

Article: Corporate Governance Problems in Kazakhstan

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In our (Synergy Partners Law Firm) corporate law practice we conducted legal due diligence in relation to more than 15 different Kazakhstani companies of different sectors, both large and medium-sized. Our experience helped us to identify some common problems in corporate governance. These problems can be observed by financiers, accountants and managers, but we would like to share these observations as professional corporate lawyers.

Management: loyalty or competence?

The fraud is the biggest damage for the Kazakhstani business. Every business and every company will from time to time deal or face with this issue. The fraud may appear as commercial bribery in company procurements, in overpricing or a profit stealing, insider leaks, the theft and sale of customers' database and valuable business information to competitors. The roots of these problems are the lack of competent management team in a company. And, vice versa, fraud should be considered as proof of the existence of incompetent top management in a company.

Many business owners in Kazakhstan prefer loyal top management than competent people in management. Thus, they often hire their relatives, friends, or "trusted people" and expecting from loyalty to ultimate beneficiaries. Sometimes it is driven whenever the methods and business practices may be unethical or illegal.

The foreign multinational companies, usually, have stronger management teams. Foreign managers are very costly for a business, but there is a perception, that they are more competent and more loyal to stakeholders. As for fraud, they solve this problem successfully. Some do it through the procedures, controls, through corporate governance, through high-quality selection of staff combined with high salaries and supported by a corporate culture. Other managers do it through certain business processes and HR-branding. Some foreign companies use software solutions, for example, the ERM-systems, CRM-systems, eliminating human factor by automation of as many business processes as possible. In general, foreign companies consider fraud elimination as challenge, and eliminate fraud successfully.

Clearly, it may appear why not to hire foreign managers?! Some foreign managers in Kazakhstan demonstrate their excellent results. However,

regardless of whether it is foreign or local top managers, the management team must be competent and able to convince their shareholders about their vision, solutions and strategic plans. One would summarize, it should first be the competence of management team, and after the integration of software solutions through the optimization of business processes in a company.

The company's value: assets or corporate governance?

Modern aggressive hedge funds in USA acquire some equity with aim to resell it. They influence on company value increase and immediately sell such shares for a margin. Usually, such company later suffers losses due to lack of long-term plans and strategies. Essentially, the same phenomenon is in Kazakhstan. Kazakh investors acquire a controlling stake or the whole Kazakh company, appoint a management team, conduct a few changes in the company. The owners do not require the management team effectiveness. In their opinion, the company's assets and management loyalty is more important than corporate governance, since in any case such a company would be sold.

The basic strategy is focused on acquisition of undervalued assets. This M&A transaction will have a speculative nature. Investment decisions are based on the asset valuation, that is, based on the availability of the undervalued property. For example, the value of mining will be based on its mineral resources. In their opinion, corporate governance and management competence, as well as the business processes will not increase company value. Similar situation, on the companies that have such assets as business centers, hotels, warehouse, factories, agricultural land, gas stations, railway cars and tanks. Evaluation of these companies is based on the valuation of its assets and cash flows generated by the property.

As someone observed in foreign mass media, Kazakhstan has low corporate governance culture. We believe that most Kazakhstani business owners are mistaken about corporate governance. They do not believe that proper corporate governance may increase the company value. In fact, corporate governance can improve the business and increase the company value for several times. Here is an example. Air Astana started with the capital of around US\$ 10 mln in 2001. Now the company has 30 airplanes. Sales amounted to about \$ 1 bln in 2014, while net income reached US\$ 20 mln. All data about the company is available on the corporate website, in annual report. The company competes with foreign and local leading air carriers. Unlike the Russian Aeroflot, Air Astana does not receive any government subsidies. The company has increased its assets in several times through good corporate governance, and raised ten times the company value, bringing profits annually.

Companies without Assets

The phenomenon of companies with no material assets is surprising. For example, the largest and leading global carrier taxi Uber has no cars. These companies have outstanding management team that conducts their core business with innovative technology. Innovations in corporate history have always taken place, but successful companies created an outstanding management team and thereafter focused on marketing with the development of best-selling products.

Now products have become obsolete very quickly under the onslaught of technological revolutions. Video tapes, fax machines, and diskettes do no longer exist. The list could go further. Therefore, companies create outstanding management team, introduced corporate governance, make the company transparent. In new economy, a classic property becomes a bottleneck due to capital and operation costs. But the main point is that new technologies will destroy some companies. The management team shall quickly identify these upcoming drastic changes and to find new business opportunities. For example, a local retailer Meloman was transformed into Marvin. It does not matter whatever the economic environment, it is important how far the management team is competent.

Decisions making process: debates

There is a perception that corporate governance is the bureaucracy that slows down decision-making process, creates rigmarole, and ties the hands and opportunities for leadership and management. Kazakhstani companies try to do everything very quickly. The decision-making process is more emotional, rather than rational and requires a good judgment. In some companies, CEOs make decisions independently. But

the logic of CEOs' reasoning and justification is undocumented. Even some boards also do not record their ideas and judgments, the reasons why they have postponed or took certain actions, decisions or business opportunities. The board meetings are even spectacular, when leaders are trying to prevent a common judgment and members' discussion, so that in most cases the company decision-making is dominated by a single person judgment rule. How bad is that? The management team is forced to consider and discuss an leader proposal, while alternative views and offerings are not considered. That creates a tunnel vision for the top management team, thereby decreasing mental abilities to find solutions at management board, board of directors, or supervisory board. Unlike the debates, Kazakhstan has not adopted the corporate culture of expressing different opinions and views. It sometimes viewed as confrontation inside the top management when different opinions are expressed.

To avoid influence of a single person, OECD Guidelines offer to introduce independent directors, who must not be influenced by the shareholders or by the management board. Certain stock exchanges require that at least half of members of board of directors are independent directors. Some business owners are mostly has distorted understanding of the role of independent directors. Large shareholders facilitate the appointment of independent directors strongly loyal to them, doing themselves a disservice. As we have seen in practice, such independent directors did not do their work. In most cases the independent directors are very passive in Kazakh companies, they not making any contribution or impact to the company business.

German co-determination laws require that in major German companies in the composition of the supervisory board shall be consisted of employees' representatives, so that they can influence decisions made by the supervisory board. In practice, employees are interested in stability and profitability of the company. Such employees' representatives may be considered as the opposition, those interests and vision may not coincide with loyal members of the supervisory board appointed by shareholders.

The composition of supervisory board or board of directors shall lead to open and effective discussions or even a debate on the most important agenda. Moreover, a debate itself is not sufficient for finding appropriate solution. We have seen the management decision of Kazakhstan companies taken in debates among 2-3 top managers or shareholders. Such decisions are taken in truly open discussion. But in practice, such decisions were wrong. Later, important decisions are taken in open discussions in among at least 5-6 people. That increased the quality of generated decisions. The firm documented the decisions. The discussions were conducted without the pressure from shareholders. The minutes of meeting mentioned the reasons and judgments on which certain decisions have been taken or deferred.

(to be continued)