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The Value Added of Board Capital in Emerging Markets: *Does human side of corporate governance matter?*

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AGENDA

- Research question and objectives
- Methodology and models
- The sample
- The results
- Discussion and policy implications

WHY BOARD CAPITAL?
Beyond Agency Paradigm

- **THIRD DIMENSION OF CG** is missing (McCahery&Vermeulen,2014).

The dominance of agency theory requires rather **narrow** board's functions focused on 2 dimensions: monitoring& control; risk management

- **Overemphasis** on the control and monitoring roles (Filatotchev and Wright, 2006);
- Agency theory underlies the fiduciary duties of the boards, keeping managerial discretion within boundaries; the active participation in **setting the strategy** is **not a priority** for board's work within the agent-principal paradigm (Ben-Amar et al, 2013).
- The strategic advice is not fully built into the agent-principal governance framework (Adams, Hermalin and Weisbach, 2010; Bebchuk and Weisbach, 2010).

WHY BOARD CAPITAL?
Dual Role and Extensions

❑ **TRADE-OFF BETWEEN CONFORMANCE & PERFORMANCE** in board's roles (Huse, 2007; Cornforth, 2004; Connell, 2004;Busco et all.2005):

- the monitoring and control functions are more attributed to conformance role, only indirectly to value creation
- the performance role is directly focused on value creation and long-term progress of a company Should be shaped more proactive
- Extension to dual roles**: integrated governance**
  - addresses enterprise itself and broader area of entrepreneurial activities than agency framework
  - involves the process of learning and knowledge sharing that the board has to ensure. Boscov et al.(2006) and A.Elgharbawy and M.Abdel-Kader (2013)

WHAT IS BOARD CAPITAL?

❑ RESOURCE - BASED VIEW:

The board capital - a proxy for a board's ability not only to monitor, but also to provide adequate resources for strategy development thru collective knowledge and expertise of the overall board. (Hillman and Dalziel, 2003)

The board focuses and contributes to the formulation of corporate strategies by fostering the access to a variety of resources (information, experience (Haynes, Hillman, 2010; Kroll, Walters and Le, 2007).

❑ HUMAN CAPITAL FRAMEWORK:

The concept of board capital is wider than the collective human capital of its members :

it also includes social (relational) capital, that is, the ability of board members to access different networks and to use them for a firm as well as their cognitive abilities (Nahapiet, Ghoshal, 1998).

CONCEPTUAL FRAMEWORK: BOARD CAPITAL LEVERAGE

DISTINCT FEATURES COMPARED TO OTHER TYPES OF HUMAN CAPITAL :

- **Accumulated tacit knowledge at both individual member- level** & **group-level** (embedded into collaborative relationships in the board room).
  tacit (implicit) knowledge: is not articulable, can not be codified and cannot be transferred (Lane&Lubatkin,1998; Liebeskind, 1996).

- **Collection of inimitable critical competitive assets**.

- board's unique roles: responsibilities in monitoring a *broad spectrum* of conflicting interests of owners and agents; majority versus minority owners
- to resist short-termism of managers.
- to act as **a type of a collective internal consultant to the firm**:
  - higher probability to create strategic value identifying strategic vision for the firm and developing firm-specific knowledge on its implementation.
  - leadership in processing information, identifying growth opportunities, applying and developing firm-specific skills for conflicts resolutions.

THE BOARD CAPITAL LEVERAGE

INTERNAL LEVERAGE MECHANISM:

- Board's collective tacit knowledge is **leveraged over the top management** of the firm:
  - set up requirements for the CEO human capital
  - responsible to gradually shape the capabilities of overall top management team
  - creates **novel multiple effects** in the unique inimitable knowledge of an organization

EXTERNAL LEVERAGE:

- Creates valuable outcomes by networking and board's social outside relations.

RESEARCH QUESTION & OBJECTIVES

The holistic role of **Board Capital** is to fill the gap in governance processes in Emerging Markets
Have the boards in EM earned sufficient strength for **leveraging board capital?**

- What are the value added components of board capital that contribute to the firm performance?
- Each type of experience contributes to the board capital and it's diversity. On the other side, specific background (e.g. long work experience in one sector) influences director's pattern of thinking and, therefore, may alter the decision-making process
- Does the board with the variety of types and degrees of education outperform the board with homogeneous education?

RESEARCH DESIGN

Determining the role of **educational diversity** of board in the firm performance

Examining each type of **experience of directors** (international, industrial, managerial, governmental) contribution to the firm performance

Step 1
Model 1

Aggregating board's characteristics into **board capital index**

Assessing **board capital index** contribution to the firm performance

Step 2
Model 2

Studying the **CEO's human capital impact** on firm performance

Step 3
Model 3

VARIABLES

Variable	Description
Age	Average age of boards' members
MBA	MBA degree of board's members
Int_exp	International experience of boards' members
Gov_exp	Government experience of boards' members
Ind_exp	Industry experience of boards' members
Ceo_exp	Experience as a CEO
Edu_distr	Range of educations which boards' members have. Its value means how much the board has different educations
Board_size	Number of members in the board according to corporate principles of each company

Variable	Description
Age	Proxy for age of CEO
Fin	If CEO was CFO or was responsible for financial issues
Mark	If CEO was CMO or was responsible for marketing or commercial issues
Oper	If CEO was COO or was responsible for operational or product issues
For	If CEO was born in any developed country
C_int_exp	If CEO worked at developed country more than 1 year
C_ind_exp	If CEO worked at the same or similar industry where his current company operates
Comp_ins	If previous job of CEO was in the current company
Dual	If CEO and Chairman of the Board are the same person
Founder	If CEO is a founder or one of the founders of the company
Major	If CEO's share in the company's equity is higher than other shareholders have
Tenure	Number of years for which CEO has his position of CEO in the current company
New	If CEO was charged during reported year

STEP 1. BOARD CAPITAL

Influence of board's characteristics:

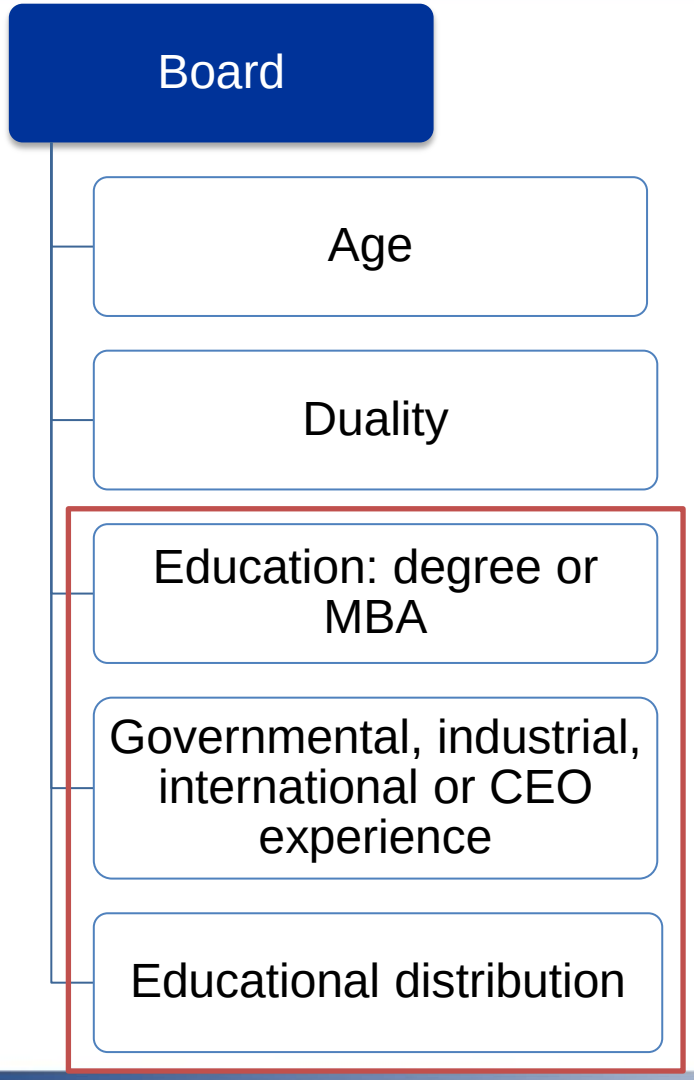
- **Dependent:** ROE, ROA, Tobin's Q
- **Independent**: age, degree, educational diversification, board size, different types of experience (international, industry, government, CEO)
- **Control:** natural logarithm of total assets, dummies for year, dummy for industry

For Board Capital variables:

(1)

$$Qtobin = b0 + b1 \times Age + b2 \times Age \times Age + b3 \times MBA + b4 \times Int_exp + b5 \times Ind_exp + b6 \times Gov_exp + b7 \times Ceo_exp + b8 \times Edu_distr + b9 \times Board_size + b10 \times Control + \varepsilon$$

STEP 2. BOARD CAPITAL INDEX



Overall contribution of board's HC through board index:

- Each characteristic's panel is divided onto terciles (<33,3%; <66,6%, >66,6%)
- Each tercile is given values 0, 1, 2
- **Dependent:** ROE, ROA, Tobin's Q
- **Independent**: age, board capital index, board size
- **Control:** natural logarithm of total assets, dummies for year, dummy for industry

Methodology according to Ben-Amar, Francoeur, Hafci, Labelle (2013)

STEP 3. CEO HUMAN CAPITAL

Influence of CEO's characteristics:

- **Dependent:** ROE, ROA, Tobin's Q
- **Independent**: age, work experience (financial, commercial, operational, industry, international), duality, tenure, insider, ownership (founder, major shareholder)
- **Control:** natural logarithm of total assets, dummies for year, dummy for industry
- **Variables:** mostly binary

For CEO HC variables:

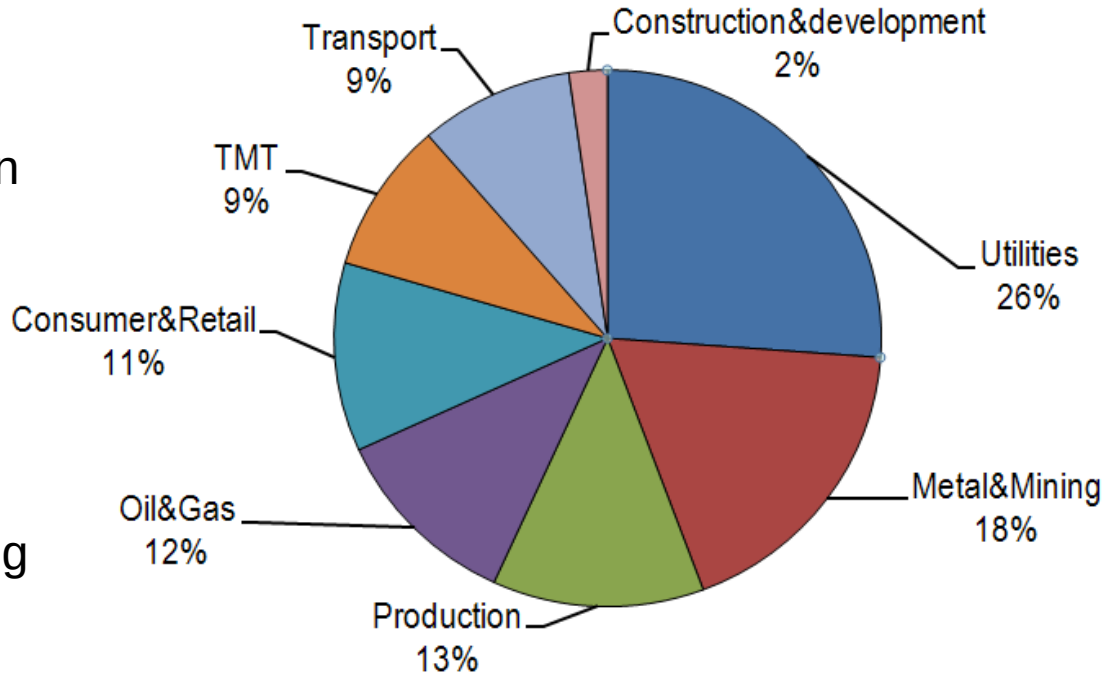
(3)

$$Qtobin = b0 + b1 \times C_Age + b2 \times Tenure + b3 \times Fin + b4 \times Mark + b5 \times Oper + b6 For + b7 \times C_int_exp + b8 \times C_ind_exp + b9 \times Comp_ins + b10 \times Founder + b11 \times Dual + b12 \times New + b13 \times Control + \varepsilon$$

THE SAMPLE

Data:
- 89 public Russian companies
- Market capitalization>100 $ mln
- Period of 2009-2014

Important:
- Criteria for sample firms
- Possible errors, outliers in data
- **Winsorizing** procedure – cutting off tails of distributions



Data sources:
- CEO's and boards' characteristics for every board's member – firms' annual reports **(hand-collected)**
- Financial data – Capital IQ (database of Standard & Poor's agency)

DESCRIPTIVE STATISTICS: THE BOARDS

Variable	Observations	Mean	Std. Dev.	Min. Value	Max. Value
Age	501	47.91	6.23	32.33	68.18
Degree	508	0.377	0.325	0	1.364
MBA	508	0.093	0.130	0	0.571
int_exp	508	0.208	0.228	0	0.833
gov_exp	508	0.167	0.170	0	0.636
ind_exp	508	0.663	0.224	0	1
ceo_exp	508	0.457	0.264	0	1
edu_distr	502	3.857	1.365	0	7
board_size	508	9.567	2.023	7	13

Typical Russian board of directors:

- 10 members
- 48 – average age
- 40% with academic degree
- Industry experience
- Education: economics, business, mathematical, technical

DESCRIPTIVE STATISTICS: THE CEOs

Variable	Observations	Mean	Std.Dev.	Min.Value	Max. Value
c_Age	515	47.503	8.904	29	67
Tenure	516	4.052	4.170	0	17
fin	516	0.134	-	0	1
mark	516	0.112	-	0	1
oper	516	0.486	-	0	1
for	516	0.031	-	0	1
c_int_exp	516	0.211	-	0	1
c_ind_exp	516	0.924	-	0	1
Comp_ins	516	0.621	-	0	1
founder	516	0.147	-	0	1
Major	516	0.161	-	0	1
New	516	0.186	-	0	1

Typical CEO of large Russian firm:

- 47 years old
- Industry experience
- Firm's insider

RESULTS: STEP 1 BOARD CAPITAL

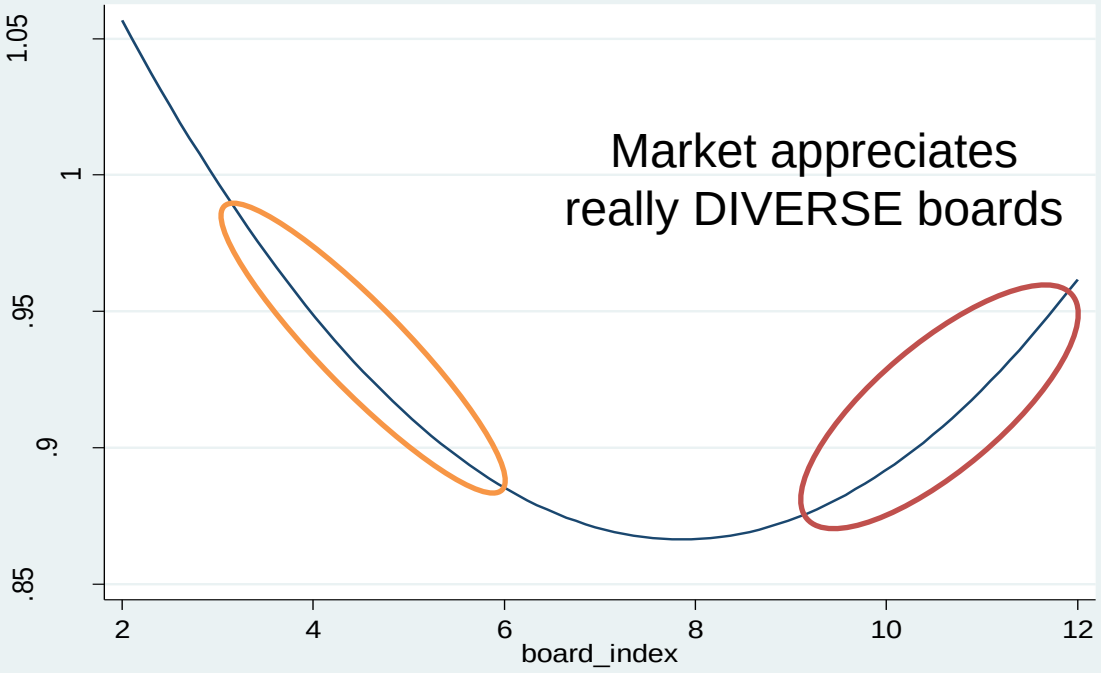
Variable	Tobin's Q	ROE	ROA
Age	-0.13*	1.47***	0.01
Age*Age	0.01**	-0.02***	-0.00
MBA	-0.16	-2.56	0.02
International experience	-0.82***	0.16	-0.10**
Gov experience	-0.04	-4.73***	-0.01
Industry experience	0.38*	1.79	0.02
CEO exp of board	0.51***	-2.16*	0.01
Educational distribution	-0.04	0.40***	-0.00
Board size	-0.02	0.02	-0.01
R-squared within	0.23	0.58	0.12
F-statistic	7.35	34.18	3.40

Findings

1) Market prefers board directors with industry or managerial experience (former CEOs) to the directors with international experience; while profitability is lower for the boards with ex-CEO directors
2) Educational diversity increases profitability, while market does not believe that
3) Market likes younger boards, while profitability is higher for older boards

RESULTS: STEP 2 BOARD CAPITAL INDEX

Variable	Tobin's Q		ROE		ROA	
Model	*Linear*	*Quadratic*	*Linear*	*Quadratic*	*Linear*	*Quadratic.*
Board index	-0.03*	-0.16***	-0.07	0.20	-0.00	0.00
Board index sq		0.01**		-0.02		-0.00



Board Capital index

- Fluctuates from 2 to 14
- Mean=7.3 (stable across 2009-2014)
- The least diverse board in Utilities (6.7 on average)
- The most diverse board in Telecommunications
- The narrowest range in Construction & Development (from 6 to 9)

RESULTS: CEO HUMAN CAPITAL

Variable	Tobin's Q	ROE	ROA
Age	0.00	0.01	0.00
Tenure	-0.00	0.02	-0.00
Financial experience	0.17*	0.51	-0.01
Marketing experience	0.06	-0.57	0.04***
Operational experience	-0.14*	-0.67*	-0.00
International experience	-0.02	0.18	0.00
Industry experience	0.06	-0.65	-0.01
Foreigner	0.08	0.48	-0.04
Company's insider	-0.04	-0.04	0.01
Duality	-0.10	0.49	0.05**
Founder	0.38***	0.02	0.01
New	-0.00	0.07	-0.01
R-squared within	0.20	0.52	0.11
Wald chi2	90.78	420.44	56.58

Findings

1) Market likes the CEOs with financial experience (ex-CFOs) and dislikes ex-COOs
2) Profitability is higher in firms headed by CEOs with experience in sales
3) Market appreciates when the founders manage their own companies

CONCLUSION: HUMAN SIDE OF CORPORATE GOVERNANCE MATTERS

1. Board Capital Leverage already works in Russia for companies with diverse boards, despite very short history of governance
   - Market appreciates high values of Board Capital Index
   - The higher the diversity of experience and education, the higher the Tobin's Q
2. Russian companies benefit from managerial and industry experience of board
   - Controversial finding: Boards dominated with directors with international experience may worsen the corporate performance in EM
3. CEO choice: Candidates with financial experience (ex-CFOs and consultants) are the best choice

Does Board Capital depend on the pattern of financial architecture? What if the ownership is extremely concentrated?

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Thank you for your attention!

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