manufacturing, interest in this area fell away rapidly. For instance, Fubon FHC is the only financial sector firm with a score above zero.

Voting by poll

Voting by poll at general meetings of shareholders is not mandatory in Taiwan, although virtually every company uses this method. However, most foreign shareholders find it very difficult to get the information about the items to be voted on, in English, in time to appoint a proxy with instructions to vote. In addition custodians are reluctant to provide this service. The result is that voices of foreign shareholders are not generally heard at these meetings.

Firms typically pay 1-5% of total earnings to the directors

Directors' remuneration

Companies in Taiwan are required to provide the total amount of directors fees and bonuses. They are not obliged to split the amount among the directors, but we understand they generally each receive the same amount. Companies in Taiwan typically pay between 1% and 5% of total earnings to the directors as a bonus. For instance, for fiscal 2006 the directors of TSMC will receive NT$285m in cash bonuses in addition to regular directors fees.

However, directors can also be employees and receive salaries and employee share bonuses. These figures are not disclosed and therefore the full remuneration of directors in Taiwan cannot be calculated.

Changes in CG scores

The primary reason for the improvement in CG at Everlight and Basso was improved disclosure - of the correct answers to our CG questionnaire. China Steel added independent directors.

Nanya PCB bought shares in affiliated companies and was de-rated as a result. BenQ got into financial difficulties with the purchase of Siemens Mobile and then got into legal difficulties when management pre-sold some employee bonus shares before shareholders became fully aware of these difficulties.

Figure 4

Greatest changes in CG scores

	(%)		(%)
Everlight Electronics	32	King Yuan	(20)
China Steel	31	Advantech	(22)
Acer Inc	30	BenQ	(24)
Basso Industry	28	Nanya PCB	(37)

Source: CLSA Asia-Pacific Markets

Qarp stocks 2005

The outperformer from our 2005 report has been Formosa Chemical and Fiber which in addition to its 40% capital return paid a 7% dividend yield. Elsewhere stocks did not perform well. Chinatrust got directly caught up in the meltdown in high-yield consumer lending and Hotai Motor was indirectly impacted through the weakness in the car market. Asustek did reasonably but ZyXEL was caught out by the commoditisation of its markets and was hurt by falling margins. It seems that sector factors were much more important than

Our 2005 picks did not do so well

Figure 5

Performance of 2005 Qarp picks

Company	CG quartile	ROE 04-05(%)	Share price Jun 05 (NT$)	Share price Sep 07 (NT$)	Performance (%)
Asustek Computer	1	17.3	73.9	90.4	22.4
ZyXEL	2	14.2	58.3	60.6	3.9
Formosa Chemical	1	30.2	54.3	75.8	39.6
Hotai Motor	2	6.5	75.5	85.7	13.5
China Trust	1	7.8	25.7	25.6	(0.3)
Average return of Qarp stocks					15.8
MSCI Taiwan two-year return					35.0

Note: price on 7 September 2007. Source: CLSA Asia-Pacific Markets

Qarp picks 2007

Our 2007 Qarp picks are those companies with an above average CG score and which have attractive valuations based on the Gordon Growth Model.

9.5% COE used for Taiwan

We use a 9.5% cost of equity for Taiwan based on the US government ten year bond yield of 5.0% and an equity risk premium of 4.5%. We use the US 10-year bond yield of 5.0% rather than the Taiwan 10-year government of 2.4% as we believe the latter is distorted by local regulatory issues.

Three companies where PB is lower than ROE divided by COE

Where the ROE divided by the cost of equity is less than the P/B multiple the company's share price is not factoring in any growth in earnings. There are three companies for which this is the case - China Steel, Basso and Tong Tai Machine and Tool. In the case of Formosa Plastics we have only to assume a 2% long term growth rate to achieve 30% upside. Given its exposure to growth products like carbon fibre and speciality chemicals this should be achieved. Alpha Networks is in the high-growth, high-return networking market and deserves an ascribed growth rate of 4%.

China Steel and Formosa Plastics are both low beta companies whereas while Basso and Tong Tai also have low reported betas, we used the market cost of equity of 9.5% to factor in a small-company risk premium. Hong Poo is both a small company and a volatile stock, so we ascribed a beta of 1.2, giving it a cost of equity of 11.75%.

China Steel's consistently high ROE is due to its focus on cost control, sensible capital spending and dominance of the Taiwan market. Basso has a strong franchise in the US market for power tools and the stock's low price more than fully reflects the weakness in US construction. Tong Tai's machine tools are taking market share from high-cost Japanese and German alternatives. This is a high-growth, high-ROE business.

Two other companies among our Qarp picks

Formosa Plastics has achieved ROE by focus on cost control, sensible capital spending and continually moving up the value chain to higher-margin/higher-tech products. The petrochemical cycle is continually being extended by strong demand from emerging markets and the company is entering high growth products like carbon fibre.

Hong Poo has achieved high ROEs by not taking on too much land. This has kept capital employed low but the risk is land won't be available at the right time to ensure profits in every year in the future.

Figure 6

Qarp list: September 2007 valuations

Company	CG quartile	Avg ROE 07-08 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
China Steel	1	25	8.60	1.00	3.14	2.10	50
Tong-Tai Machine	2	19	9.50	2.00	2.27	1.55	46
Hung Poo Real Estate	2	21	11.75	0.00	1.76	1.27	38
Basso Industry	1	25	9.50	0.00	2.66	1.97	35
Formosa Plastics	2	21	8.60	2.00	2.81	2.16	30

Note: price on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Thailand - Unfavourable trends

Removal of government reduces manipulation and conflict of interest

In 2002, Thailand's Securities Exchange Commission (SEC) established the National Corporate Governance Committee, chaired by the Prime Minister. However, at the time, the Thaksin government was rife with numerous conflicts of interest, ie, politicians directly and indirectly had stakes in many listed companies. Unsurprisingly, the independence of the SEC and Stock Exchange of Thailand (SET) remained an unresolved issue during the Thaskin era. However, with the military coup in September 2006, stock manipulation and conflicts of interest have lessened considerably. Yet the military government has done little to bolster the independence of the SEC and SET, as these organisations fall close to the bottom of its priority list. As a result, the overall country macro CG score has dropped slightly, mainly owing to lower scores on the political and regulatory criteria.

Government is considering an environmental tax on companies

The top companies in our corporate-governance survey include Siam Commercial Bank, Kasikornbank, PTT, Siam Cement and Bank of Ayudhya. It may be no coincidence that two of the top five companies in our corporate-governance survey are also at the top of our Clean & Green survey. In this case, Siam Cement and Siam Commercial Bank also rise to the top, joined by PTTEP, Aromatics Thai and Thai Oil. In recent years, environmental awareness has taken root in Thailand, making headlines at the national level. Concerns are rising among the population on issues such as the impact of industrial waste and global warming. For example, a recent study concluding that Thailand is losing two square kilometres of coastline a year as sea levels rise made headlines across the country. The government has already responded by imposing stricter controls on emissions for companies located in Map Ta Phut, Thailand's industrial heartland. New projects will not receive approval from the Ministry of Industry unless they meet new environmental standards. The government is also reducing the excise tax on "eco-friendly" cars from 30% to 17% in order to encourage their manufacture and use in Thailand.

Current picks are Aromatic Thailand, PTT and Thai Oil

Our quality at a reasonable price (Qarp) metric has proven a good measure of future stock performance since we last carried out the exercise two years ago. Our eleven Qarp picks in 2005 have appreciated by an average of 25% over the past two years compared to an 18% appreciation by the MSCI Asia. Of the eleven, five companies outperformed, including Aeon Thana Sinsap, Egco, PTTEP, Aromatics Thailand and Asian Property. This year just three stocks meet our Qarp criteria, primarily as a result of recent stock market appreciation. These are Aromatics Thailand, PTT and Thai Oil.

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Country CG score

Thailand's ranking in this year's survey falls to eighth, from sixth in 2005, mainly due to political tensions and the adverse effects on economic policy and corporate-governance reform. While Thailand scored relatively well in some parts of the survey - notably "CG Rules and Practices" and international accounting and auditing rules and practices (IGAAP) - the kingdom's score in the "Political & Regulatory Environment" category plummeted from 50% in 2005 to 31% this year.

Military government slowed CG reform process

The bloodless military coup of September 2006 that ousted Prime Minister Thaksin Shinawatra not only produced an inexperienced government that made a series of economic policy blunders (primarily in currency controls and planned changes to foreign ownership rules), but also forced corporate-governance reform onto the backseat and slowed the passage of major amendments to securities and public company laws even further. Many of these events were set in motion by the sale in early 2006 of Shin Corporation to Temasek Holdings of Singapore, a deal in which the Shinawatra family pocketed US$1.9 billion tax-free and led to some of the reactionary policy moves by the interim government.

Overall score remains close to 2005 results

Figure 1

Thailand ratings for macro-determinants of CG

(%)	2007 rating	2005 rating	Comments
Rules & practices	58	58	Unchanged
Enforcement	36	40	Lowered on stricter criteria
Political & regulatory environment	31	50	Score reduced with the military coup
Adoption of international accounting/auditing standards	70	73	Scores highly
Culture	39	35	Improvement in score
Overall score	**47**	**50**	

Source: ACGA, CLSA Asia-Pacific Markets

Regulatory authorities forced to be creative

Partly due to the slow pace of legislative reform, Thai regulatory authorities have been forced to be creative in pushing their corporate-governance agenda. The SEC has initiated a new programme to assess the quality of annual general meetings (AGMs). Through this it hopes to encourage, and cajole, listed companies to raise the quality and transparency of their shareholder meetings and proxy voting processes. The SET has meanwhile revised its code of corporate governance and is meeting with companies to explain these best practices.

Enforcement and implementation continue to vex Thai regulators

While these efforts are commendable and seem to be having some effect, at least among the larger listed companies in the SET 100, enforcement and implementation issues continue to vex Thai regulators as much as their counterparts in the rest of the region. Insider trading remains a serious issue, for example, with the authorities finding it extremely difficult to prove allegations. In 2005, the SEC began compiling a database of acceptable directors, known as the "white list". Unfortunately, the effort has proved less effective than expected at removing inappropriate members from various boards. Other schemes promoted as important catalysts for better governance have also faltered, including the governance ratings service of Thai Rating and Information Service (TRIS) - despite the backing of the SEC and SET, and various financial incentives designed to gain corporate participation.

Watching the grass grow

Proposed amendment to SEC Act yet to be enacted

Proposed amendments to the Public Companies Act and the Securities and Exchange Act (SEC Act) languished in the pipeline for many years, and have yet to come to the National Assembly and be enacted into law.

In November 2006, however, the SEC's board finally approved the proposed amendments to the SEC Act, including:

- Introducing a nominating committee to select the chairman and secretary general of the SEC board. Only industry experts would be eligible for the chairmanship. The Minister of Finance chairs the current board;

- Tightening supervision of connected transactions between a listed company or a subsidiary and its executives or related persons;
- Allowing courts to order a listed company to pay the legal expenses of shareholders who bring a derivative lawsuit in honesty;
- Enhancing the rights of shareholders to propose agenda items for shareholders' meetings; and
- Introducing protection for "whistleblowers".

Amendments to Public Companies Act hasn't progressed

The amendments have been approved by the Cabinet and are waiting to go to the National Assembly, according to regulators. Amendments to the Public Companies Act, however, are still no further along than they were several years ago. The proposed amendments include:

- Provisions to increase the rights of minority shareholders, including the ability to initiate class-action lawsuits;
- Increased disclosure obligations of management; and
- Greater scrutiny of insider dealings.

There does not seem to be any urgency to the reform agenda on the act, although people say that it will eventually get done.

Adding some fertiliser

Lacking teeth, but a step in the right direction

In a bid to engage institutional investors in AGMs, the SEC in 2006 made it compulsory for asset-management companies to publish their voting policies and disclose their voting records in their annual reports. Indeed, AGMs were a theme that the SEC embraced last year, calling it the "Year of AGM Reform", and setting up an "AGM Assessment" programme with the cooperation of the Thai Investors Association (TIA). The programme, which was modified this year, evaluates the AGMs of all listed companies according to a checklist composed of four parts: before the AGM day, on the AGM day, after the AGM day and bonus points. The checklist includes:

- Whether all the relevant documents, eg, detailed information of each agenda, annual and proxy forms, have been attached to the AGM notice;
- Sufficient disclosure of information on each agenda item to facilitate the voting decisions of shareholders;
- Full attendance of directors/management for clarification/response to inquiries from shareholders;
- Ballots have been provided, especially for shareholders wishing to vote "against" or "abstain"; and
- Votes are counted, and the results disclosed, by indicating the number of shares that voted for, against, or abstained on each agenda of the AGM.

TIA sends volunteers to all the AGMs to grade their performance according to the checklist; points are collated and those companies that achieve 70 or more points receive a rating of "good", which is then posted on the SEC website. It is worth noting, however, that this is a voluntary programme that lacks teeth. Companies are not penalised if they do poorly or choose not to join. The SEC views the programme as an opportunity to help companies, especially those SET 100 companies that fared poorly in the 2006 assessment, to achieve better results in 2007 through consultation.

The exchange issued best practice guidelines for AGMs in Nov 06

Revised Code of Corporate Governance

In November 2006, the SET issued best practice guidelines for AGMs in its revised Code of Corporate Governance, encouraging companies to adopt clear procedures for allowing minority shareholders to propose agenda items for annual meetings.

The revised code now closely follows the five key principles of corporate governance at the Organisation for Economic Cooperation and Development (OECD) and adopts recommendations made in the 2005 World Bank corporate-governance paper, *Report on the Observance of Standards and Codes on Thailand*, such as the establishment of remuneration and nomination committees.

Comply or explain approach

The code remains voluntary, but now takes a "comply or explain" approach, with companies required to disclose results in their 2007 annual statements and report what they have complied with and to what extent. If they fail to comply with the principles, they must explain the reasons for not doing so.

Target was to achieve full convergence with IFRS by end 2007

Accounting convergence

The Federation of Accounting Professions, which sets the accounting and auditing standards of Thailand, is aiming to achieve full convergence with international financial reporting standards and international auditing standards by end 2007. However, the process of setting standards is a long one, with drafts going through public hearings before another round of reviews by the Accounting and Auditing Standard-Setting Committee. The sub-committee then approves the drafts before they are sent for final approval to the Oversight Committee of Accounting Professions, which is chaired by the Minister of Commerce. Once approved, the standards are published in the *Royal Gazette*. Many accountants in Thailand doubt that full convergence can be achieved by the end of this year.

CG is not a government priority

Meanwhile, many institutional investors in Thailand remain less than impressed with the state of corporate governance. Although the regulators are generally seen to be trying to improve enforcement, the SET is looked upon by many as a bystander with few powers, while the SEC is seen as less vigilant than it should be. A slowing economy, an unstable political environment and a certain degree of xenophobia have conspired to push corporate governance off the government's priority list in Thailand.

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Corporate CG issues over the past two years

Within our coverage, there have been few instances of corporate-governance blunders. But this is likely because our coverage is mainly the larger listed Thai corporations, which should display better governance than smaller peers. One notable exception is TV operator, MCOT. Following last September's military coup, the junta replaced MCOT's CEO, Ming Kwan, with an individual who stated his preference to focus less on profitability and more on social responsibility. In our view, this strategy is contrary to MCOT's status as a listed company. However, there has been a plethora of accounting irregularities at smaller firms. As such, the SEC has set up a panel to discuss irregularities. Some of the firms included are: Thai Film; Thainox, Stainless Steel; Picnic Gas; Datamat; KMC and Kuang Pei Sai.

Figure 2

Companies in the top-two CG quartiles for Thailand (CLSA coverage)

Top quartile	Second quartile
Advanced Info Service	Bangkok Bank
Bank of Ayudhya	Big C
Kasikornbank	Egco
PTT	Land & Houses
Siam City Cement	PTTEP
Siam Commercial Bank	Thai Union Frozen
Thai Oil	

Source: CLSA Asia-Pacific Markets

Clean & Green survey

Environmental issues an increasing concern

Around 85% of companies polled in our corporate-governance survey responded to our newly created Clean & Green survey. The highest scoring companies were industrial companies with petrochemical or oil and gas facilities such as Siam Cement, PTTEP, Thai Oil and Aromatics Thailand.

A greater focus on environmental issues is reflected by the government's recent tough stance on new expansion projects in Thailand's industrial heartland of Mat Ta Phut, Rayong Province, in addition to its proposal to collect an environmental tax. Since the beginning of 2007, many projects in the Mat Ta Phut area have been delayed due to the government's growing concerns on environmental issues, given the alarming rise in residents suffering from related illnesses. The government has primarily targeted oil and gas, petrochemical and power projects as they create the most emissions. As a result, many of these companies have focused on reducing levels at their existing plants as well as creating new standards for future projects. These efforts help explain their high Clean & Green scores.

However, it is evident that many companies surveyed have not begun to incorporate environmental issues into corporate policy, in particular non-industrial sectors such as telecoms and banking.

Figure 3

Clean & Green score

Company	(%)
Siam Cement	85
PTTEP	80
Aromatics Thailand	80
Thai Oil	80
Siam City Cement	65
PTT	65
Banpu	55
CP Foods	50

Source: CLSA Asia-Pacific Markets

Voting by poll

A surprising high number of companies vote by poll

Of the twenty-six companies covered in our poll, just two do not vote by poll. This is perhaps surprisingly high, but previous vote-counting scandals at AGM/EGMs have likely prompted the encouragement of better governance.

Figure 4

Companies that vote by poll

Company	CG quartile
Egco	1
Kasikornbank	1
PTT	1
Siam Cement	1
Siam Commercial Bank	1
Thai Oil	1
Aromatics Thailand	2
Bangkok Bank	2
Bank of Ayudhya	2
Banpu	2
Big C	2
Thai Union Frozen	2
Advanced Info Service	3
BEC World	3
Land and Houses	3
PTT Chemical	3
Siam City Cement	3
Thai Beverage	3
Central Pattana	4
CP 7-Eleven	4
Glow Energy	4
Ratchaburi Electricity Generating	4
Total Access Communication	4
True	4

Source: CLSA Asia-Pacific Markets

Directors' remuneration

Directors not paid much relative to corporate profitability as a whole

Directors' remuneration as a percent of net profit for companies surveyed is just 0.51%. This likely reflects the comparatively low level of pay in Thailand despite many listed companies competing in global industries such as petrochemical. Directors at Thai Beverage are paid the most as a percent of profits, followed by CP Foods. At the other end of the scale, PTT and AIS pay their directors the least relative to profitability. Those companies where remuneration has outpaced net profit growth are generally those where profitability has declined, such as CP Foods and Land & Houses.

Figure 5

Companies with directors' remuneration at highest % of net profit

Company	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
Thai Beverage	2.60	Yes
CP Foods	1.50	Yes
Siam Commercial Bank	0.90	No
CP 7-Eleven	0.70	Yes
Siam City Cement	0.52	No
Ratchaburi	0.50	No
Aromatics Thailand	0.50	No
Thai Oil	0.40	No
Bangkok Bank	0.33	No

Source: CLSA Asia-Pacific Markets

Figure 6

Companies with directors' remuneration at lowest % of net profit

Company	Directors' remuneration as % of net profit	Has directors' remuneration risen faster than net profit over the past five years?
BEC World	0.30	No
Glow Energy	0.30	No
PTT Chemical	0.30	No
Siam City Cement	0.28	No
Thai Union Frozen	0.23	No
Land & Houses	0.20	Yes
Central Pattana	0.20	No
PTTEP	0.16	No
PTT	0.04	No
Advanced Info Service	0.04	No

Source: CLSA Asia-Pacific Markets

Changes in CG scores

Corporate governance continues to improve

Excluding the new Clean & Green section and new questions in our corporate-governance survey, the average corporate-governance score has risen from 56 to 60 since our last report in 2005. Genuine improvements have occurred, but are also aided by the discontinuation of analyst coverage on low scoring companies such as Thai Airways and Airports of Thailand. The biggest improvements have come from PTT and Central Pattana. PTT has improved in areas of accountability and responsibility, while CPN has performed well across-the-board. Meanwhile, Banpu and Ratchaburi have seen declines across all sections. However, the extent of these declines seems unlikely and may be due to a change in analyst coverage, given the degree of subjectivity in responses.

Figure 7

Companies with changes in CG scores: 2005-07

Company	Chg in CG score (ppt)	2005 quartile ranking
PTT	13.9	1
Central Pattana	12.5	4
CP 7-Eleven	12.1	3
DTAC	10.6	4
Big C	10.2	2
True	(5.1)	4
Siam City Cement	(8.9)	3
Ratchaburi	(12.0)	4
Banpu	(13.7)	2

Source: CLSA Asia-Pacific Markets

Qarp stocks 2005

Fewer Qarp picks reflecting higher regional valuations

Our 2005 Qarp stocks have outperformed over the past two years, rising by an average of 25%, compared to 18% by the benchmark MSCI Asia index. Of the eleven stocks, five outperformed including Aeon Thana Sinsap, Egco, PTTEP, Aromatics Thai and Asian Property. One stock has been taken-over (National Petrochemical) while the remaining five underperformed. Only Siam City Cement's share-price actually declined over this period and by just 0.7%. In general, external cyclical stocks such as petrochemicals have outperformed as global economic growth has remained robust, buoying earnings. Domestic stocks have generally underperformed due to rising political risks, oil prices and interest rates. This year we have just three Qarp stocks. The lower number reflects higher valuations after stock market gains.

Figure 8

Performance of 2005 Qarp picks

Company	CG quartile	ROE 04-05 (%)	Share price Jun 05 (Bt)	Share price Sep 07 (Bt)	Performance (%)
Aeon Thana Sinsap	2	34.5	37.50	49.50	32.0
Egco	2	15.6	79.00	108.00	36.7
PTTEP	1	33.9	76.80	108.00	40.6
Aromatics Thailand	2	55.2	51.50	65.00	26.2
Thanachart Capital	2	14.6	12.80	14.50	13.3
Asian Property	2	23.7	3.62	6.00	65.7
Siam City Cement	2	24.9	278.00	276.00	(0.7)
Siam Cement	1	49.1	228.00	260.00	14.0
Tisco Finance	1	17.1	25.00	27.50	10.0
KK Bank	1	16.0	27.50	32.00	16.4
Average return of Qarp stocks					25.4
MSCI Thailand two-year return					17.8

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

Qarp picks 2007

Top picks predominantly cyclical

Our three 2007 Qarp picks are all cyclicals (petrochem and refiners), including Aromatic Thai, PTT and Thai Oil. Arguably, cyclical companies trade on low valuations relative to generated returns at the peak of the economic cycle in anticipation of a fall in future returns as global growth slows. However, if global growth remains strong, they will likely continue to outperform.

Room to move cost of equity lower

In deriving Qarp, we have employed a 12% cost of equity. This is arguably a percentage point below the market's estimated longer term 13% cost of equity. However, interest rates haven fallen 150bps in the past seven months and may fall further, which suggests a lower cost of equity is presently more appropriate. Should we lower cost of equity by a further percentage point to 11%, companies that would meet Qarp criteria include Thai Union Frozen, Glow Energy, Egco and Ratchaburi. Of these, only tuna processor Thai Union Frozen is appropriate as the remaining power companies have finite concession periods.

Figure 9

Qarp list: September 2007 valuations

Company	CG quartile (1-4)	Avg ROE 07-08 (%)	COE (%)	Long-term growth (%)	Theoretical PB (x)	Market PB (x)	Theoretical upside (%)
Aromatics	2	32.0	12	5.0	3.9	2.2	75.0
PTT	1	25.5	12	5.0	2.8	2.3	20.9
Thai Oil	1	23.4	12	5.0	2.6	2.0	28.4

Note: priced on 7 September 2007. Source: CLSA Asia-Pacific Markets

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Appendix 1: About ACGA

The Asian Corporate Governance Association (ACGA) is a non-profit, membership association dedicated to promoting substantive improvements in corporate governance in Asia through independent research, advocacy and education. ACGA engages in a constructive dialogue with regulators, institutional investors and listed companies on key corporate governance issues and works towards making improvements.

For more details on ACGA's activities and a database of information on corporate governance in Asia, see our website: www.acga-asia.org

ACGA is funded by a corporate membership base of almost 70 companies that includes:

- Several of the world's largest fund managers. ACGA investor members manage more than US$5 trillion globally and hold significant stakes in Asian companies.
- Two major multilateral banks.
- Leading insurance firms and brokers.
- Several Fortune 500 and Financial Times "Global 500" corporations.
- Highly regarded listed companies and professional firms in Asia.
- Leading educational bodies.

Membership list (in alphabetical order)

1	Aberdeen Asset Management Asia	35	Linklaters
2	Alliance Trust Asset Management	36	Lloyd George Management (Hong Kong)
3	Aon Asia	37	Lombard Asian Private Investment Company[1]
4	Asia Mezzanine Capital Group (AMCG)	38	Manulife (International) Ltd
5	Asian Development Bank	39	Maple-Brown Abbott
6	Baker & McKenzie.Wong & Leow	40	Marsh
7	Bank of America	41	Mekong Capital
8	Bank Consortium Trust	42	Merrill Lynch
9	British Columbia Investment Management Corporation	43	Milbank, Tweed, Hadley & McCloy
10	Bumiwerks Asset Management	44	Morrison & Foerster
11	California Public Employees' Retirement System (CalPERS)	45	Neptune Orient Lines
12	California State Teachers' Retirement System (CalSTRS)	46	Oaktree Capital (Hong Kong)
13	Capital Group	47	Overlook Investments
14	Chubb Insurance[1]	48	Portfolio Managers Asia (PMA)
15	CLSA Asia-Pacific Markets[1]	49	Prudential Asset Management
16	Credit Agricole Asset Management	50	Russell Investment Group
17	Deloitte Touche Tohmatsu	51	SAP Asia
18	Deutsche Asset Management (Asia) Ltd	52	Standard and Poor's
19	F&C Asset Management	53	Standard Life Investments
20	Fidelity Investments Management (HK)	54	State Street Global Advisors (Asia)
21	GIC Special Investments	55	Sumitomo Mitsui Asset Management Co Ltd
22	Governance for Owners	56	Sun Life Financial Asia[1]
23	Grant Thornton	57	Swire Pacific
24	Hermes Pensions Management	58	Symphony Financial Partners Co Ltd
25	Hewitt Associates	59	Taiwan Greater China Fund
26	Hong Kong University of Science and Technology	60	Taiyo Pacific Partners
27	Ichigo Asset Management Limited	61	TIAA-CREF
28	IMC Solution Shipping	62	Universities Superannuation Scheme
29	International Finance Corporation (IFC)	63	University of Wisconsin Law School
30	ING Asia-Pacific	64	Value Partners Ltd
31	Jardine Lloyd Thompson Asia	65	VTech Holdings Ltd
32	Jones Day	66	Watson Wyatt Hong Kong Ltd
33	Li & Fung	67	Wellington Management Company
34	LIM Advisors		

[1] Also a founding corporate sponsor of ACGA. Source: CLSA Asia-Pacific Markets

Appendix 2: ACGA/CLSA market-ranking survey

1. CG Rules & Practices

		Ch	HK	India	Indo	Jp	Kr	My	Ph	Sp	Th	Tw
1	Do financial reporting standards compare favourably against international standards? (eg, frequency and timeliness of reporting; international accounting standards; continuous disclosure rules; and so on)	L	L	L	S	L	S	Y	L	Y	Y	L
2	Do financial reporting practices among large listed companies compare favourably against international best practices?	L	Y	Y	S	Y	L	L	L	Y	L	L
3	Do financial reporting practices among small- and medium-sized listed companies compare favourably against international best practices?	S	L	M	M	S	S	M	S	S	S	L
4	Do non-financial reporting standards compare favourably to international standards? (ie, the MD&A, Report of Directors, and corporate-governance statements in annual reports)	M	L	L	M	S	S	S	S	Y	L	S
5	Do non-financial reporting practices among large listed companies compare favourably to international best practices?	M	L	L	S	L	L	M	S	L	L	S
6	Do non-financial reporting practices among small- and medium-sized listed companies compare favourably to international best practices?	M	S	M	M	M	M	N	M	S	M	S
7	Do large listed companies report their audited annual results within two months or 60 days?	N	M	Y	S	N	M	N	N	Y	Y	M
8	Do small- and medium-sized listed companies report their audited annual results within two months or 60 days?	M	N	S	M	N	N	N	N	Y	Y	M
9	Is quarterly reporting mandatory, is it consolidated and does it provide adequate and credible P&L, cash flow and balance sheet data?	S	N	S	Y	Y	L	Y	Y	Y	Y	L
10	Do securities laws require disclosure of ownership stakes of 5% and above (ie, when an investor becomes a substantial shareholder)?	Y	Y	Y	S	Y	Y	Y	Y	Y	Y	S
11	Do securities laws require disclosure of share transactions by directors and controlling shareholders within 3 working days?	S	Y	M	S	L	M	M	M	Y	Y	S
12	Do securities laws require adequate disclosure of material transactions, including major connected transactions? (ie, sufficient information to allow informed minority investors to assess the risk to themselves of these transactions)	S	L	S	M	L	L	L	M	L	S	L
13	Do securities laws provide a credible deterrent against insider trading and market manipulation?	N	L	S	N	M	S	M	N	Y	M	L
14	Are class-action lawsuits permitted and undertaken?	N	N	M	M	N	M	N	M	N	N	S
15	Is voting by poll mandatory for resolutions at AGMs?	N	S	N	N	S	N	N	N	N	N	N
16	Is there a national code (or codes) of best practice largely based on international CG standards?	Y	Y	Y	L	M	Y	Y	S	Y	Y	L
17	Is there a clear and robust definition of "independent director" or "outside director" in the code or listing rules? (ie, one that says such directors should be independent of both management <u>and</u> the controlling shareholder; which does not make it easy for former employees and former/current professional advisors to become independent or outside directors; and which produces genuinely independent directors)	S	S	S	S	N	S	S	S	S	M	S
18	Must companies disclose the exact remuneration of individual directors and senior executives (top 5) by name (or do they)?	S	Y	Y	N	N	N	M	N	S	S	N
19	Are audit committees (or an equivalent) mandatory and implemented?	Y	Y	Y	Y	S	Y	Y	Y	Y	Y	S
20	Are audit committees chaired by a genuinely independent director and given sufficient powers in practice (by the company) to examine financial reports and announcements, internal controls and the independence of external auditors? Are they operating independently?	M	S	S	M	N	S	M	N	S	M	M
21	Can minority shareholders easily nominate independent or outside directors and are these candidates likely to be elected?	N	M	M	N	N	N	N	N	M	N	M
22	Is there a statutory or regulatory requirement that directors convicted of fraud or other serious corporate crimes must resign their positions on boards and in management?	L	S	L	M	Y	M	S	S	L	M	Y
23	Are pre-emption rights for minority shareholders - their right to buy any new shares issued by the company on a pro-rata basis - firmly protected? (ie, enshrined in the company law and requiring a supermajority - 75% - to disapply them; and with any new shares only issued under fairly strict caps on percentage of issued capital and price discounts)	N	M	M	L	N	M	M	N	M	S	M
24	Do companies release their AGM notices (with detailed agendas and explanatory circulars) at least 28 days before the date of the meeting?	L	L	L	M	S	M	L	L	S	S	M

Y = Yes (+1 point); L = Largely (+0.75 points); N = No (+0 point); S = Somewhat (+0.5 points); M = Marginally (+0.25 points);
X = Data unavailable (+0 point)

2. Enforcement

		Ch	HK	India	Indo	Jp	Kr	My	Ph	Sp	Th	Tw
1	Do financial regulators in your country have a reputation for vigorously and consistently enforcing their own CG rules and regulations?	S	S	S	M	S	S	S	N	L	M	S
2	Have their efforts improved tangibly in recent years?	L	Y	Y	M	Y	Y	Y	S	Y	Y	Y
3	Are securities regulators seen to treat all companies and individuals equally?	S	L	S	M	M	L	M	M	L	N	S
4	Are the regulatory authorities sufficiently resourced - in terms of funding and skilled staff - to do their job properly?	S	L	S	N	L	S	L	N	L	S	S
5	Does the main statutory regulator (ie, the securities commission) have effective powers of investigation and sanction?	S	S	Y	M	L	S	L	S	L	S	Y
6	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years? (eg, against cases of market misconduct such as insider trading, share-price manipulation, self-dealing)	X	X	X	X	X	X	X	X	X	Y	X
7	Has it had a successful track record prosecuting cases of insider trading and market manipulation in recent years?	N	S	S	N	M	M	M	N	L	N	S
8	Does the stock exchange have effective powers to sanction breaches of its listing rules?	M	M	M	M	S	M	S	M	M	M	L
9	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years?	X	X	X	X	X	X	X	X	X	X	X
10	Do the regulators (ie, the securities commission and the stock exchange) disclose detailed and credible data on their enforcement track records?	L	Y	S	N	Y	M	L	S	S	L	S
11	Do institutional investors (domestic and foreign) exercise their voting rights?	S	S	M	M	S	M	S	M	S	S	S
12	Are institutional investors actively voting against resolutions with which they disagree?	S	Y	M	M	L	M	M	N	L	S	Y
13	Do institutional investors (domestic and foreign) often attend annual general meetings?	M	N	M	M	M	M	N	M	M	M	S
14	Do minority shareholders (institutional or retail) often nominate independent directors?	N	M	N	N	N	M	N	N	N	N	N
15	Do retail shareholders see the annual general meeting as an opportunity to engage with companies and ask substantive questions?	N	Y	M	S	S	M	M	S	S	S	M
16	Are minority shareholder activists willing to launch lawsuits against companies and/or their directors?	M	N	M	M	M	Y	N	N	N	N	M
17	Are minority shareholders adequately protected during takeovers, privatisations, and voluntary delistings?	S	Y	S	M	M	S	M	N	S	M	M
18	Is there an independent commission against corruption (or its equivalent) that is seen to be effective in tackling public- and private-sector corruption?	M	Y	M	Y	L	M	M	S	Y	N	S

Y = Yes (+1 point); L = Largely (+0.75 points); N = No (+0 point); S = Somewhat (+0.5 points); M = Marginally (+0.25 points);
X = Data unavailable (+0 point)

3. Political & Regulatory Environment

		Ch	HK	India	Indo	Jp	Kr	My	Ph	Sp	Th	Tw
1	Does the government have a clear, consistent and credible policy in support of corporate governance reform?	S	S	S	S	M	M	S	M	S	M	S
2	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; and without fragmentation and disagreement between different financial and economic regulatory authorities)	S	S	S	M	M	S	S	M	L	S	S
3	Is the statutory regulator (ie, the securities commission) formally and practically autonomous of government (ie, not part of the ministry of finance; nor has the minister of finance or another senior official as chairman; not unduly influenced by government; and not dependent on the government for its annual budget)?	N	S	L	N	M	N	M	S	N	M	N
4	Has the government and/or the statutory regulator been actively reviewing and modernising company and securities laws over the past two years (ie, to improve corporate governance and bring local rules and regulations up to international standards)?	Y	S	S	S	S	M	Y	M	S	N	Y
5	Has the stock exchange been actively reviewing and modernising its listing rules over the past two years (ie, with a view to improving corporate governance)?	Y	S	M	M	Y	M	M	M	S	M	S
6	Has the securities commission signed the IOSCO Multilateral Memorandum of Understanding?	Y	Y	Y	M	N	N	Y	M	Y	M	M
7	Do the regulators (ie, securities commission and stock exchange) have informative websites, with English translations of all key laws, rules and regulations easily accessible?	S	Y	L	S	S	Y	Y	L	Y	L	Y
8	Does the stock exchange provide an efficient, extensive and historical online database of issuer announcements, notices, circulars and reports (ie, archived for at least 4-5 years)?	L	Y	S	S	Y	L	Y	S	S	M	Y
9	Does the legal system allow minority shareholders effective access to courts to settle disputes? (ie, in terms of the cost of going to court and the range of legal remedies available)	M	M	M	N	S	S	M	N	M	N	S
10	Is the judiciary independent and clean (in relation to company and securities cases)?	M	Y	S	M	L	S	M	M	Y	N	L
11	Is the judiciary sufficiently skilled in handling securities cases?	N	Y	S	M	M	L	M	M	Y	M	M
12	Is the media free to report on corporate governance abuses among listed companies?	S	Y	Y	Y	Y	Y	S	Y	L	M	Y

Y = Yes (+1 point); L = Largely (+0.75 points); N = No (+0 point); S = Somewhat (+0.5 points); M = Marginally (+0.25 points);
X = Data unavailable (+0 point)

4. IGAAP (or "Accounting & Auditing")

		Ch	HK	India	Indo	Jp	Kr	My	Ph	Sp	Th	Tw
1	Does the government or the accounting regulator have a policy of following IAS/IFRS accounting standards?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
2	Are local accounting rules largely in line with international standards?	L	Y	L	S	L	S	L	Y	Y	L	L
3	Are accounting practices among large listed companies in line with international best practices?	S	Y	L	S	Y	L	L	S	Y	L	L
4	Are accounting practices among small- and medium-sized listed companies in line with international best practices?	M	S	M	M	S	M	M	M	L	S	S
5	Do the rules require disclosure of consolidated accounts?	Y	Y	Y	Y	Y	M	Y	Y	Y	Y	L
6	Do the rules require segment reporting?	Y	Y	Y	L	S	L	Y	Y	Y	Y	Y
7	Is disclosure of audit and non-audit fees paid to the external auditor required?	Y	Y	Y	N	N	Y	Y	S	S	Y	S
8	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	Y	Y	Y	L	Y	Y	Y	Y	Y
9	Are local auditing rules in line with international standards?	L	Y	L	S	L	L	Y	Y	Y	L	L
10	Are auditing practices among large listed companies in line with international best practices?	L	Y	L	L	L	L	L	L	Y	L	Y
11	Are auditing practices among small- and medium-sized listed companies in line with international best practices?	M	L	M	S	S	M	M	S	S	M	S
12	Is the government or the accounting regulator actively implementing new international best practices on the independence of external auditors? (eg, by introducing limits on the non-audit work that external auditors can do; requirements for audit-partner rotation; whistleblower protection for auditors; and so on)	S	M	S	S	S	Y	Y	S	Y	S	Y
13	Must the CEO, CFO or directors sign and certify a company's annual accounts?	Y	L	Y	Y	Y	Y	Y	Y	L	Y	Y
14	Is the government strengthening the regulation of the accounting profession? (eg, by setting up an independent oversight board)	M	M	M	S	S	M	N	M	L	M	N
15	Is the expensing of share-based payments mandatory?	Y	Y	Y	Y	Y	Y	Y	Y	Y	N	N

Y = Yes (+1 point); L = Largely (+0.75 points); N = No (+0 point); S = Somewhat (+0.5 points); M = Marginally (+0.25 points);
X = Data unavailable (+0 point)

5. CG culture

		Ch	HK	India	Indo	Jp	Kr	My	Ph	Sp	Th	Tw
1	Does the average listed company believe that corporate governance will provide tangible benefits? (eg, lower cost of capital, improved share price, better risk management, etc)	N	S	M	N	M	M	N	M	S	N	S
2	Are large listed companies genuinely trying to follow the spirit, not merely the letter, of corporate governance rules? (ie, in practical terms this would mean doing more than the rules require)	M	S	L	S	S	S	S	S	S	S	S
3	Is there an up and coming group of small- and/or mid-cap stocks that is gaining a reputation for being well-governed and also going 'beyond compliance'?	N	M	S	M	S	N	M	M	M	M	S
4	Are large listed companies actively seeking to improve their communication with shareholders? (eg, through more regular briefings; detailed online disclosure; better reports; and webcasts)	Y	Y	Y	S	L	Y	Y	Y	Y	L	Y
5	Are small- and medium-sized listed companies actively seeking to improve their communication with shareholders?	S	S	S	M	S	S	M	M	S	M	L
6	Do company boards generally have separate chairmen and CEOs, with the Chairman being independent of the CEO?	N	M	M	N	N	N	N	N	S	N	N
7	Are listed companies increasing the pay of independent or outside directors in line with the latter's growing responsibilities and liabilities?	M	Y	S	M	M	N	S	M	S	S	S
8	Do listed companies provide adequate disclosure of their internal-control and risk-management functions in their annual reports?	N	M	M	M	M	M	M	M	M	M	M
9	Is there a trend towards large listed companies voluntarily voting by poll at their AGMs and making the results public afterwards?	S	Y	M	N	M	N	N	N	N	S	N
10	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	N
11	Are institutional investors (domestic and foreign) actively engaged in promoting better corporate governance practices?	N	M	M	M	S	M	N	M	M	M	M
12	Have institutional investors set up any corporate governance "focus funds"?	N	N	N	N	Y	Y	N	N	N	N	N
13	Are retail investors or non-profit organisations engaged in promoting better corporate governance practices?	N	Y	S	M	S	Y	S	M	Y	S	S
14	Have retail investors or members of the public formed their own independent shareholder or corporate governance organisations?	N	S	Y	M	S	Y	S	N	L	M	L
15	Is there an institute of directors that is actively engaged in director training?	M	Y	S	S	Y	M	S	Y	Y	Y	M
16	Are other professional associations - of accountants, company secretaries, financial analysts and so on - promoting corporate governance training and awareness raising?	M	Y	S	S	M	M	L	Y	Y	M	S
17	Are professional associations and academic organisations carrying out original research on local CG practices?	Y	Y	Y	M	Y	Y	S	M	Y	Y	Y
18	Does the media actively and impartially report on corporate governance reforms and developments?	S	Y	Y	S	L	S	S	Y	S	S	Y

Y = Yes (+1 point); L = Largely (+0.75 points); N = No (+0 point); S = Somewhat (+0.5 points); M = Marginally (+0.25 points);
X = Data unavailable (+0 point)

Appendix 3: CLSA CG questionnaire

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? Does the company's Annual Report include a section devoted to the company's performance in implementing corporate governance principles?

2. Do senior management or the controlling shareholders have a meaningful direct stake in the equity of the company? (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.)

Questions in bold have negative scoring

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/convertibles for new equity, for acquisitions and/or financing new projects where there was controversy over whether the acquisition/project was financially sound, or whether the issue of equity was necessary if gearing was not high by industry standards, 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?

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?

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 full year results within three 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 45 days 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)?
20. 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?)
21. **Is it true that the company has not applied for a waiver on disclosure rules for the market?**

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? Is there an independent director with financial expertise named on the committee?**

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? 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.]

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?

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 2003?

    B) And at the end of 2006?

    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?

Q38 and Q39 are new questions in this year's survey

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?
38. Do companies vote by poll (as opposed to by show of hands) at AGMs and EGMs for all resolutions?
39. Do companies make publicly available by the next working day the result of the votes taken during the AGM/EGM?

Responsibility (15% weight)

40. 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".)
41. 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.")
42. **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".)
43. 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".)
44. 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".)
45. **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 that may be separately listed.)

46. Is it true that the controlling shareholder (whether an individual or company) is not known or widely believed to be highly geared?

47. **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)

48. **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.)

49. Do all equity holders have the right to call General Meetings? (Any classes of shares that disenfranchise their holders would mean a "No" answer.)

50. 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.)

51. 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?

52. 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?

53. **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?**

54. A) Does the controlling shareholder group own less than 40% of the company?

    B) Please provide the stake owned by the controlling shareholder.

55. Does the head of Investor Relations report to either the CEO or a Board member?

56. 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.)

Clean & green (10% weight)

See the C&G questionnaire on page 14.

Notes:

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