What Hindenburg has got wrong

In their report on the Adani group, Hindenburg took a jab at the governance of Indian companies. We don't agree with their broad-brush rationale for dissing corporate India. Our view is that over the past few years, corporate governance standards in India have strengthened.

The Hindenburg report has been critical of the state of Indian capital markets. It says, "*India is home to many of the world's most brilliant entrepreneurs, engineers, and technologists and is emerging as a global superpower. However, the country's economy has been held back by the broken state of its capital markets.*" This sweeping statement about the state of Indian capital markets risks creating a false perception about India with global investors.

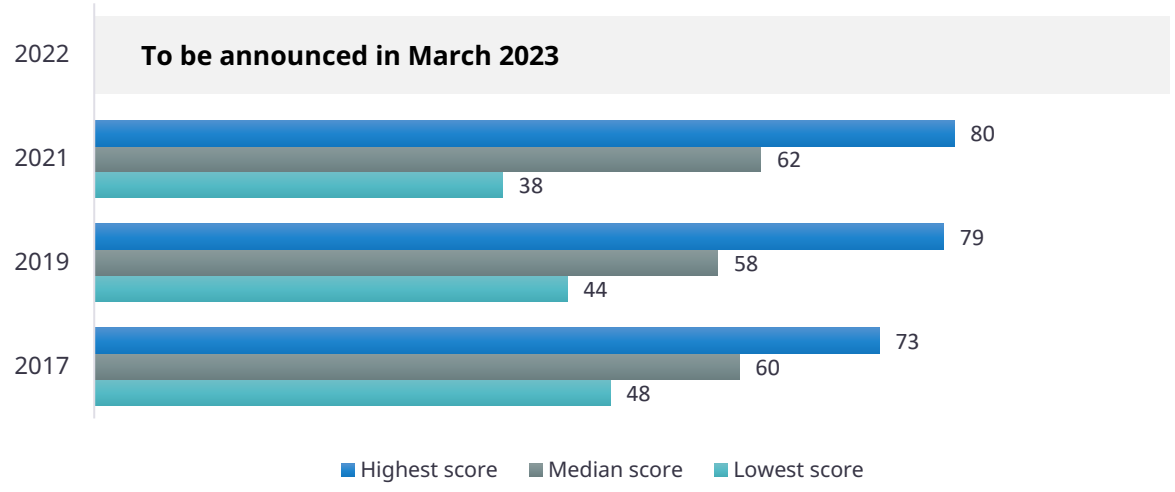
Given the spotlight on the Adani group, the allegations made by Hindenburg are likely to colour the view of Indian markets for many. We have a contrarian view: a few bad apples aside, the corporate governance standards of Indian companies have only been improving.

For one, Foreign Institutional Investor ownership in NSE listed companies (by market capitalization) has increased from less than 10% in June 2001 to 18.4% in June 2022[1]. Outside of the global macroeconomic conditions, foreign portfolio investors are unlikely to stay invested if the markets rest on shaky governance structures.

[1] *Source: India Ownership Tracker dated 22 September 2022 published by NSE*

Our argument is bolstered when we look at data from our annual scores based on Indian Corporate Governance Scorecard (Scorecard)[2]. Developed jointly by IFC (International Finance Corporation), BSE, and IiAS, and based on the G20/OECD Principles of Corporate Governance, it scores S&P BSE 100 index constituents, on a host of governance parameters[3]. These 100 index constituents account for over 70% of total market capitalization – therefore, their measure on the Scorecard is representative of the broader market. On a base of 100, median scores have been inching up over the past five years and stood at 62 for companies evaluated on their 2021 disclosures (Exhibit 1). More than half or 57% of the companies scored 60 or more – the threshold for being considered well-governed under the Scorecard assessment framework – against 45% in 2019 (Exhibit 2). The assessment based on 2022 disclosures is underway, but early results tell us that the governance scores have increased further, on a much more stringent assessment framework[4].

Exhibit 1: Scores over the years of S&P BSE 100 companies on the Indian Corporate Governance Scorecard



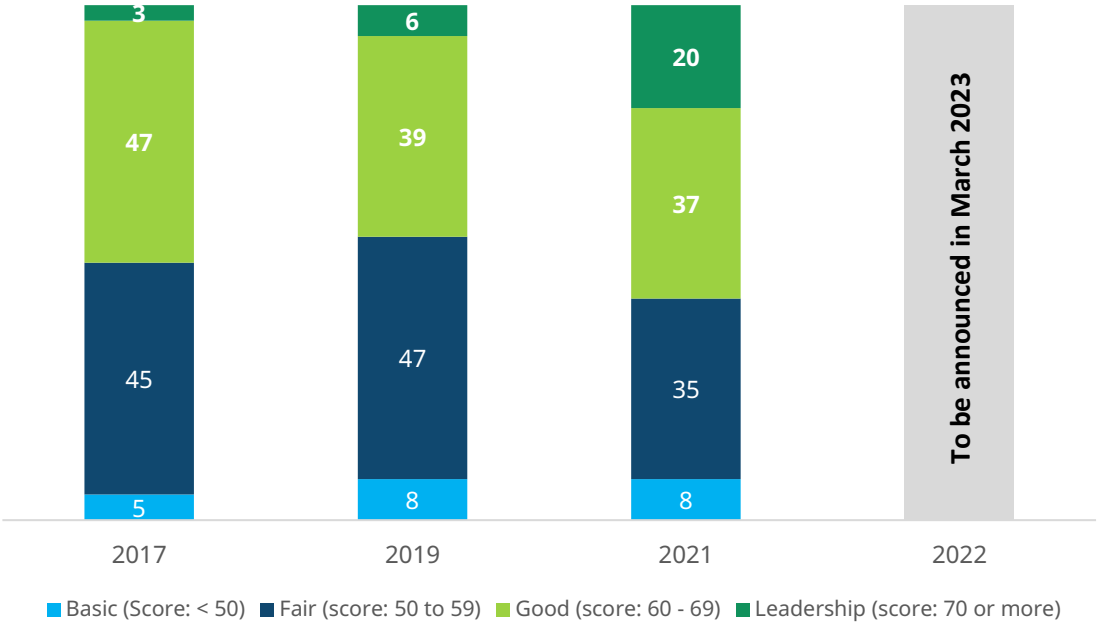
Source: IiAS Research; https://www.iiasadvisory.com/governance-Scorecard

[2] *More information about the CG Scorecard is available here: https://www.iiasadvisory.com/governance-Scorecard*

[3] *As all evaluation frameworks do, the methodology of the Indian Corporate Governance Scorecard also has its own limitation. A high score on the scorecard is not an indicator of current or future financial performance, or stock price performance. The scores also do not indicate the permanency of governance practices: a company's governance practices may improve or deteriorate from the date of the scoring. The scorecard is based on publicly available information, which has its limitations and cannot predict corporate behaviour – especially during contentious or divisive situations.*

[4] *Following a consultative process, IiAS revised the scoring methodology which included modifying the existing framework, adding a few new questions, and increasing the threshold for a 'Leadership' score to 75 from 70. The 2022 assessments will be based on this revised framework.*

Exhibit 2: Higher number of companies are crossing the 'Leadership' threshold on the Indian Corporate Governance Scorecard



Source: IiAS Research; https://www.iiasadvisory.com/governance-Scorecard

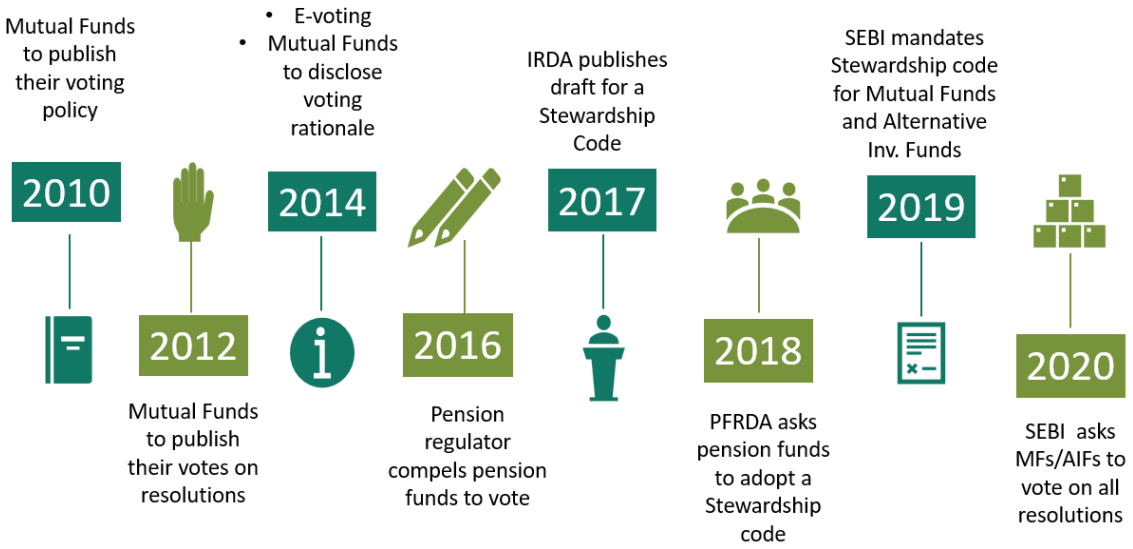
Regulations in large part have helped strengthen governance practices.

Beginning with the voluntary adoption of governance codes in the mid-1990s, we have shifted to regulatory standards. In this journey, 2014 and 2015 were watershed years with the Companies Act 2013 and the SEBI (Listing Obligations and Disclosure Requirements) Regulation 2015 focussing on empowering shareholders, and recognizing the role of auditors and boards, particularly independent directors, in shaping corporate behaviour. Online voting was introduced for all companies in 2014 and since then shareholder resolutions are weighted by the shareholding even as many geographies persist with a show-of-hand and non-binding votes. This alone has empowered shareholders to push back. Further stewardship responsibilities imposed through codes – by IRDAI, PFRDA and SEBI has led to domestic institutional investors voting their shares and engaging with companies on governance and operational issues (Exhibit 3).

Indian regulations around corporate governance maps onto the G20/OECD Principles of Corporate Governance with regulators using a mix of regulations and mandatory disclosures to drive better behaviour. Not only do regulations require adherence to what are seen as global best practices, in many aspects our expectations are tighter than well-established global norms. Shareholders of Indian companies approve executive

remuneration while the US has a say-on-pay. Mandatory auditor rotation, CSR spends, a reverse book-building mechanism for delisting are just some of the aspects that are largely unique to the Indian market.

Exhibit 3: Regulations pushing for stewardship



Source: IiAS research

Financial leakages through related party transactions remain a focus area of SEBI where rules are constantly being tightened. Most now call for a majority of minority vote. As companies find escape routes, SEBI continues to tweak its regulations to close innovative hatches. Gaps remain. Closing some loops is made difficult by global treaties restricting data access regarding beneficial owners or tracking the money trail till the very end. These embolden companies and promoters.

No market is immune to governance failures. India, too, has had its share of governance failures, much like other mature markets: from GE to Volkswagen, to Wells Fargo, to Toshiba. Regulations cannot plug all holes. They can only solve for what can be envisaged and learn from what they missed. Investors know that there can be no guarantees against corporate governance failures. And well-governed companies recognize that transparency and predictability of corporate behaviour is not built overnight but takes years and decades to build.

Given the harsh market reaction, the Adani group by now, will have recognized the fragility of investors' trust in the group. The lack of wide-spread domestic institutional ownership too tells its own tale. The group needs to change behaviour and improve transparency including in areas like share-ownership (which it has long mistakenly believed it can side-step) and related party transactions. Largely leaving unanswered

questions such as Vinod Adani, Gautam Adani's brother, being a related party[5] will not bolster investor confidence.

It will be unfortunate if the questions raised by Hindenburg on the Adani group cast a shadow on the capital market in India. The two should not be conflated. Trust in the governance practices of corporate India is an important element to attracting capital – both foreign and domestic. The Indian regulators are aware how fleeting and fragile this trust is, which is why they focus so much on it.

A modified version of this blog was published in Business Standard on 14 February 2023. You can access the blog by clicking this link or typing the following in your url: https://www.business-standard.com/article/opinion/what-hindenburg-has-got-wrong-123021301539_1.html

[5] *Section 2(76) of the Companies Act 2013 defines a "related party"*

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This article is a commentary on general trends and developments in the capital market.

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IiAS provides bespoke research and assists institutions in their engagement with company managements and their boards. It runs two cloud-based platforms, SMART to help investors with reporting on their stewardship activities and ADRIAN, a repository of resolutions and institutional voting pattern.

IiAS with the International Finance Corporation (IFC) and BSE Limited, has developed a Corporate Governance Scorecard for India to evaluate company's governance practices and market benchmarks.

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