CLSA
ASIA-PACIFIC MARKETS

CG Watch 2005

Corporate governance in Asia

ACGA

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October 2005

Asia
Special report

CG stars
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HSBC
Infosys
Public Bank
Tanjong

QARP picks
Chinatrust
Formosa Chemical
Hana Bank
Hynix Semiconductor
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Nan Ya Plastics
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Shinhan Financial Group
SingTel
Standard Chartered

Higher-ranking CG markets
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Hong Kong
India
Malaysia
Taiwan

Qarp

The holy grail

Quality at a reasonable price

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Jointly published by

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

www.acga-asia.org

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

www.clsa.com

First published in paperback and ebook formats in 2005.

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

Creator	Gill, Amar, editor Allen, Jamie, editor
Title	The holy grail : quality at a reasonable price / edited by Amar Gill, Jamie Allen.
Series title	CG watch
ISBN	988-78680-4-3 (paperback) 988-78680-5-1 (ebook : pdf)
Other creators/ Contributors	Asian Corporate Governance Association, issuing body. CLSA (Firm), issuing body.
Dewey decimal	658.4

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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 4 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.

The holy grail

QARP – Quality at a reasonable price

The performance of stocks and markets with high levels of corporate governance (CG) negatively correlates with risk appetite. When liquidity enters markets it raises risk appetite and effectively reduces the risk premium. This leads to a rerating of poorer quality names - the opposite of when liquidity is heading out. MSCI Asia ex-Japan was up 47% in the three years to end-2004. However, the better performing markets – the top two being Indonesia and Thailand - were in the lower half of our CG rankings.

However, a portfolio of companies with above average CG, ROE above cost of equity and at an undemanding PB ratio - that is "quality at a reasonable price", which in this report we call QARP - has provided extremely strong performance. The QARP basket of the largest 100 stocks in Asia ex-Japan, rebalanced at the start of each year, beat the unweighted performance of the large-cap sample by an average of 46ppts a year over the three years to 2004, a cumulative three-year return of 467%, 10x that of MSCI Asia ex-Japan. Within the 10 markets surveyed in this report, the top CG quartile of stocks underperformed the bottom one in six of the markets in 2004. However, the QARP basket outperformed in eight of the markets while marginally underperforming in only two. It gave an average return of 36% in the respective markets last year, double the average market return.

The 2H05 QARP basket among large caps has **Formosa Chemicals**, **Hynix Semiconductor**, **Posco**, **Chinatrust**, **StanChart**, **NanYa Plastics**, **SingTel**, **Shinhan Financial**, **Hana Bank** and **HSBC**.

Country scores - Lowered

Our country scores for macro-determinants of CG have trended down on stricter criteria. A few years ago regulators were praised for tightening up on rules and regulations; today it is apparent that many of these rules have only a limited effect on corporate behaviour. Where implemented, they are often not carried out effectively. Conversely, in the area of enforcement, a steady improvement is discernible albeit from a low base. The gap between our scores on the top two ranked CG markets, Singapore and Hong Kong, has narrowed from last year. At the middle of our rankings, Korea's position has slipped behind Taiwan. In the lower segment, the Philippines' and China's scores remain close to each other, with a gap over Indonesia.

CG rankings of the large caps

Larger companies tend to have higher CG scores – partly as the costs of having the best standards are easier to meet. In our sample of 496 companies in Asia-Pacific ex-Japan, the largest 100 by market cap have an average CG score of 62.9, 5.5ppts above that of the overall sample average. Over the past year, the average score of the total sample has risen marginally (+0.6ppts) while that of the large caps by 1.9ppts. Of the top scoring companies **HSBC**, **Infosys**, **Public Bank** stand above most of the rest. Of medium-caps, **HK Exchanges** and **Tanjong** also score above 80%.

Ten markets in Asia ex-Japan surveyed

We survey CG issues and progress in 10 Asia markets ex-Japan covered by CLSA. Outright fraud leading to blowups has blemished not just the poorer CG markets, but also Singapore and Hong Kong. Questions over which side the government is on are raised by legislative changes in Korea as well as edicts on bank takeovers in Taiwan. Government-linked company (GLC) reform in Malaysia, however, should lead to improvement in CG. Momentum on regulations continues also in India, but has stalled in Indonesia and the Philippines. The quest for the holy grail of good governance continues.

QARP - Quality at a reasonable price

Performance of high-CG stocks tends to occur when markets are falling

In recent years we have found that high-CG stocks do not necessarily outperform when markets are rising, especially when there is strong liquidity inflow into markets. Rising markets generally lead to increased risk appetite among investors and a search for stocks at lower valuations with greater re-rating potential. These would usually not be higher CG names. Studies showing outperformance of higher CG stocks have almost invariably been for periods when markets were declining. When markets are falling, investors' risk appetite diminishes and higher risk names tend to be thrown out of portfolios. As investors gravitate to better quality names, one then finds higher CG stocks outperforming when markets are heading down.

When markets are rising, it is usually lower quality names that outperform

But when markets are rising, higher quality stock names and higher CG markets, which are likely to start off in the upturn at higher valuations, are not likely to be strong performers. Liquidity coming into markets in effect pushes down the risk premium in stock valuations. Stocks at a larger valuation discount see a larger rerating when markets rise.

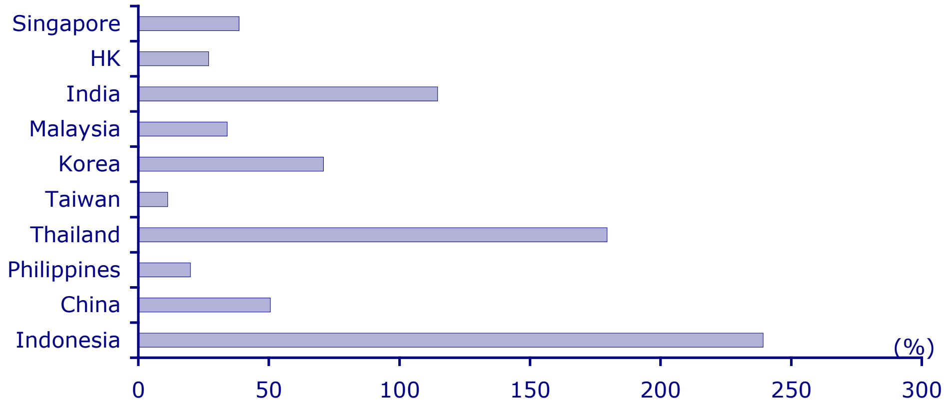
In the past three years when markets were rising, strongest performing markets had lower CG rankings

Certainly at the level of markets, we find countries not regarded as strong for corporate governance tending to outperform when markets in the region are generally rising; and vice versa when markets are falling. For instance, in the three years to end 2004, MSCI Asia ex-Japan is up 46.7%: of the ten markets we survey in the region, the two with by far the strongest performance (all in dollar terms) were Indonesia and Thailand up 239% and 179% respectively over these three years. Both these markets rank in the lower half of country CG rankings. The five markets in the lower half of our macro-CG rankings (based on 2004 country scores) on average rose 100.1% in the three years, about double the return of the five markets that we ranked in the upper half, which were up on average 57%.

Strongest performance in Thailand and Indonesia over the past three years

Figure 1

Three-year performance to end-2004 of markets ranked by CG



Source: CLSA Asia-Pacific Markets

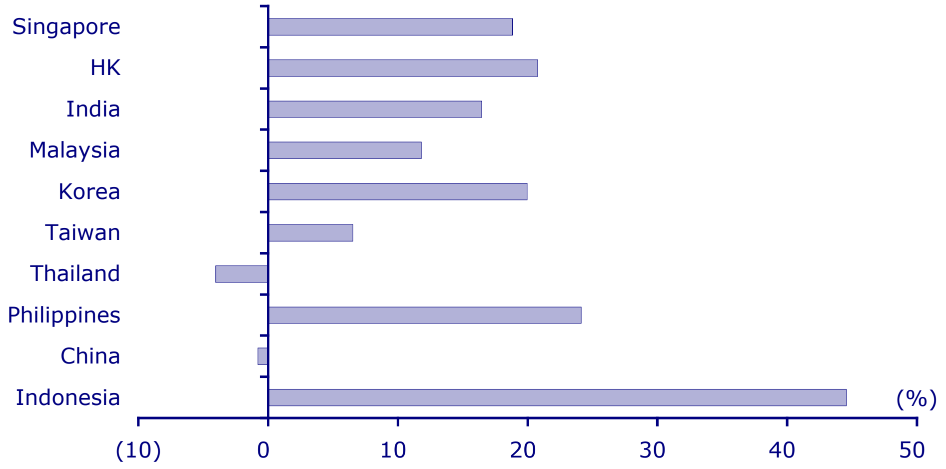
In 2004, top performing markets were in the lower half for CG; but overall performance of lower CG markets were more dispersed

For 2004 alone, MSCI Asia ex-Japan was up 14.4% and the top two performing markets in our survey were again among the lower half in our CG rankings: Indonesia was up 44.5% and the Philippines rose 24.1%. However, the returns for the lower five markets for CG were more dispersed while returns in the upper-half CG-ranked markets were more consistent. For last year, the upper-half markets for CG by our 2004 rankings on average marginally outperformed the lower half (17.6% versus 14.1%).

In 2004, more consistent performance in upper half CG markets; but strongest returns were in two of the lower half ranked markets for CG

Figure 2

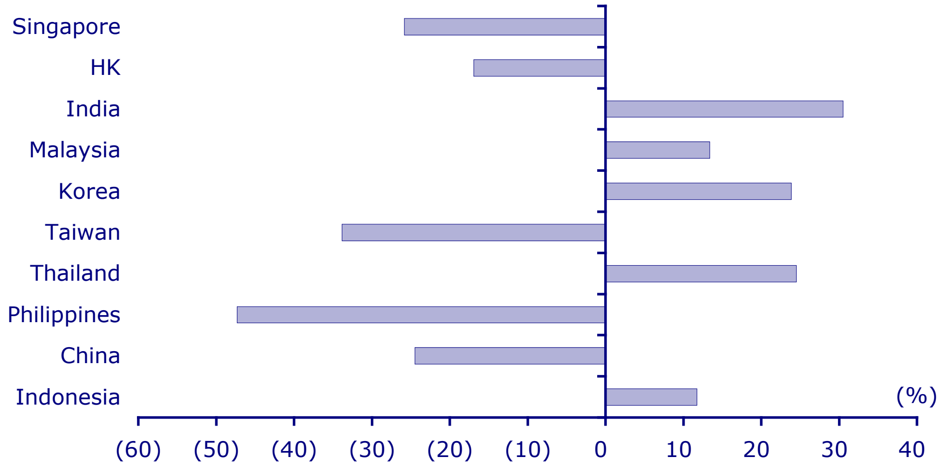
2004 performance of markets ranked by CG



Over past five years when regional index is down; worst performing were the lower ranked markets for CG . . .

Figure 3

Five-year performance to end 2004 of markets ranked for CG



Source: CLSA Asia-Pacific Markets

. . . better performing markets were in the upper half of our CG rankings, viz. India, Korea and Malaysia

Taking a five-year time frame to end-2004, MSCI Asia ex-Japan is down 12.1%. The upper half markets for CG did better, managing an average gain of 5% driven mainly by positive returns in India, Korea and Malaysia outweighing negative returns in Singapore and Hong Kong. The lower half markets by our 2004 survey slumped on average 13.9% with the larger declines being in the Philippines, Taiwan and China.

This analysis based on 2004 country rankings; by our 2005 rankings Korea and Taiwan switch from upper half to lower half

Note that this review on performance of markets to 2004 is based on our 2004 market rankings for CG. (Similarly, the country sections below also looks at performance of CG quartiles based on 2004 CG scores – while our picks for 2005 are based on the updated 2005 scores.) Our updated 2005 country rankings (see pages 17-20) now scores Taiwan slightly ahead of Korea, i.e. on our 2004 ranking Korea was fifth and just in the upper half while Taiwan was in the lower half of country rankings, but this switches around in our 2005 rankings of markets.

Even by the 2005 rankings, low CG markets do well when markets are generally rising

If we used our 2005 market rankings, the performance for the three years to end-2004, and the 2004 one-year returns, would be stronger for the lower half CG markets – strengthening the argument that lower ranked markets for CG tend to outperform when markets are generally rising. The 2004 return would tilt towards lower half CG markets slightly outperforming the upper-half (16.8% versus 14.9%). On the updated 2005 ranking, the five-year performance would become much more mixed: the top half CG markets would then have provided a five-year average return of minus 6.5% while the lower half would then have an average return of minus 2.3%.

When markets do not have strong direction, performance is mixed; when markets falling hard earlier evidence is that higher CG markets more resilient

The point remains that when markets are rising strongly, lower CG markets tend to outperform; when markets are not moving strongly (five years to 2004 MSCI Asia ex-Japan minus 12%, 2004 one-year return up 14%) the performance of markets sorted by CG is not clear cut. And in our reports from past years, we found evidence that when markets are falling hard, markets with better CG are more resilient.

QARP - Marrying CG with VCARP

Valuations cannot be ignored in stock picking

Obviously investing cannot be done without taking into account valuations. Relative performance over a given period will depend on various factors including valuations at the starting point and changes in risk appetite over the period. A major drawback of just sorting companies for CG is that without a tie-in to financials and valuations, these rankings are at best a checklist against an independently arrived choice of stocks by one's chosen valuation metric.

CG linked to VCARP in selecting stocks

Our CG report this year specifically seeks to make the link between CG and financials to arrive at not just top quality companies, but stocks that are attractive to invest in. To do this, we marry CG with the analyses we have elsewhere called "value creators at a reasonable price" (VCARP). The idea is to screen for companies with above average CG in their respective markets, and with attractive financial returns. Those generating ROE above cost of equity (COE) we define as value-creators.

We use the Gordon growth model (see below) to determine the value creators at a reasonable price (VCARP). Applying the VCARP analysis to companies with above average CG gives what we call in this report QARP stocks, ie representing quality at a reasonable price.

ROE chosen over ROIC

Is there a big difference in focusing on ROE instead of return on invested capital (ROIC) for our value-creator list? For equity investors with little or no control over capital structure of companies invested in, ROE would appear the key return measure. In most instances, the list one would get focusing on ROE or ROIC will not be very different. It can be shown that a company with gearing will have ROE above COE if and only if ROIC is above its weighted average cost of capital (WACC).

Companies with ROIC above cost of debt will have positive impact on ROE

In essence, if a company is gearing up and able to generate an ROIC that remains above cost of debt, then the additional returns over debt financing cost translates to higher ROE – the positive impact of gearing on ROE. But if the return on incremental capital employed falls below the cost of debt used to finance it, then the impact will be negative on ROE. (For companies with net cash, however, ROIC might be above WACC yet overall returns being pulled down by cash balances could lead to ROE being lower than COE.)

Equity investors with little influence over capital structure should focus on ROE

Those looking to buy over a company and having the option to make changes to capital structure might well focus on ROIC rather than ROE. But for equity investors with little influence on capital structure, to determine whether management is generating sufficient returns on the equity we are investing in, ROE rather than ROIC should be the appropriate return measure. That is, there is less reason to pay a high premium on equity value for companies with a very high ROIC, but with a large amount of cash on the balance sheet that brings down the ROE.

And when ROE is being gauged, the appropriate benchmark for cost of capital is COE rather than WACC. A high level of gearing would tend to reduce WACC but might actually have the opposite effect on COE: companies with too high gearing will likely have a higher COE.

Hurdle for ROE is COE

Thus for equity investors generally, the financial measure to apply on companies and the effectiveness of management is whether ROE is higher than COE given the capital structure of the firm. While ROIC is benchmarked against WACC, the hurdle for ROE is COE.

Value creators where ROE > COE

The traditional definition following Stewart Stern is that companies generating a ROIC above WACC are creating positive economic value; similarly those generating an ROE above COE are creating value for shareholders/equity investors. An added advantage of focusing on ROE rather than ROIC is that this approach can easily be extended to banks as well, while ROIC and WACC are not concepts that readily apply to banks.

Applying the Gordon growth model

Gordon growth model to determine theoretical value for stocks with ROE > COE

A company with ROE above COE can be defined as a value-creator. Whether the stock is an attractive investment depends on valuations. We use the Gordon growth model, as applied often by bank analysts, to determine a theoretical PB multiple based on estimates of ROE, long-term growth and cost of equity. The formula for the theoretical PB value is:

PB = (ROE – g) / (COE – g); where

ROE = long-term sustainable ROE

g = long-term growth

COE = cost of equity.

Long-term sustainable ROE is subjective

Different analysts will give different values for long-term sustainable ROE for any given company. Theoretically, excess returns should wither away as competition gets attracted in lured by those returns. In practice, companies that have built up a franchise have a higher operating margin and high ROEs for a long period, *Coca Cola* being a classic example. A company building up its business might also have a lower ROE than what it might be able to achieve in a few years as its franchise becomes more secure. That is, for good companies, ROE might well trend up in the foreseeable future before coming down way in the future.

In general we use two years forward average ROE as a proxy for LT ROE

Against the potential decline in ROE in the long-term is the likely improvement for many successful companies in the short- to medium-term (ie five to 10 years). Rather than subjective estimates of long-term sustainable ROE, we thus use our current FY05-06 ROE as a proxy. However, for companies where the current ROE are clearly not sustainable – eg where we are presently at a cyclical peak for certain sectors eg shipping, petrochemicals etc – we seek a cross-cycle ROE instead.

Long-term growth rates of 3% to 5% used for most of the companies

Long-term growth rates, another key input in this valuation methodology, are based on estimates of research heads and the analysts. In general we use rates between 3-5%, and up to 6% in some countries such as India where inflation is higher (the growth rates are in nominal terms). For some industries growth is set as low as zero (eg steel companies).

Cost of equity derived from CAPM

Cost of equity is derived through the capital asset pricing model (CAPM). We use 4.3% as the risk-free rate (close to the current US 10-year Treasury yield). On this we apply a base equity risk premium of 4% (approximation for the average excess returns of equities over bonds in the US); over and above this we add country risk-premia ranging from zero (Singapore) to 7% (Indonesia, Philippines). This gives a market cost of equity ranging from just over 8-15% for the markets surveyed as indicated in Figure 4.

Cost of equity of markets ranging from 8-15%

Figure 4

Cost of equity used for markets under coverage

(%)	US 10-yr	ERP	Country risk	MRP	Local currency cost of equity
Singapore	4.3	4.0	0.0	4.0	8.3
Hong Kong	4.3	4.0	1.0	5.0	9.3
Taiwan	4.3	4.0	2.0	6.0	10.3
Malaysia	4.3	4.0	3.0	7.0	11.3
China	4.3	4.0	4.0	8.0	12.3
Thailand	4.3	4.0	4.0	8.0	12.3
Korea	4.3	4.0	4.0	8.0	12.3
India	4.3	4.0	4.5	8.5	12.8
Philippines	4.3	4.0	7.0	11.0	15.3
Indonesia	4.3	4.0	7.0	11.0	15.3

Source: CLSA Asia-Pacific Markets

QARP trumps plain CG for performance

QARP basket of stocks tend to outperform strongly

Applying the QARP methodology to Asia's large caps, we find strong outperformance that substantially beats picking just stocks that have high CG. The result we found for 2004 was repeated going back to each of the last three years. A similar result was also found that QARP stocks generally vastly outperformed in each of the respective markets, not just against the index but also against the higher CG stocks in most of these markets.

In 2004 no clear outperformance in large cap stocks sorted for CG

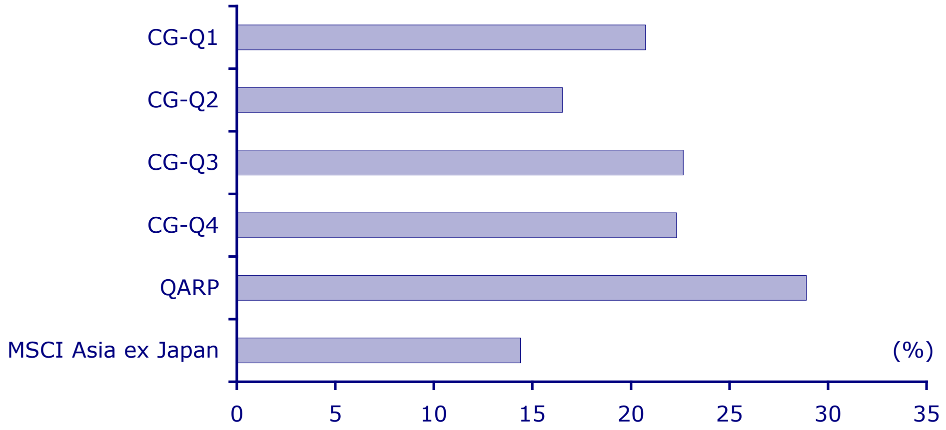
The largest 100 stocks in our Asia ex-Japan universe as ranked in our CG report of last year gave an average return of 20.6% in 2004 (higher than the 14.4% MSCI Asia ex-Japan performance largely because the regional index is market cap weighted and some of the larger caps underperformed). The top quartile CG stocks among these largest 100 performed almost exactly in line with the average (+20.7% versus +20.6%) while the upper-half CG stocks underperformed slightly, by 1.9-ppts, because the second quartile CG stocks of this group turned out to be the worst performing.

However, these levels of out- and under-performance are quite small in context of the overall average returns. Basically for 2004, there was no clear pattern of relative performance for stocks sorted by CG among the large caps in Asia ex-Japan.

QARP basket of 100 largest market caps stocks in Asia ex-Japan in 2004 of 28.9% was double the return on MSCI Asia ex-Japan and higher than any of the CG quartiles

Figure 5

2004 performance of CG quartiles, QARP of large caps & MSCI Asia ex-Japan



Source: CLSA Asia-Pacific Markets

Substantial outperformance for the QARP stocks among the large caps

There appears, however, to be quite clear outperformance for the QARP stocks of this list. The 20 stocks that met the QARP criteria, among the 100 largest by market cap last year, came in with an average return of 28.9%, double the return of MSCI Asia ex-Japan, and substantially above the returns of each CG quartile: the top two CG quartiles of this large-cap group were up 20.7% and 16.5% respectively.

Similar result for large cap QARP picks going back to 2002

Taking this analysis back for the last three years, ie extending it to 2002 and 2003 as well, we find a similar result. (Note that the QARP portfolio is rebalanced for PB valuations at the start of each year and upside to theoretical value based on ROE for the following two years; the stocks in each CG quartile are kept unchanged based on our 2004 rankings of these 100 largest stocks.)

In 2002, the top CG quartile outperformed strongly, up 60% against MSCI Asia ex-Japan, which was down 10% (see Figure 6). However the top QARP stocks that year gave a return of 131%, which is double that of the highest CG quartile.

In 2003, the top CG quartile actually underperformed the lower CG quartiles. The QARP stocks for that year, however, gave a return of 90% that was double that for MSCI Asia ex-Japan. This performance was close to that of the lower CG quartiles that last year happened to have the top performing stocks of the large caps.

In 2004, while the top performing stocks of the large caps happened to be in the bottom two CG quartiles, yet the QARP stocks - upper half CG companies that also met the QARP criteria - were still clear outperformers.

Top QARP basket outperformed MSCI Asia – ex-Japan and also the top CG quartile in each of the past three years

Figure 6

Asia large-cap perf. by CG quartiles, QARP portfolio & MSCI Asia ex-Japan 2002-04

(%)	2002	2003	2004
QARP	131.0	90.3	28.9
CG-Q1	60.3	33.8	20.7
CG-Q2	(0.2)	105.2	16.5
CG-Q3	(3.9)	55.3	22.6
CG-Q4	17.9	95.4	22.3
MSCI Asia ex Japan	(10.2)	42.8	14.4

Source: CLSA Asia-Pacific Markets

When markets are down, top CG stocks tend to outperform among the large caps; but not when markets are rising

The conclusion is that there is no consistent correlation between CG and relative stock performance for the largest caps in Asia. We note however that when markets are down, eg 2002, the top CG stocks tend to outperform. However when markets are up as was the case in 2003 and 2004, the better performing stocks tend not to be in the top CG quartile (found in the second quartile in 2003 and the third quartile in 2004).

But in each year, QARP selected outperformed among the large caps

However in each of the last three years, the QARP portfolio beat MSCI Asia ex-Japan, beat the top CG quartile, and beat the average performance of the large cap stocks. On average, the QARP stocks, rebalanced at the start of each year, beat the performance of these large-cap stocks by 46-ppts each year, giving a cumulative return of 467% between the end of 2001 to 2004, versus MSCI Asia ex-Japan which had a cumulative return of 47%, and the simple average of the 100 stocks, (not market cap weighted) which returned 146%.

Mixed performance of top CG stocks in respective markets

On average slight outperformance for top CG stocks in respective markets in 2004 . . .

Within the ten markets we survey, last year the top CG stocks gave on average slight outperformance. But the level of outperformance was small and in six of the ten markets, the bottom CG quartiles actually had better average stock performance than the top quartiles. Statistically, 2004 was not a great year for performance of high CG stocks within markets.

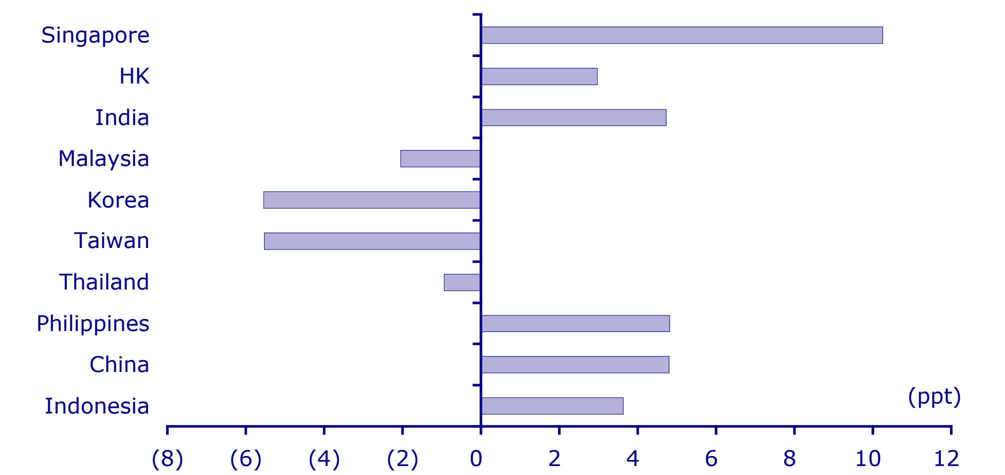
. . . but in half the markets the top CG stocks underperformed

On average the top CG quartile in the respective markets gave a return of 19.6% last year. While this is 3.8-ppts higher than the gain in the MSCI country index for the respective markets, this is partly owing to a size effect pulling down the market cap weighted index. On a simple average of stocks under CLSA coverage, the top CG quartile average return in the markets was just 1.7-ppts higher than the respective country stock samples. With the country samples of stocks under CLSA coverage on average up 17.9%, this is not a huge added return. Indeed, in six of the ten markets surveyed – India, Indonesia, Korea, Malaysia, Taiwan and Thailand – the bottom quartile CG stocks outperformed the top quartile (see Figure 8).

In seven of the ten markets surveyed, top CG stocks outperformed in 2004 – seen in the top and lowest markets ranked for CG

Figure 7

Quartile 1 CG stocks performance in 2004 against country samples

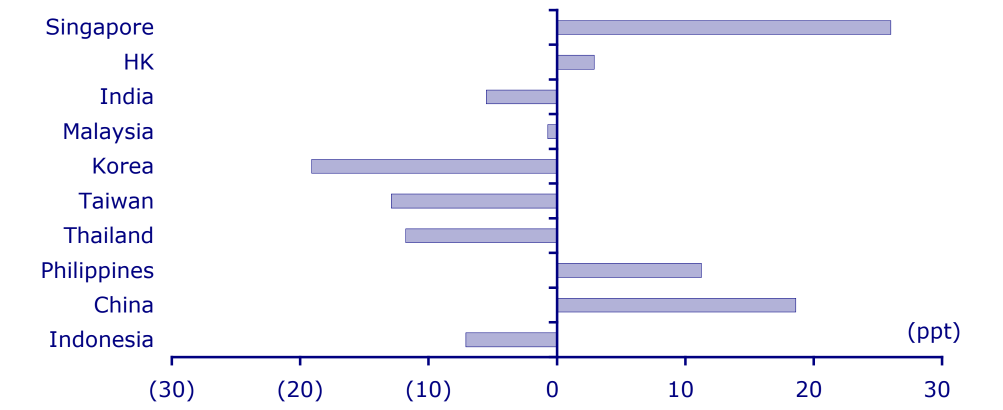


Source: CLSA Asia-Pacific Markets

However, top quartile CG stocks underperformed the bottom quartile in half the markets

Figure 8

Quartile 1 CG stocks performance in 2004 against Quartile 4



Source: CLSA Asia-Pacific Markets

Top performing CG stocks were strongest outperformers in Singapore; underperformed in Korea, Malaysia and Thailand

The strong performance of top quartile CG stocks was mainly in Singapore: 38% average return for the top quartile CG stocks, 10.3-ppts above the sample of stocks for the market. In the other markets, the top CG quartile gave less impressive average returns: up slightly less than 5-ppts in the Philippines, China and India against the country samples, and less in other countries. The top CG quartile underperformed the market samples in Korea, Taiwan, Malaysia and Thailand.

QARP significant outperformance within markets

QARP basket beat the MSCI for the respective countries in eight of 10 markets; slightly underperformed in two

Within the markets, the QARP basket however last year provided much stronger returns. In nine of the ten markets, the QARP basket in 2004 outperformed the top CG stocks and beat the country MSCI index. Where the basket underperformed it was only to a minor degree.

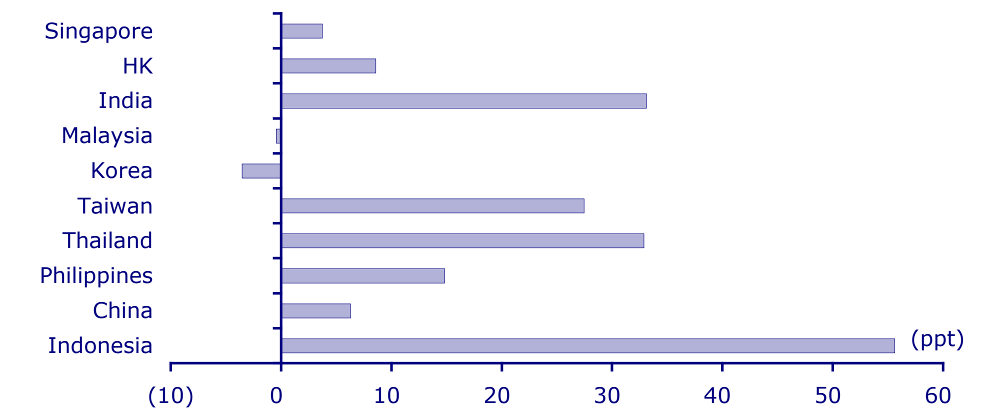
Outperformance in the eight markets was over 10-ppts

The QARP basket gave an average return in the markets of +35.8% in 2004, ranging from +11% in Malaysia and China to 108% in Indonesia. (See Appendix 3 for details on the performance within the markets.) In the eight markets where the QARP stocks outperformed the country index, the outperformance was at least 10-ppts and as high as 34.5-ppts for India and 63.5-ppts in Indonesia. In the two markets where the QARP stocks underperformed, the underperformance was relatively minor, just 1-ppt in Malaysia and minus 4.3-ppts in Korea.

Clear outperformance of QARP stocks in all markets other than Malaysia and Korea in 2004

Figure 9

QARP stocks performance against overall samples in each country (2004)

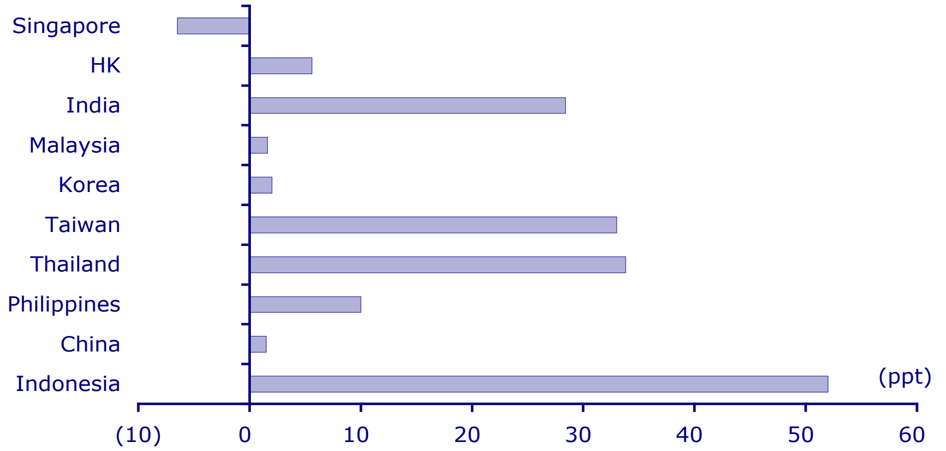


Source: CLSA Asia-Pacific Markets

QARP stocks beat the top quartile CG stocks performance in all markets other than Singapore

Figure 10

QARP stocks performance against top CG quartile (2004)



Source: CLSA Asia-Pacific Markets

In 9 of 10 markets, QARP basket beat the top CG quartile

In all the markets other than Singapore, the QARP stocks did better than the top CG stocks. On average the top CG quartile stocks gave an average return of 19.6% (just 1.7 ppts higher than the average return of the sample of stocks in each market), while the QARP stocks gave a return of 35.8%, a significant 17.9-ppt added return over the average for the sample of stocks in each country.

Country findings similar to that for large caps on QARP outperformance

The result supports the findings above on the large caps. The performance of top CG quartile stocks is not significantly above average within the markets. However, in most of the markets, the QARP basket outperformed by a wide margin, and in only two of the ten markets did the basket underperform but in each case by a fairly small margin. Tying CG to VCARP to get a QARP portfolio thus seems a promising way of providing strong added returns within the Asia ex-Japan markets we cover.

2005 QARP list

Companies with high ROE more likely to surprise on the upside

The logic behind the strong performance of the QARP basket is not difficult to grasp. Companies generate a high ROE when they have a strong industry position and/or have capable management. These are companies more likely to surprise on the upside. Unless their business model is not country specific, then they are more likely to succeed in international expansion. And unless their business model is tied to specific niches, these companies are also more likely to succeed through acquisition and expansion.

CG is an alternative management screen; but also filters out value-traps

Adding a CG screen is an alternative management screen. Companies with good management would tend also to have good corporate governance – particularly as management respond to this being a higher priority for their shareholders/investors. Also, filtering out companies with strong financials but low CG helps to eliminate the potential value traps. Companies with good financials but where the value-created is, or at risk of, being siphoned by the controlling shareholders or other parts of the group, often stay cheap.

Taking out low CG stocks also reduces risk

Taking out low CG stocks also reduces the risk in a portfolio. In market downturns, it is the higher risk, low CG stocks that are likely to be thrown out of the portfolio by investors. Hence, with the QARP basket restricted to companies with above average CG, there should be less downside pressure on this basket when markets turn down.

At the start of 2004, 20 of the large caps were included in the QARP list

Using end June 2005 valuations, the QARP stocks among the large caps in Asia has reduced substantially. For our 2004 list of the large caps, 20 names of the largest 100 in Asia ex-Japan qualified. Note that the criteria on QARP include a cut-off of at least 10% upside to theoretical PB value: we seek to have stocks with theoretical upside allowing for some margin of error. Of last year's list of QARP stocks among the large caps, 18 of the 20 had more than 20% upside to theoretical value.

Last year's QARP list among large caps in Asia included star performers eg Esprit, KT&G, Keppel Corp, Shinhan Financial

Figure 11

2004 QARP for Asia ex-Japan large caps

Company name	04/05 avg ROE (%)	CG Quartile	04 mkt PB(x)	Upside (%)	04 perf (%)
POSCO	26.0	1	0.8	193	32.1
Hana Bank	22.5	1	0.8	191	35.1
SingTel	23.0	2	1.9	95	26.9
Shinhan Financial Group	20.7	2	1.1	92	41.5
Keppel Corporation	16.5	2	1.5	72	50.7
Esprit Holdings	46.0	1	5.8	63	81.8
PTT	43.7	2	3.1	52	(4.8)
Samsung Electronics	30.1	2	2.3	50	15.0
PetroChina	30.0	2	1.8	48	(6.7)
PLDT	69.3	2	3.8	41	38.5
CLP Holdings	20.9	1	2.1	34	20.8
OCBC	11.6	1	1.3	31	16.2
HK Electric	16.9	1	1.7	27	15.6
DBS Group Holdings	11.8	2	1.4	24	14.1
Chinatrust FHC	18.7	2	1.9	23	26.0
StandChart	18.6	1	2.3	22	14.3
Singapore Press	31.0	2	4.4	21	26.7
KT&G	15.9	1	1.1	21	72.2
Swire	9.8	2	0.9	19	35.7
Great Eastern Hdg.	16.0	2	2.2	12	26.5

Source: CLSA Asia-Pacific Markets

Of these, 16 outperformed MSCI Asia ex-Japan

In the event, of the 20 stocks that were selected in 2004, 16 outperformed MSCI Asia ex-Japan. The strongest performers were Esprit, KT&G, Keppel Corp, Shinhan and PLDT.

Current list of large cap QARP stocks is reduced to just 10 names of the 100 largest caps

The list for 2005, with MSCI Asia ex-Japan up 19% in 18 months since the start of 2004 is now a much shorter one bearing in mind the valuation criterion of having at least 10% upside to theoretical value. We have used valuations at mid-2005 for the QARP selection, and use our current CG rankings of these largest 100 companies by market cap in Asia ex-Japan. The current list of QARP stocks among the large caps comes down to just ten names of which only four have 20% or more upside to theoretical value.

Only four have upside of 20% or higher to theoretical value in the current QARP list: Formosa Chemicals, Hynix Semiconductor, Posco and StanChart

Figure 12

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

Source: CLSA Asia-Pacific Markets

Four from Korea, three from Taiwan, two from HK and one from Singapore

Of the ten on the current QARP list for the large caps, four are from Korea (Hynix Semiconductor, Posco, Shinhan Financial and Hana Bank), three from Taiwan (Formosa Chemicals, Chinatrust and Nan Ya Plastics), two from Hong Kong (the international banks listed in the market, HSBC and Standard Chartered) and one from Singapore (Singtel).

For some, adjustments made in ROE used

All ten are in the top CG quartile of the large caps, other than Chinatrust, which is in the second quartile. For Formosa Chemicals and Nan Ya Plastics, there are one-offs to earnings from conversion of ECBs which are stripped out of the ROE. For Posco, the current year ROE of 26% falls to 15% in our projection for FY06 onward: we have used the last ten year average of 13% instead. For the other companies, the FY05-06 ROE are being used as a proxy for long-term ROE.

Attractive yields and low PE valuations on a number of the current QARP stocks

Figure 13

Valuations on 2005 large-cap QARP portfolio

	05 PB (x)	05 yield (%)	06 PE (x)
Formosa Chem	1.9	8.9	6.0
Hynix Semiconductor	1.3	-	6.5
Posco	0.8	4.0	5.8
Standard Chartered	2.1	2.8	14.0
Chinatrust	2.0	3.9	8.0
Nan Ya Plastics	2.1	7.1	7.6
SingTel	2.4	4.2	11.5
Hana Bank	0.9	2.7	10.7
HSBC	2.0	4.3	13.0
Shinhan Financial	1.3	2.7	9.4

Source: CLSA Asia-Pacific Markets

Attractive valuations on some are fairly obvious

The attractive valuation of these high CG companies is fairly obvious in most cases. Formosa Chemical with a 26% ROE and 1.9x PB, translates to a forward PE of 6x and a dividend yield of 9%. Similarly Nan Ya Plastics is at under 8x forward earnings and provides a yield of 7%. Hynix with an ROE of

24% and PB of 1.3x, is at 6.5x PE. Posco, generating an ROE across the cycle that is above cost of equity, valued at 0.8x PB and 6x PE is attractive. Chinatrust is at an undemanding multiple of 8x. Shinhan Financial is at just over 9x FY06 earnings.

Some already at high PB multiples – this is not a list of value stocks per se

Within this basket, the three presently at the highest PB multiples are Singtel, StanChart and HSBC. However, SingTel's high ROE of close to 18% means that its PE multiple is an undemanding 11.5x; the QARP model would suggest near 20% upside on the stock from mid-2005 valuations. HSBC and StanChart are at a 2x PB multiple but generating ROEs of 16-17% would still have upside if they can generate long-term growth of 4% which is the input used. The inclusion of some of these higher PB stocks is a reminder that the QARP criteria does not pick out value stocks per se, but stocks at reasonable PB valuations against the ROE they generate.

Valuations based at mid-2005 prices for 2H05 onwards

The valuations here are based on mid-2005 and some of these stocks have already had a reasonable run-up in 3Q05. The QARP list can be updated based on valuations at any given time, but we believe that the time-line of mid-05 would be a fair starting point to review the performance of these stocks in a year's time. That a number of the previous high flying stocks have now fallen off the list, would suggest bottom-up at the current point, either the markets need some correction or further upside will be fuelled by liquidity rather than upside on fundamental valuations.

In the latter scenario, ie liquidity pushes markets higher, it is possible that higher quality names might not lead. But eventually a correction seems due with MSCI Asia ex-Japan having doubled from its low in 2003. A portfolio biased towards these quality names (high CG, high ROE, reasonable PB) will quite likely give protection and relative performance over the coming year or so.

Country sections provide QARP list of medium-cap stocks as well

While the list among the large caps is a relatively small one at this stage, note that in each of the country sections, we highlight some of the medium and smaller caps that also fit the QARP bill. That is, within markets, there is a much larger list of stocks that satisfy the QARP criteria, compared to the list above that covers the large caps in the region.

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Country scores - Lowered

Country scores and rankings jointly by ACGA and CLSA

A clearer pattern is emerging about the objective status of corporate governance standards and practices in Asia. Whereas a few years ago financial regulators were being quickly praised for introducing new rules and regulations on corporate governance, today it is apparent that many of these rules and best practices have only a limited effect on corporate behaviour. Some of the more important "mandatory" rules are not being implemented by listed companies or, if implemented, not carried out effectively. Conversely, in the area of enforcement, traditionally seen as *the* weak spot in Asian regulatory regimes, it is possible to discern a steady improvement, albeit from a low base. The wide gap between the scores for rules and enforcement is therefore narrowing.

Rankings largely unchanged but scores for most countries have trended down . . .

Overall, there are two main results from our country scores this year. The ranking of countries has largely stayed the same as last year, with the exception that Korea has fallen one notch - it is now below Taiwan. And the weighted scores for most countries have trended downwards (see figure 14 below).

. . . because of more rigorous survey methodology

Lower scores this year do not equate to a decline in objective corporate governance standards. On the contrary, we believe that most countries have continued to improve. What they largely reflect is an even more rigorous survey methodology being used this year compared to last. In effect, we are saying that scores in previous years were on the generous side and the actual quality of corporate governance in most Asian markets is somewhat lower than previously assessed.

Singapore, HK and India remain at the top

Figure 14

Markets ranked by CG macro-determinants (%)

Rank	Countries	Rules (15%)	Enforce (25%)	Pol/reg (20%)	IGAAP (20%)	CG cult (20%)	Weighted score	2004 score
1	Singapore	74	56	73	95	57	70	75
2	Hong Kong	64	58	78	91	54	69	67
3	India	66	56	65	75	43	61	62
4	Malaysia	59	49	60	75	38	56	60
5	Taiwan	53	49	65	59	33	52	55
=6	Korea	51	40	43	82	39	50	58
=6	Thailand	58	40	50	73	35	50	53
8	Philippines	53	22	50	82	31	46	50
9	China	43	40	50	68	22	44	48
10	Indonesia	33	29	30	68	28	37	40

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

Shades of grey

Markets assessed on five main categories

The country ranking methodology used in "CG Watch" has improved markedly over the past two years. Last year for the first time we introduced a detailed survey of around 60 questions that assessed the extent to which markets were meeting international standards of corporate governance in five macro categories: 1) rules and regulations; 2) enforcement (by the regulator and "private enforcement" by the market); 3) political and regulatory environment; 4) international accounting and auditing standards; and 5) corporate governance culture. Each question was given a "Yes", "No" or "Somewhat" answer, with one point, zero, or half a point given, respectively, for each.

Survey refined this year

This year the survey has been refined further:

- 18 new questions have been added, including fundamental issues such as the operation of audit committees, pre-emption rights of minority shareholders, and management of shareholder meetings (see Figure 15 for the complete list);
- The wording of many questions has been made more precise;
- In each macro category—in particular the first on rules and regulations—we are examining not simply rules on paper, but their implementation by companies. The existence of a rule no longer ensures that the market will receive a full point for that question—the rule also has to be widely followed. Where it is not, the country is marked down. Conversely, if market practice is ahead of the regulatory curve (ie, companies are doing things they are not required to), then we would mark those countries up;
- A fourth level has been added to the scoring system. In addition to answering "Yes", "No" or "Somewhat" to each question, we have included a category called "Marginally" (which receives a quarter of a point). This is because many aspects of corporate governance are neither black or white - countries typically comply with international standards to a degree, rather than fully or not at all. But in several cases marginal compliance is a more accurate reflection of reality than moderate compliance.

Figure 15

New questions in 2005 country scoring
A14. Are audit committees mandatory and implemented?
A15. 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?
A18. Are pre-emption rights for minority shareholders firmly protected? (ie, enshrined in the company law and requiring a super majority—75%--to disapply them)
A19. Do companies release their AGM notices (with detailed agendas and explanatory circulars) at least 28 days before the date of the meeting?
B2 Have financial regulators' efforts improved tangibly in recent years?
B7 Has the regulator had a successful track record prosecuting cases of insider trading and other market manipulation in recent years?
B10 Do the regulators (ie, the securities commission and the stock exchange) disclose detailed and credible data on their enforcement track records?
B12 Are institutional investors actively voting against resolutions with which they disagree?
B15 Do retail shareholders see the annual general meeting as an opportunity to engage with companies and ask substantive questions?
C6 Do the regulators (ie, securities commission and stock exchange) have informative websites, with English translations of all key laws, rules and regulations easily accessible?
C7 Does the stock exchange provide an efficient and extensive online database of issuer announcements, notices, circulars and reports?
D11 Must the CEO, CFO or directors sign and certify a company's annual accounts?
E1 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)
E3 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'?
E5 Are most other listed companies also actively seeking to improve their communication with shareholders?
E6 Do company boards generally have separate chairmen and CEOs, with the Chairman being independent of the CEO?
E9 Is there a trend towards large-cap stocks voluntary voting by poll at their AGMs and making the results public afterwards?
E16 Is there an institute of directors that is actively engaged in director training?

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

Singapore and Hong Kong - Still on top

Singapore and HK still rank at the top – gap between the two has narrowed

Not surprisingly, there is no change in our top two countries this year—Singapore remains in first place, followed by Hong Kong. Of more significance is the fact that the score for Singapore has fallen further this year - from 75% in 2004 to 70% this year, while that for Hong Kong has risen incrementally from 67% to 69%. The gap between the two has narrowed considerably.

Singapore score lowered on enforcement category

Singapore's score is lower principally because of a fall in its enforcement score - from 65% in 2004 to 56% this year - and a slightly reduced score for its political and regulatory environment. (See Appendix 1 for questionnaire and detailed scoring of the countries.) While Singapore has achieved some important enforcement successes in recent months, most notably the criminal prosecutions of five directors of China Aviation Oil, doubts are being expressed as to whether the regulatory authorities are treating all companies and individuals fairly, disclosure of regulatory action is quite limited, and fund managers face significant procedural difficulties in attending shareholder meetings.

HK score stable after a drop last year

Hong Kong, which suffered a large drop in its overall score last year, basically had no further to fall. Most of its macro-category scores were similar to last year, even with the more rigorous methodology being used this year. The one area that did change was "CG culture", which improved from 46% to 54%. This was mainly a result of positive developments such as the emergence of well-governed mid-cap companies, higher pay for independent directors, and voluntary voting by poll among large-cap companies.

Muddle in the middle

India score similar to last year; Malaysia, Taiwan and Korea scores lowered

After India, which also receives a similar score as last year, come Malaysia, Taiwan, Korea and Thailand. The overall score for all three markets fell this year, with Korea falling further than Taiwan (and thereby dropping one place in ranking).

Less generous score on rules and regulations for Malaysia owing to implementation

A major area of weakness in Malaysia is rules and regulations - this category fell from 71% in 2004 to only 59% this year. Significantly, this is an area where Malaysia normally ranks well, but examining the implementation of rules, not just what is on paper, brings the score down. The country's rating for corporate governance culture also fell some way - from 46% to 38% over the past two years. However, its assessment for political and regulatory environment rose - from 50% to 60%.

Taiwan and Korea neck-and-neck, but on our stricter scoring, Korea slightly below and slips one notch from last year's ranking

Taiwan and Korea, two countries racing neck and neck in the corporate governance stakes, both saw a 10 percentage-point slippage in their score this year for rules and regulations over last year (for similar reasons as Malaysia). On enforcement, they start to diverge - Taiwan rose from 46% in 2004 to 49% in 2005; while Korea slipped from 50% to 40% over the same time frame. On political and regulatory environment, they separate even further - Taiwan basically staying steady with last year, while Korea slipping quite badly from 50% to 43%. Korea comes out considerably better than Taiwan in accounting and auditing standards. And Korea is slightly stronger in terms of its corporate governance culture - mainly because it has had a vibrant minority shareholder activist movement, extensive engagement of academics and professionals in the reform process, and more interesting developments at the corporate level.

Thailand now ranks equal sixth with Korea

In this year's rankings, Thailand ranks equal sixth with Korea. Thailand's country CG score is down slightly from 53% to 50%, mainly owing to a markdown in its score for accounting and auditing standards by our stricter criteria. However, this is a smaller weighted decline than the eight-point drop for Korea. While the weighted score for Korea and Thailand are now equal, Korea has a higher score for accounting and auditing standards as well as overall CG culture; while Thailand is ahead on rules and regulations as well as the political and regulatory environment.

The bottom three

No change in ranking for the bottom three

There is no change this year in the ranking of the bottom three countries –the Philippines, China and Indonesia (in descending order) - and overall scores for each fell a few percentage points under our tougher scoring system.

The biggest area of reduction for most of them was, as with other markets, in rules and regulations. Enforcement scores also came down several percentage points in the Philippines and China, while staying largely steady in Indonesia (being on a very low base already). The political and regulatory rating for most stayed level, but dropped in Indonesia. Scores for accounting and auditing standards remained similar in the Philippines, while dropping in China and rising in Indonesia. And there was little change across the board in corporate governance culture.

Philippines ahead of China on rules and regulations and accounting standards

One contentious issue is whether China should rank higher than the Philippines. Intuitively, this may seem reasonable - China is a major economy, its economic and regulatory regime is improving by leaps and bounds, government administration is becoming more effective, and its leading companies are raising huge amounts of capital on overseas markets. But there are two areas where the Philippines still outruns China. One is in rules and regulations - not necessarily the implementation of, but in their design and wording. Rules in the Philippines are generally clearer than in China, where vague language creeps into many regulations, and are sometimes stricter. The second area is accounting and auditing standards, where the Philippines has done far more work than China to bring its standards into line with international norms.

But we expect China to catch up

Looking forward, however, there are good reasons for believing that China will soon catch up and overtake the Philippines. China continues to improve its rulebook - major amendments are being considered for its company and securities laws. It scores much higher on enforcement than the Philippines - and is making clear efforts to get better. Both countries rate roughly the same in terms of their political and regulatory environment, but China undoubtedly has more upside potential as a result of its need for a vastly improved regulatory and legal regime to manage its increasingly complex economy, the competitive pressures that its companies face at home and abroad, and the further opening of its economy under WTO rules. All of these factors will drive gradual improvements in corporate governance.

Devilish detail

Looking more deeply into the specific questions in our country survey reveals some common areas of weakness across the region. For example:

Quality of quarterly reporting often poor; audit committees often not functioning independently

- **Rules and regulations: "The more you look, the less you find".** Quarterly reporting may be mandatory in most markets, but its quality is less than sufficient in many of them. Audit committees are also mandatory in most places, but they not always implemented by all listed companies - or, if they are, not functioning independently and effectively. Securities laws are generally not deterring insider trading and market manipulation. And the pre-emption rights of minority investors are not firmly protected.

Partial treatment by regulators

- **Enforcement: Tough going.** There is an ongoing perception in many markets - and evidence - that regulators do not treat companies and individuals equally. Regulators have not been particularly successful in stopping insider trading and other forms of market manipulation. Most regulators provide only limited information on their enforcement activities. And voting by institutional investors remains a minority sport.

Regulatory action might be influenced by political considerations; limited legal remedies

- **Political and regulatory environment: Swings and roundabouts.** Securities regulators are not sufficiently autonomous from governments in much of the region, leading to concerns that regulatory action is sometimes influenced by political considerations. There are lingering questions over regulatory structures, especially with regard to the role of listed stock exchanges as "frontline" regulators. Some markets provide very limited information in English on their corporate governance regulations, guidelines and codes - a serious omission if they are trying to attract foreign portfolio investment (not all such investors have local-language capability ready to hand) and win international recognition for their corporate governance regime. And an intractable problem in almost all markets, with the possible exception of Korea, is the lack of adequate access that investors have to courts and the limited legal remedies available.

The average company does not seem to believe that CG brings tangible benefits

- **CG culture: Minimalism.** There is little evidence that the average listed company in Asia genuinely believes that corporate governance will bring tangible benefits to its business. There continues to be a split among large-cap stocks as to their commitment to transparency and accountability. Very few companies have independent chairmen. And substantive disclosure of critical checks and balances, such as internal controls, is lacking in probably the majority of listed firms.

Higher notes

Improvement in financial reporting standards, rules on disclosure, voting by poll

Other evidence, however, points to areas of definite improvement in corporate governance in Asia. There has been considerable improvement in financial reporting standards and practices in most markets. Rules on disclosure of "material transactions" and other price-sensitive information have become stricter. Voting by poll is moving onto the agenda of leading companies in some markets, notably Hong Kong, and is likely to become more of an issue in future. And the best companies are responding to market demands for quicker release of annual and interim results.

Regulators are investing more resources for enforcement

In enforcement, it is only fair to recognise that regulators across the region are investing more resources in this task - and they certainly feel under pressure to produce results. While successes against criminal activity are slim, there has been increased supervision of intermediaries (eg, brokers, advisors) and greater examination of the quality of disclosure of IPO prospectuses.

Figure 16

Key regulatory/ macro-CG issues across markets (i)

	China	HK	India	Indo	Korea	Malaysia	Pines	Sing	Taiwan	Thai
CG RULES & REGULATIONS - and their implementation										
Do companies report their annual results within two months or 60 days?	M	M	Y	S	M	S	N	Y	M	Y
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	S	Y	S	Y	S	Y
Do securities laws require disclosure of ownership stakes above 5%?	Y	Y	Y	S	Y	Y	Y	Y	S	Y
Do securities laws require disclosure of share transactions by directors, controlling shareholders and substantial shareholders within two working days?	S	Y	Y	M	N	Y	Y	Y	N	S
Are class-action lawsuits permitted?	S	N	N	M	S	N	S	N	S	N
Is voting by poll mandatory for resolutions at AGMs?	S	S	N	N	S	N	N	N	S	N
Do the national CG code and/or local listing rules contain a clear and robust definition of "independent director"?	S	S	S	M	S	S	Y	S	Y	S
ENFORCEMENT										
Do the regulatory authorities have effective powers of investigation and sanction?	S	Y	Y	M	Y	Y	S	Y	Y	S
Has the securities commission been investing significantly more financial and human resources in investigation and enforcement in recent years?	S	Y	Y	S	S	Y	M	S	Y	Y
Does the stock exchange have effective powers to sanction breaches of its listing rules?	S	S	S	M	S	Y	S	Y	S	S
Has it been investing significantly more financial and human resources in investigation and enforcement in recent years?	S	S	S	S	N	N	M	S	S	S
Do the regulators (ie, the securities commission and the stock exchange) disclose detailed and credible data on their enforcement track records?	S	Y	Y	N	M	Y	S	M	M	S
Are institutional investors actively voting against resolutions with which they disagree?	S	Y	M	M	M	M	N	S	M	M
Is there an independent commission against corruption (or its equivalent) that is seen to be effective in tackling public- and private-sector corruption?	N	Y	S	N	S	M	N	Y	S	N
POLITICAL & REGULATORY ENVIRONMENT										
Is the statutory regulator (ie, the securities commission) formally and practically autonomous of government ?	M	S	S	N	N	S	S	S	N	M
Has the government and/or the statutory regulator been actively reviewing and modernising company and securities laws in recent years?	Y	Y	Y	M	S	S	S	S	Y	S
Has the stock exchange been actively reviewing and modernising its listing rules in recent years ?	Y	Y	S	S	S	Y	M	Y	Y	Y
Is the judiciary independent and sufficiently skilled in handling securities cases?	N	Y	S	N	M	M	M	Y	N	M
Is the media free to report on and investigate corporate governance abuses among listed companies?	M	Y	Y	Y	S	S	Y	Y	Y	S

Note: Y = Yes, S = Somewhat, M = Marginally, N = No. Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Figure 17

Key regulatory/ macro-CG issues across markets (ii)

	China	HK	India	Indo	Korea	Malaysia	Pines	Sing	Taiwan	Thai
IGAAP (or "ACCOUNTING & AUDITING")										
This section addresses the nature of accounting and auditing rules and practices, as well as the regulation of the accounting profession.										
Are local accounting rules and practices largely in line with international standards and practices?	S	Y	S	S	Y	Y	S	Y	S	S
Do the rules require segment reporting?	Y	Y	Y	S	S	Y	Y	Y	S	Y
Is disclosure of audit and non-audit fees paid to the external auditor required?	Y	Y	Y	N	Y	Y	S	Y	Y	Y
Are local auditing rules and practices in line with international standards and practices?	S	Y	S	S	S	S	S	Y	S	S
Must the CEO, CFO or directors sign and certify a company's annual accounts?	Y	S	Y	Y	Y	M	Y	S	S	Y
Is the government strengthening the regulation of the accounting profession? (eg, by setting up an independent oversight board) ?	S	S	M	S	S	S	S	Y	S	S
Is the expensing of share-based payments mandatory?	N	Y	S	Y	Y	S	Y	Y	N	N
CG CULTURE										
Does the average listed company believe that corporate governance will provide tangible benefits?	N	M	M	M	M	M	N	S	M	M
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'?	M	Y	Y	Y	M	M	M	Y	N	N
Are large-cap stocks actively seeking to improve their communication with shareholders and providing more substantive disclosure?	S	Y	Y	S	Y	Y	Y	Y	Y	Y
Do company boards generally have separate chairmen and CEOs, with the Chairman being independent of the CEO and controlling shareholder?	M	N	M	N	N	M	N	S	N	N
Is there a trend towards large-cap stocks voluntary voting by poll at their AGMs and making the results public afterwards?	M	Y	N	N	M	M	N	N	M	M
Have retail investors formed their own shareholder activist organisations?	N	N	S	S	Y	M	N	Y	S	M
Is there an institute of directors that is actively engaged in director training?	S	Y	M	S	S	Y	Y	Y	M	Y

Note: Y = Yes, N = No, S = Somewhat, M = Marginally. Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

Online databases of exchanges add to transparency

In terms of stock market transparency, one bright area is the extremely useful online databases of issue information that almost all exchanges have established. Such databases contain extensive collections of listed-company reports, announcements and notices.

Certain mid-caps working to gain a reputation for good CG

Lastly, at the corporate level, there is evidence in some markets such as Hong Kong, India and Singapore that certain mid-caps are working hard to gain a reputation for good governance. The incentives include a wider analyst following, a stronger institutional investor base and a valuation rerating - as well as better boards and more robust internal controls. Independent directors are starting to receive higher pay for their work - a positive move as long as such directors provide value. And some brave companies around the region are starting to appoint independent chairmen.

Macro to micro on CG

Improvement in scores mainly in larger caps

The cost of implementing better corporate governance standards is not negligible—additional resources are needed to produce quarterly reports and speed up the preparation of accounts, particularly in bigger groups; higher remuneration and insurance is required for independent directors; and there is a cost in management time and possibly fees in selecting good directors for a board. These factors go some way to explaining the slightly higher improvement in scores for larger cap companies in this year's report, as noted in the next section.

Management often with the view that CG of passing interest for investors

However, in rising markets, as has been the case in much of Asia over the last two years, investors are willing to take more risk and invest again in companies that a few years back had had serious governance issues. This is leading to some (if not most) management of companies seeing corporate governance as a passing interest of investors. The real commitment to better governance is questionable, more so at the corporate rather than the regulatory level. Hence, the overall scores of the CLSA sample of 496 companies across Asia ex-Japan has risen only marginally from last year.

CG rankings of the large caps

Large caps tend to have higher CG; the differential with sample average has widened compared to 2004

Larger companies tend to have higher CG scores – partly as the costs of having the best standards are easier to meet for a bigger company. In our overall sample of 496 companies, the largest 100, with market capitalisations above US$5bn, had an average CG score of 62.9 a full 5.5 points above that of the average of the sample. The difference in CG scores between the larger companies and the overall sample has widened from 4.2 points above the overall sample average last year. While the largest 100 companies this year had a 1.9-point improvement in score from 2004, the rest of the sample improvement in score averaged 0.3-point; the overall sample saw a 0.6-point improvement.

Three of the large caps with the highest CG scores are 5-pts or more above the rest

Of the large caps, three stand out right at the top with scores 5-ppts above the others and all three at close to 86 points. Two of these are no surprises: HSBC and Infosys which remain with the highest scores in our samples as in previous years.

Not surprising that HSBC and Infosys are again right at the top of the table

Figure 18

Top 25 CG companies of Asia-Pacific large caps

Company name	Country	Country CG quartile	Recommendation
HSBC	Hong Kong	1	U-PF
Infosys	India	1	BUY
Public Bank	Malaysia	1	U-PF
Kookmin Bank	Korea	1	BUY
KT	Korea	1	U-PF
SingTel	Singapore	1	BUY
LG Philips LCD	Korea	1	BUY
TSMC	Taiwan	1	O-PF
Maybank	Malaysia	1	O-PF
Esprit Holdings	Hong Kong	1	BUY
Li & Fung	Hong Kong	1	O-PF
SCC	Thailand	1	U-PF
Wipro	India	1	O-PF
StandChart	Hong Kong	1	BUY
Hynix Semiconductor	Korea	1	BUY
CLP Holdings	Hong Kong	1	SELL
Nan Ya Plastics	Taiwan	1	U-PF
Formosa Plastics	Taiwan	1	SELL
Shinhan Financial Group	Korea	1	BUY
POSCO	Korea	1	U-PF
Formosa Chem	Taiwan	1	BUY
Bharti	India	1	BUY
Maxis	Malaysia	1	O-PF
Samsung Fire & Marine	Korea	1	U-PF
PTTEP	Thailand	1	O-PF

Source: CLSA Asia-Pacific Markets

Public Bank score is also among the highest in our sample

The other with a score just fractionally below is Public Bank, which might come somewhat as a surprise. However, its score is basically unchanged from last year when it was also among the highest scoring companies. As stated in our 2004 report, the bank is run by a visionary banker, Teh Hong Piow, who has appointed a co-chairman who is seen as independent. It has increased the number of independent directors: there are now six independent non-executive directors of its board of nine. The group reports quarterly results within three weeks of period-end; each quarterly result is accompanied by a briefing to analysts and the media. Management provides clear ROE and CAR targets. Senior management are easily accessible to investors and the analyst community. The audit partner is rotated every five years. Like HSBC and Infosys, it justifies being at the very top of our rankings.

Not among the large caps, but among the top CG scores in the region are HK Ex and Tanjong

Worth noting are two companies among the top scoring in our overall sample but not in the 100 largest by market cap: HK Exchanges and Tanjong, both of which have scores above 80%. HK Exchanges, like HSBC, has no large controlling shareholder, is managed to the highest level of governance in our sample and is one of the few companies that has independent directors nominated by minority shareholders: one of the independent directors, David Webb, is a CG gadfly in Hong Kong who in 2001 had put forward his own proposal for an association of minority shareholders to pursue better governance. Meanwhile Tanjong, another high scoring company from Malaysia, is also listed in the UK thus follows the higher standards of the London exchange; but in any case it has top quality management which stick to fairly simple businesses and recognise that premium valuations are attached to good CG.

Top decile of the large caps have an average CG score exactly double that of those in the bottom decile

Other companies have high scores as well but at 80% and below there is little to distinguish the scores between one and the next – where differences of less than 1-ppt in score arguably reflects as much on the weightings of the questions and possible analyst biases as any real difference in CG commitment. However the scores and rankings do give a representation of which are the better, average and worse companies for CG in the markets covered. The range in CG among the big caps is reflected in the top decile of the large caps scoring an average of 82% while the bottom decile of this group scoring exactly half of this.

Improvements in company scores

Of the largest companies, average CG score moved up to 62.9 from 61.0 last year

At company level, for the large caps as well as in most markets, we note a slight improvement in CG scores. Last year, the 100 largest by market cap in our coverage for Asia ex-Japan had an average CG score of 61.0 and ranged between a high of 89.2 to 25.8. This year, the average for the largest 100 market cap companies has edged up to 62.9 with a range from 85.9 to 33.3. The basket of the largest 100 stocks is however slightly different from last year (based on changes in share prices over the last year): using the 2005 basket, the average score has gone up 1.1 point from 61.8 last year. (Comparisons with earlier years are not quite valid as in 2004 there was a revamp in our company scores with eight new questions, and negative scoring introduced for 15 questions.)

Declines in average score in Philippines, China and Indonesia – but most markets saw some improvement in average score for their companies

Figure 19

Changes in CG scores of companies: 2004-05 (%)

	2004 avg score	2005 avg score	Highest score	Lowest score
Asia large caps	**61.0**	**62.9**	**85.9**	**33.3**
China	51.0	50.4	67.7	29.2
Hong Kong	64.2	65.6	86.5	46.2
India	54.9	56.2	85.8	28.2
Indonesia	44.3	43.3	67.2	12.1
Korea	56.8	61.4	80.5	29.8
Malaysia	62.5	62.4	85.6	36.7
Philippines	56.3	51.8	74.9	5.8
Singapore	61.1	62.8	80.2	43.0
Taiwan	54.9	56.5	80.0	17.6
Thailand	62.0	63.5	80.4	38.2
Country avg/max/min	56.8	57.4	86.5	5.8

Source: CLSA Asia-Pacific Markets

Korea and Malaysia saw a larger increase on average in their companies' CG score

Similarly at the country level, in six of the ten markets, the average CG score for companies rated by CLSA moved up compared to last year. On average, the improvement in score was 0.6 point at the country level, but as high as 4.6 for Korea. In Korea, companies continue to take steps like increasing independent directors, placing corporate governance in their mission statement and launching an English website that improves communications. These help to raise the score although questions remain on how much of this is just cosmetic.

In markets like China, increasing the sample size brings down the average score

However, the average score for the companies dropped 4.5 points in the Philippines, and was down about a point in China and Indonesia while basically unchanged for Malaysia. In the Philippines the sample is relatively small (18 companies scored) and changes in the scores of groups like Ayala where the number of independent directors has come down, had a bigger impact on the overall score. In China, a larger sample of companies surveyed (81 this year compared to 55 in 2004) led to a lower score – as the sample increases, having more mid-caps with less robust CG brings down the overall score. In these markets, the scores were also brought down to some extent by more critical scoring.

Company score methodology

Seven CG categories

CLSA's corporate governance score for companies is based, as in previous years, on seven key categories – discipline, transparency, independence accountability, responsibility, fairness and social responsibility. Under each of these categories, we assess the companies on issues that are key to 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 2.)

CLSA's CG assessment summarised

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

I. Discipline

Public commitment to CG and financial 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

II. Transparency

Ability of outsiders to assess true position of a company

- Timely release of Annual Report
- Timely release of semi-annual financial announcements

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

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

III. Independence

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

Proper accountability of management to the board

IV. Accountability

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

Record on taking measures in case of mismanagement

V. Responsibility

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

VI. 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

VII. Social responsibility

Labour and environmental issues

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

Questionnaire designed to give a numeric for ranking purpose

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

Types of companies penalised in CLSA's CG score

Tradeoff in objectifying scoring and assessing for commitment of management

No system of scoring is perfect as there is an inevitable trade-off 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) with the questions that assess the commitment to CG (track record on treatment of minorities, effective action taken in the past to correct for mismanagement etc). The former are the more objective assessment but the latter are more subjective. Trying to move beyond scoring a company on just the objective formal criteria necessarily means incorporating some questions that require an element of judgement, ie subjectivity.

X% of the score requires judgement of the analyst

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

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

For instance, most conglomerates would score negatively on the question whether a company sticks to its core business. Many of these will also have material related party transactions and get penalized on that as well. A company that is a subsidiary of a 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 drivers of the economy rather than the profits of a particular listed company that the government has privatized.

Is SRI part of CG?

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

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

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

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

Issue of scoring accuracy

There is also the issue of scoring accuracy just as there is in forecasting. Analysts are not trained to assess on CG, and hence may not always be alert to the negative actions of a company that would have counted as a transgression. Still, we believe that with 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 the company. 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.

Fifteen questions have negative scoring

Questions with negative scoring in the company CG assessment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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China - Landmark year

China's corporate governance developments over the past year was shaping up to be another typical year – some progress, many companies where the culture is as before, and a few cases once again of apparent outright fraud. A host of policy initiatives were promulgated to restructure and revitalise the domestic A share market. The key among these is the "Guideline on Shareholding Structure Reform of the Publicly Traded Companies", jointly promulgated by the CSRC, SASAC, Ministry of Finance, PBOC and the Ministry of Commerce in August.

Two other key CG reforms were announced last year

In addition, two other major CG developments over the past year came from the promulgations of the "Provisions to Protect the Interests of Public Investors" (December 2004) and the "Guidelines for Investor Relations of Listed Companies" (July 2005).

Our China universe CG scores declined slightly; our CG and QARP picks did well

Reform developments aside, our China universe coverage has seen a marginal decline in their CG scores from 51% last year to 50.4% this year, although this is probably a function of raising the number of companies we scored from 55 to 81 (diminishing returns). Both our quartile 1&2 CG stocks and our QARP picks outperformed the benchmark index MSCI China, on a relative basis by an average of ~10ppt. This is in an environment where the market remained in a trading range for most of the year (and ended the period down ~1%), ie a market for bottom-up stock-picking. Our QARP picks for 2H05 are PetroChina, CNOOC, China Netcom, China Vanke, Zhenhua Port Machinery and Hopson Development.

Country CG score

Scores decline this year on amended and 'tougher' questionnaire

Our market score for CG has declined from 48% in 2004 to 44% this year. This is owing to more stringent scoring in the slightly amended country CG questionnaire which has reduced the score for rules & regulations, enforcement and adoption of international accounting/auditing standards, particularly due to the introduction of a new "*marginally*" answer choice with a lower score than "*somewhat*". In reality, there is not much of a change in the overall CG environment in China other than the shareholding structure reform, which is not captured in these scores. Improvements are still needed, and many companies need to pay more than just lip service to the reform measures promulgated in recent years.

Figure 1

China ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	43	53	Took down some scores for financial reporting standards
Enforcement	40	42	Efforts still ongoing, but regulators still not sufficiently funded or resourced
Political & regulatory environment	50	50	Largely in line with last year
Adoption of international accounting/auditing standards	68	75	Accounting/auditing standards following international practices, but still not there
CG culture	22	23	Still a disconnect between following CG rules and the spirit behind them

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

Regulatory environment

Shareholding structure reform helps solve government conflict of interest in shareholdings

The major change in China's corporate governance development over the last year is the A-share shareholding structure reform, whereby the CSRC is setting up guidelines for domestic listcos for the conversion of their non-tradable shares (state-owned shares or legal person shares) into tradable shares. Around 65% of Chinese listco's shares are non-tradable shares, which results in corporate governance and conflict of interest dilemmas as the government effectively remains the regulator, manager and shareholder of these companies; they are not working for minority shareholders.

Previous attempts to dispose non-tradable shares failed

Looking back at history, the disposal of non-tradable shares is not a new thing in China. Indeed it was proposed back in 1999 and further attempts have been made in recent years. However, each time the proposal surfaced, the Shanghai-A Index nose-dived on expectations that a significant number of tradable shares will enter the market, and the CSRC had to halt such plans.

This time – offering free shares as compensation + barring equity issuance activity

This time however, the CSRC is using a 'carrot and whip' approach to introduce the reforms. Carrot in the sense that as demonstrated by the trial reform schemes, minority investors are compensated for the conversion by being given free shares in the ratio of c.2-3.5 for every 10 shares they own. The whip comes from these listcos being barred from future equity issuance activity (including companies planning to offer overseas listings and listcos with subsidiaries wishing to be listed overseas) and being prevented from implementing management incentive schemes (eg share-based) until their shares become fully tradable.

Key outstanding issue is compensation to A/B and A/H dual listing companies

As we write, three batches of stocks have been announced under this reform plan, but a lot of uncertainties remain. The key issues includes whether the B/H shareholders of A/B and A/H dual listed companies will be compensated under this reform? Will they receive fair treatment (or what will be regarded as 'fair treatment')? In the latest guidelines promulgated, the CSRC has already expressly opined that only A share holders will have voting rights on the shareholding structure reform (an EGM for all shareholder classes is NOT required). However, they have left the decision on compensation to B/H shareholders to the majority A-share holders, to be decided in consultation with all related shareholders. We expect further guidelines to be announced in time.

In addition, other issues still to be solved included compensation when the dual-listed companies has H shares share price higher than the A shares – such as Anhui Conch. Also, there is talk of possible legal issue if equal compensation is not given to companies with ADR listings in the United States – eg Sinopec and Shanghai Petrochem.

Positive medium-and-long term development; near-term incentivising investors to speculate

Nevertheless, overall we see this set of corporate governance reforms as very positive both in the medium-and-long-term to reducing the government's role in the listcos and the inherent conflict that exists with their role. In the near-term, however, this reform has resulted in the undesired effect of incentivising domestic investors to focus less on company fundamentals as the parameter for stock picking, but rather on whether a company is among the shareholding structure reform and what kind of concession the major shareholders are willing to offer as part of the reform.

Furthermore, restoring equity raising functions is positive for health of the capital market long term, and performance and share based management compensation schemes should better align management interests with minority shareholders. Making domestic shares tradable should also foster a strong takeover/M&A market, again creating incentives to force management to make more efficient use of the resources/capital they have on hand.

Other reforms that have been promulgated in the past year:

- Allowing A-share companies to buy back shares – for example Handan Iron and Steel.
- ***Guidelines for Investor Relations of Listed Companies (11 Jul 2005)*** - to promote good investor relations practice and protect interest of public investors. The six basic principles behind this guideline include: 1) adequate disclosure of information; 2) proper disclosure of information; 3) equal opportunities for all investors; 4) honest and credibility; 5) low cost and high efficiency; and 6) two-way communication.
- ***Provisions to Protect Interests of Public Investors (7 Dec 2004)*** - to establish a control mechanism to prevent corporate power abuse and protect interests of public/minority investors. Provisions include: 1) material events to be passed by 50% votes of public shareholders; 2) strengthen the function of independent directors; 3) improve investor relations and quality of information disclosure; 4) earnings distribution – companies having not distributed cash dividends for 3 yrs cannot issue new shares or convertible bonds; 5) fiduciary duties of the majority shareholder and company senior management.

Any changes in the regulatory environment – rules, enforcement etc. Can keep brief if no major developments.

Any major issues that are being campaigned – eg vote by poll, pre-emption rights for new issues etc.

Companies – the good, the bad and the ugly

Good CG improvements at some companies, we focus on the poor examples here

In ranking the governance of Chinese companies, we again focus more on the negatives than the positives despite some steady improvements made by the Chinese listcos. While there was no blow-up this year of Xinjiang Delong's extent, some still took a backward step, while a more difficult operating environment unearthed what probably were poor governance cultures at some companies.

CG disappointments

Yangzhou Coal's loan to third party

Yanzhou Coal – as the second-largest coal producer in China, selling thermal and semi-soft coking coal to domestic and export markets, the company disappointed investors at the beginning of the year when it a provided a loan to a third party in an attempt to generate a higher return on excess cash. The third party subsequently defaulted on the loan, and while the proceeds were fully recovered through the sale of collateral, the event raised significant questions over the company's capital management.

Beijing Media's lack of investor communication post poor 1H05 results

Beijing Media. Only eight months after its IPO, Beijing Media almost turned into loss in 1H05. Market-share loss is almost certain but management is unwilling to face this issue. Limited access to the top management and limited communications with minority shareholders after the poor results also showed low commitment to transparency.

China Gas's significant share options and warrants

China Gas issued significant amount of share options (25%) to staffs/managements and warrants (12%) to private individuals. This historical legacy has put pressure on the share price despite booming growth prospects.

China Force soybean hedging gone wrong

China Force Oil & Grains Industrial Holdings (1194 HK) – recorded a net loss in 1H05 due to bad decisions on soybean future contracts at the Chicago Board of Trade. China Force is engaged in processing and selling edible oil products in mainland China, and they entered the CBOT futures contract based on observed strong correlation between spot prices of refined soybean oil on the mainland and future prices on the CBoT. However, this trend unexpectedly reversed. The total loss in the soybean business in 1H05 was Rmb187m.

Others. Many of Guangdong Kelon (one of China's refrigerator maker)'s senior management have been detained for fraud. Skyworth, one of China's largest TV makes, had top management arrested by Hong Kong's anti-corruption watchdog on allegation of fraud and misappropriating HK$48m of company funds. Shenhua Energy has been lamented for by investors its poor information disclosure, despite its high-quality coal operation, examples include unwillingness to break down its coal selling price net of transportation costs.

CG improvements

China Life improved disclosure

China Life's disclosure significantly improved this year versus its maiden accounts last year post IPO. This year, China Life's disclosure includes a breakdown of new business, an update on actuarial valuation, as well as its key assumptions and sensitivity analyses. The quality of information is better, closer to being in-line with international practice.

Hopson Development new CEO brought about investor communication, transparency and board improvement

Hopson Development has much strengthened its investor communications and transparency after a new CEO and CFO joined the company five months ago. Its placement of 20% new shares to two strategic shareholders, namely Tiger Global and Temasek, not only established a more diversified shareholder base but also invited new board directors of strong institutional background. With the CEO and CFO's prior conglomerate and investment banking background respectively, we expect Hopson to gradually establish a more structured management team at corporate level to relieve previously the decision-making burden and risk borne solely by the chairman Mr Chu.

Figure 2

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

Top quartile	Second quartile
Anhui Expressway	Baoshan I&S
Beijing Airport	Beijing North Star
Chalco	BYD
China Fire Safety	China Life Insurance
China Pharmacetical	China Merchants Bank
China Vanke	China Mobile
Ctrip.com	China Netcom
Fu Ji	China Oilfield Services
Hengan Intl	China Overseas Land
Lianhua Supermarket	China Telecom
Linktone	CNOOC
Netease	Hopson Development
PetroChina	Shanda Interactive
Ping An Insurance	Shenzhen Expressway
TCL International	Sina.com
Tencent	Tsingtao Brewery
Wumart Stores	UTStarcom
Zhenhua Port Machinery	Weichai Power
ZTE Corp	Weiqiao Textile

Source: CLSA Asia-Pacific Markets

Changes in CG scores

Top CG score improvements China Telecom, China Vanke, Jiangxi Copper

Among the companies with changes in CG scores from 2004 to 2005, China Telecom improved most with new audit and remuneration committees and increases in independent directors, while China Mobile also introduced audit and remuneration committees. Jiangxi Copper increased its number of independent directors and improved its guidance of market fundamentals.

CG score retraced for Sinopec, CEA and Zhenhua Port Machinery (although Sinopec and Zhenhua still tier 1)

We took scores down for Sinopec and PetroChina given management's reluctance in giving minority shareholders priorities in the overseas asset acquisitions. China Eastern Airlines scores were down partly because they booked gains to boost their 2004 profits (otherwise a loss). Very few of these score changes reflect major CG scandals.

Figure 3

Companies with changes in CG scores: 2004-05

	Chg in CG score (ppts)	2005 quartile ranking
China Telecom	11.3	2
China Vanke	10.8	1
Jiangxi Copper	8.7	2
China Mobile (HK)	7.7	2
Hainan Meilan Airport	(5.3)	2
China Res Power	(5.8)	4
Lenovo Group	(7.5)	2
PetroChina	(8.0)	1
China Overseas Land	(9.0)	3
Zhenhua Port Machinery	(9.1)	1
China Eastern Airlines	(11.9)	4
Sinopec	(13.1)	1

Source: CLSA Asia-Pacific Markets

Our QARP companies returned 11%, vs benchmark -1%

Does QARP work?

The MSCI China Index was down 1% in 2004. Our CG quartiles 1-3 outperformed this with 9%, 7% and 12% returns, while quartile 4 was down nearly 9%. Our QARP companies China Vanke, Zhenhua Port Machinery, PetroChina and Global Bio-chem, were chosen from the top 2 quartile CG list, with ROE above cost of equity and have more than 10% upside to theoretical value by the Gordon growth model. This subset produced an average return of 11%, again better than the benchmark. Interestingly, this came in a period where the overall market was range-trading, and bottom-up stock-picking was the key to fund performance.

Figure 4

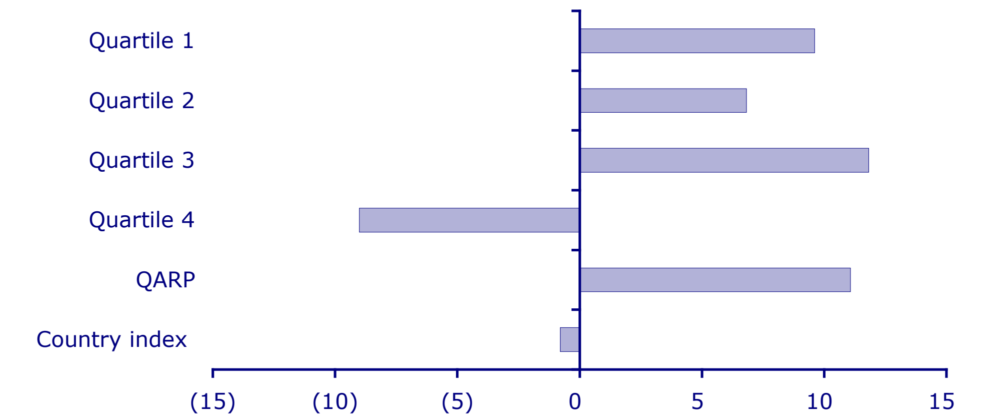
QARP list: Jan-2004 valuations and stock performance

Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 stock perf (%)
China Vanke	17.5	10.7	5	2.2	0.8	169.4	2	35.3
Zhenhua Port Machinery	19.6	11.4	5	2.3	1.6	46.8	1	8.3
PetroChina	30.0	13.3	2	2.5	1.9	28.6	1	(5.6)
Global Bio-Chem	22.5	13.1	3	1.9	1.6	21.7	2	6.3
Ave performance								11.1

Higher CG stocks outperformed MSCI-China last year; QARP basket did better than top two quartiles, comparable to third quartile performance but with better quality CG names

Figure 5

2004 performance of CG quartiles, QARP and country index



Source: CLSA Asia-Pacific Markets

We expect good performance from our QARP picks for this year

QARP picks

For this year's QARP picks, we have chosen, with the same parameters, seven stocks including three returnees from last year – Zhenhua Port Machinery, PetroChina and China Vanke. The others are Hopson Development, CNOOC and China Netcom. We have BUY recommendations on all except for China Netcom, which we rate as an Outperform.

Note this list could have included more commodity stock names which are trading near their cyclical-peak ROEs, but we normalised some of these ROEs to reflect what we expect to be sustainable in the long term. Interestingly, our stocks come from a wide variety of sectors – two property developers, two energy plays, a steel manufacturer, a telco and a heavy equipment manufacturer. We expect these seven stocks to again lead to good performance on both an absolute and relative level this year.

On current valuations on Fy05-06 ROE what are the stocks that have upside to theoretical value on the VCARP model, the financials leg of QARP, and in the upper half of current CG rankings in the market.

Figure 6

2H05 QARP picks

Co.	CLSA Recom.	FY05-06 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (30-Jun-05) (x)	Upside to theor. PB (%)	CG quartile (1-4)
Hopson Development	BUY	20.4	8.5	4	3.6	10.0	267.4	2
CNOOC Ltd	BUY	37.5	12.0	3	3.8	2.6	47.6	2
Zhenhua Port Machnery	BUY	23.0	11.4	5	2.8	2.0	41.1	1
PetroChina	BUY	30.7	13.3	2	2.5	2.0	26.2	1
China Vanke	BUY	18.0	10.7	5	2.3	1.8	25.9	1
China Netcom	O-PF	16.4	11.5	2	1.5	1.2	21.4	2

Source: CLSA Asia-Pacific Markets

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Hong Kong - Mauling reminder

Blowup of US$430m market cap company

Like some of the other markets with high CG rankings, Hong Kong too had a major corporate blowout this year. Although Moulin's collapse was somewhat smaller in scale than other implosions in the region, it was nevertheless sudden, coming just after a bold US$250m takeover of an American eyewear retailer and saw what was a US$430m market cap company, previously the third-largest eyewear manufacturer in the world, now in receivership with its chairman as well as his son, the chief executive, being sued for fraud.

Slight increase in company scores

Moulin aside - which is not under CLSA coverage - the companies we cover in Hong Kong have seen a slight rise in their CG scores from 64.2% last year to 65.6% this year. Top CG stocks outperformed slightly in 2004; the outperformance however was much greater for companies under our QARP criteria. On average, these are up by 31.1% against MSCI-HK, which rose 13.2% last year. However, after market gains to mid-2005, the list of QARP stocks going into 2H05 has narrowed to just five names: OOIL, Wing Hang Bank, Ports Design, Standard Chartered and HSBC. These are high CG companies, with strong ROE and reasonable valuations, which should help portfolio performance even in a potentially volatile market.

Country CG score

Market score for macro determinants of CG relatively unchanged

Our country score for macro CG determinants is similar to last year (69% this year versus 67% in 2004) with some minor adjustments in the scores in the various categories for the updated country ranking criteria. The full scores and criteria used are in Appendix 1. We continue to rank Hong Kong high for accounting standards as well as for the regulatory and political environment with regard to CG and shareholder value creation. The market also gets a high score relative to the region for rules and regulation as well as enforcement.

High score for accounting standards and political/regulatory environment; lower score for CG culture

Figure 1

HK ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	64	66	Similar score to last year, minor change based on more elaborate country criteria
Enforcement	58	58	Similar score to last year
Political & regulatory environment	78	75	High score for regulatory environment
Adoption of international accounting/auditing standards	91	90	High score too for accounting standards
CG culture	54	46	Lower score for overall CG culture (although slightly higher than last year)
Overall score	69	67	

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

Various standards of good governance not adopted at the company level and by market intermediaries

The score for CG culture – ie general practices of accounting professionals, market intermediaries and issuers – is only average and lower than the other categories, but higher than for most other markets we cover. The areas here where the score is pulled down is on whether companies have chairmen who are separate and independent from the CEO (generally not the case), whether companies provide sufficient information on risk management and internal controls in annual reports, whether market intermediaries place emphasis on good CG for companies coming to the market (not with the rush to bring on companies from the motherland), whether institutional investors have created their own CG activist groups and/or CG-focus funds, whether companies see CG as providing tangible benefits (we doubt they do) etc.

Gap in the score with Singapore has narrowed

Hong Kong ranks second behind Singapore in the country rankings, but by the more stringent criteria being used this year, the gap in the score for the two markets has narrowed to just one percentage point from 8 ppts last year. Singapore scores higher for rules and regulations, HK scores above Singapore for political and regulatory environment; for the other categories there is little difference between the scores for the two markets.

Regulatory environment

Position of chairman of the SFC is being split

The major change with regard to the regulators in Hong Kong is at the head of the Securities and Futures Commission (SFC). Andrew Sheng stepped down as executive chairman in September. His position is being split into a non-executive chairman and a chief executive. Purportedly, a non-executive chairman would be able to exert an over-sight function over the executives running the commission.

However, it is not clear that a non-executive who is part-time will be able to keep up-to-speed with goings on in the commission as well as the intricacies and evolution of securities regulation. In any case, the SFC already had a structure where a chief operating officer was responsible for the day-to-day running while previously the executive chairman was responsible for policy issues and representing the SFC to the government and internationally. Hence for the commission, the split in function between a chairman and a CEO is somewhat more controversial than for companies.

Moulin International – Family company disaster

Moulin owed the banks HK$5.3bn

The biggest corporate disaster among Hong Kong companies in recent years occurred this year. Family-controlled Moulin Global Eyecare went into receivership owing HK$5.3bn. Its chairman and his son, the chief executive, are being sued personally for over HK$100m. Moulin was once the world's third-largest eyewear maker, producing brands like Aigner, Longines, Benetton, Revlon and Nikon. In 2004, it attempted an ambitious acquisition of US eye-wear retailer Cole National for US$440m but was outbid by rival Luxottica. In March 2005, however, it paid US$250m for a 56% stake in Eye Care Centers of America. Soon after the group started to unravel.

Two external auditors resigned in four months

Deloitte Touche Tohmatsu, its auditor resigned in April, which followed the departure of Ernst & Young as auditor last December. The 2004 results were delayed. A proposed US$320m convertible bond issue was aborted. The stock was suspended which put it in breach of a loan agreement. Just three months after the acquisition of the American company, Moulin was in provisional liquidation.

Co understated its loans and overstated its cash

When the creditors looked at the books more closely, they found that total debt was HK$5.3bn (US$680m) rather than HK$2.8bn which the company had stated. Meanwhile cash levels were down to HK$15m rather than the HK$90m that had been reported. Independent directors resigned and the bank creditors called in loans of HK$946m. Meanwhile, the chairman Ma Bo-kee and his son Cary Ma, the chief executive, are facing lawsuits personally claiming over HK$100m for bounced cheques and breaching margin finance agreements with local broking companies.

Moulin once again underscores the risk of family-controlled companies. Not only was the chief executive the son of the chairman, but in all five of the six executive directors were from the Ma family. Such companies tend to be higher risk, particularly smaller companies where the patriarch and/or family board members might have greater influence over management and independent directors (Moulin had three on the board which in total comprised nine members). Problems can then be hidden for longer but which gives time for the situation to worsen and lead to a corporate collapse.

HK Ex, HSBC, Esprit, L&F, StanChart are among top companies for CG in the market

Figure 2

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

Top quartile	Second quartile
HK Exchanges	Bank of East Asia
HSBC	Swire
Esprit Holdings	Noble Group
Li & Fung	HK Electric
StanChart	Ports Design
Johnson Electric	Hopewell Holdings
CLP Holdings	Hopewell Highway Infr
Techtronic	SHKP
Giordano	Hang Seng Bank
Orient Overseas	Hang Lung Gp
Wing Hang Bank	Cafe de Coral
SCMP	CRA
Lee & Man Paper	Cathay Pacific
Next Media	ASM Pacific
Sa Sa	Hang Lung Props

Source: CLSA Asia-Pacific Markets

Changes in CG scores

Hutchison's CG score has gone up 12 points

Among the companies with increases in CG scores, for Hong Kong the biggest improvement is in Hutchison. The group now has a large section in its annual report dealing with CG practices with detailed disclosure on composition and functions of various board committees. As importantly, the group's previous controversial policy of amortising customer acquisition cost (CAC) over three years was brought into line with other telcos: it now charges CAC upfront for pre-paid customers and for post-paid customers over the typical life of the contract which in general is 12 months. These lead to a 12-point improvement in its CG score. However like other conglomerates, and those that are a subsidiary of another listed entity where the controlling shareholder's interest is indirect, it is still penalised by our CG scoring system.

Figure 3

Companies with changes in CG scores: 2004-05

	Chg in CG score (ppts)	2005 quartile ranking
Hutchison Whampoa	12.2	4
Next Media	8.8	1
HSBC	7.3	1
Johnson Electric	6.3	1
Techtronic	6.3	1
HK Exchanges	5.6	1
SCMP	5.6	1
Linmark Group	(6.5)	3
Dah Sing Financial	(10.9)	4

Source: CLSA Asia-Pacific Markets

Other companies have also made a noticeable effort in detailing the work of their board committees, appointing independent directors to chair these committees and providing a lot more information on their CG practices in annual reports. This has led to improvements in the scores for the likes of Next Media, HSBC, Johnson Electric, Techtronic and SCMP. HSBC and HK Exchange's score has moved up with an increase in independent directors.

Decline in scores for DSFH and Linmark

Linmark's score is reduced owing to more limited access to senior management and disclosure issues. Dah Sing Financial's (DSFH) score was brought down in light of the somewhat controversial spin-off of the bank last year. The explicit wording of our CG questionnaire requires a negative score for companies when there are such controversies, even if the group and directors arguably have legitimate reasons to justify the exercise. In the event, over the past 12 months, the group has made three acquisitions; however the relatively small size of these still raise the question whether a separate listing for the bank, which was dilutive for DSFH, was warranted.

QARP stocks beat just high CG for performance

Top quartile CG stocks gave a return in 2004 slightly ahead of overall sample of stocks for HK

On average stocks under coverage in Hong Kong gave a return, excluding dividends, of 22.5% (not weighted by market cap) in 2004. The top quartile CG stocks performed 3-ppts ahead of this with an average return of 25.5%. The QARP Hong Kong portfolio for 2004, however, gave a much superior return. These are the stocks in the upper half of our CG rankings within the market last year, which have an ROE above cost of equity and have more than 10% upside to theoretical value by the Gordon growth model. Stocks with ROE above cost of equity and with upside to theoretical value are what we define as value-creators at a reasonable price (VCARP). A full definition and explanation of these criteria is on pages 4-8 of this report.

31% return from QARP stocks last year for HK

The 16 QARP names for Hong Kong last year rose 31.1% on average. This performance was driven by over 50% returns last year from Noble Group, Esprit and Techtronic; and 30-50% gains in the stock values of OOIL, Lung Kee, Café deCoral and Giordano. Only three of the 16 stocks selected by these criteria last year gave a return less than MSCI-HK's 13% rise, viz. Dah Sing Financial, Hang Seng Bank and HSBC.

QARP beat top quartile CG stocks by 5.6-ppts

The QARP portfolio last year beat the performance of the top CG quartile by a significant 5.6-ppts. Although this is based on just one year's performance, HK is one of the nine markets last year - of the ten that we survey in this report - where the QARP portfolio outperformed top-quartile CG stocks. It is one of the eight markets where the QARP stocks outperformed the country index. Adding a valuation dimension (PB) to picking stocks with good financials (ROE above cost of equity) and high CG intuitively should give better performance than simply choosing stocks with high CG irrespective of financials and valuations. This is corroborated by the evidence from Hong Kong, most of the other markets we cover, as well as for the region's largest caps (see pages 8-10 for our findings on the large caps in the region).

QARP stocks beat each of the CG quartiles and the country index by a comfortable margin

Figure 4

2004 performance of CG quartiles, QARP and country index

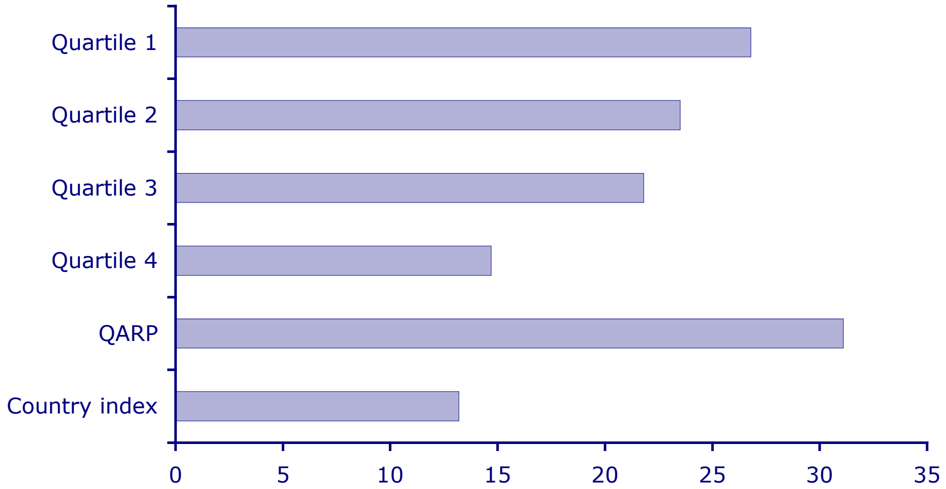

Figure 5

QARP list: Jan-2004 valuations and stock performance

Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 stock perf (%)
Noble Group (S$)	49.78	8.2	3.5	9.8	1.2	727.9	2	83.5
OOIL	38.06	9.1	0.0	4.2	0.9	343.4	1	35.8
Dah Sing Financial	19.78	8.4	4.0	3.6	1.7	105.8	2	4.3
CLP	20.09	8.2	3.0	3.3	2	63.1	1	20.8
HK Electric	17.25	8.2	3.0	2.7	1.7	59.7	1	15.6
Lung Kee	25.26	9.5	3.0	3.4	2.1	59.6	2	43.3
Ports Design	29.67	8.2	3.5	5.6	3.5	58.0	2	19.7
Esprit	45.97	9.5	5.0	9.2	5.8	57	1	81.8
Techtronic	33.14	9.3	5.0	6.5	4.4	48.2	2	57.3
Wing Hang Bank	16.56	8.8	4.0	2.6	1.8	41.9	1	18.0
Café de Coral	18.89	8.2	4.0	3.5	2.6	36.7	2	29.5
Standard Chartered	17.94	8.6	4.0	3.0	2.3	34.1	1	14.3
Hang Seng Bank	29.13	8.2	4.0	6.0	4.8	25.6	2	5.9
Wing Lung Bank	10.81	8.2	4.0	1.6	1.3	24.8	1	24.1
HSBC	13.97	8.3	4.0	2.3	2.0	14.5	1	8.6
Giordano	21.79	9.8	4.0	3.1	2.7	14.3	1	35.4
Ave performance								31.1

Source: CLSA Asia-Pacific Markets

HK QARP picks 2005

Now only five names in the QARP list for 2H05

After the 13% rise in the HSI from the beginning of 2004 to mid-2005, the number of stocks that qualify on our QARP criteria based on mid-2005 valuations is a much shorter list of just five names. These are companies which rank in the upper half for CG within the market, with high ROE and at least 10% upside to theoretical value. The companies that make it for the current list for Hong Kong, as shown in Figure 6, are OOIL, Wing Hang Bank, Ports Design, Standard Chartered, and HSBC.

Figure 6

2H05 QARP picks

Co.	CG Quartile (1-4)	Avg ROE 05-06 (%)	COE (%)	Ascribed gr (%)	Theoretical P/B (x)	Mkt P/B(x) (%)	Upside (%)
OOIL	1	14.6	9.5	2.5	1.7	1.3	38.5
Wing Hang Bank	1	17.1	9.3	4.0	2.5	1.8	33.9
Ports Design	2	30.3	9.3	4.0	5.0	4.1	22.4
StanChart	1	17.1	9.3	4.0	2.5	2.1	19.6
HSBC	1	15.7	9.3	4.0	2.2	2.0	12.4

Source: CLSA Asia-Pacific Markets

For OOIL, we use average ROE between 1992-2004

The key inputs for the VCARP criteria (ie the financials leg of QARP) are ROE, cost of equity and ascribed long-term growth. The ROE used should reflect what is sustainable in the long term, which is somewhat subjective. We use average FY05-06 projected ROE as an approximation, except for companies where current ROEs are clearly not sustainable. Thus for OOIL, we are using the average ROE over the last cycle, ie from 1992–2004 of 14.6%, rather than FY05-06 ROE of 38%.

9.3% cost of equity for the market

Cost of equity is derived from CAPM with 4.3% as the risk-free used for this exercise (approximately the 10-year Treasury yield), a 4% general equity risk premium across markets and an additional 1% country risk for Hong Kong. This give a 5% market risk premium and a market cost of equity of 9.3%. Beta is derived from Bloomberg, but we input a minimum beta of one, on the assumption that investors will not be looking for equity returns less than 9% even on less volatile stocks. The ascribed long-term growth used in general is between 3-5%, depending on the perceived sustainability of growth.

Current list is skewed toward banks – including the two large international banks listed in HK

The list is dominated by banks, including the two large international banks listed in Hong Kong, Standard Chartered and HSBC, as well as Wing Hang Bank which is strong in both Hong Kong and Macau. If OOIL is able to achieve its ROE of close to 15% over the last cycle, then its current PB of 1.3x looks undemanding. Similarly Ports Design with an ROE of 30% has upside on this model even though it is already at 4x book multiple (as at mid-2005). This underscores that our value-creators at a reasonable price criteria is not about value stocks per se, but about high ROE stocks where there is upside against current market valuations if ROE is sustainable.

This list of QARP stocks should provide good performance even if markets are volatile with a downward bias while interest rates are rising into 1H06, as is our current market view.

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India - Well regulated

India maintains its third rank in CG score

While India maintained its third rank in corporate governance among countries under our coverage for the fifth year in a row, there have been a number of interesting developments during the year. Most of these have been positive, especially on the regulatory front. The average CG score for the companies under our coverage has gone up by 1.3ppt to 56.2%, primarily driven by the companies in the lower quartiles of our CG ranking.

SEBI's clause 49 gives clear guidelines on independent directors, audit committee

In October 04, the Securities Exchange Board of India (SEBI) issued a revised Clause 49 containing clear guidelines on independent directors, audit committees and accounting of subsidiary companies. It disqualifies any persons having material pecuniary relationship with the company, relatives of promoters/directors, ex-employees over the past three years, auditors, lawyers, customers, suppliers, substantial shareholders etc. from becoming a director on the board. Clause 49 becomes mandatory from December 2005.

Review of Company's Law, Money Laundering Act

In May 05, the JJ Irani committee submitted its report on simplification of the Company's Law, which contains substantial provisions for protection of minority shareholder's interest. It recommends preventive action against vanishing companies, suggests clearly spelt out duties of directors, with civil consequences to follow for non-performance. The Prevention of Money Laundering Act, 2002 (PMLA), which is aimed at combating money laundering in India, also came into effect from 1 July 2005.

Family dispute brought Reliance CG standards under scanner

This year we also witnessed an ownership dispute between the Ambani brothers as they fought over control of the Reliance Group entities. The dispute, eventually settled by a welcome demerger of the flagship Reliance Industries, brought into focus a number of CG issues like the independence of Reliance's board and the cross-holding among various group companies. Interesting also was the disqualification of directors of Essar Oil for reappointment to its board as well as other companies after it failed to make payments to its debenture holders.

Infosys continues to lead, Bharti has shown significant improvement

Infosys continues to lead the pack with the highest score. Bharti Televenture reported significant improvements in the score with improved disclosure standards. New entrants in the listed space NTPC, TCS and Patni Computers figure in the second quartile, while Biocon is in the first quartile. We have penalised TCS for movement in share price ahead of its quarterly results and Tata Steel and Cummins for reduced access to senior management.

Country CG score

Figure 1

India ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	66	66	Continuous efforts being made to have simpler and more effective regulations
Enforcement	56	58	While SEBI and stock exchanges have necessary powers, little evidence of minority shareholders pushing for adherence to CG norms.
Political & regulatory environment	65	63	The political and regulatory will to improve and sustain high CG standards remain strong
Adoption of international accounting/auditing standards	75	75	Indian accounting standards are not at par with the international standards.
CG culture	43	50	CG practices of many small companies remain poor. Not much interest shown by minority shareholders to strive for better CG norms.

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

India scores high on regulatory front, accounting standards

On our more stringent criteria, India's score for CG macro-determinants is little changed at 61% from 62% last year. India scores high on the regulatory front and adoption of international accounting practices. Constant efforts are being made by SEBI to improve the regulatory environment. However, India scores low on CG culture. While most large companies are now striving for better CG standards, there are still a large number of small companies with poor CG practices. Also there is little evidence of minority shareholders engaged in promotion of better CG standards.

Key corporate governance developments in India

SEBI's revised Clause 49 becomes mandatory in Dec 2005

All listed companies have to follow the listing rules contained in revised Clause 49 by SEBI which was issued in October 2004. The key highlights of this clause are:

Independent directors

Over half of the directors should be independent directors

- The board of directors should comprise of at least 50% non-executive directors.
- If the chairman of the board is an executive director, at least half the board should comprise of independent directors. If the chairman is a non-executive director, at least one-third of the board should comprise of independent directors.
- The clause provides a clear definition of independent directors which excludes persons having any material pecuniary relationship / relatives / ex-employees in recent past etc.
- A director shall not be a member of more than 10 companies or act as a chairman in more than five committees across all companies in which he is a director.

Audit committee

Two thirds of the members of the audit committee shall be independent directors

- The audit committee shall have minimum three directors. Two thirds of the members of the audit committee shall be independent directors.
- All members of the committee should be financially literate and at least one members should have financial/accounting expertise.

Figure 2

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

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

Source: CLSA Asia-Pacific Markets

Subsidiary companies

Independent directors to be directors on the board of non-listed subsidiaries

- At least one independent director on the board of directors shall be a director on the board of a material non-listed Indian subsidiary.
- The audit committee of the listed holding company shall also review the financial statements of the unlisted subsidiary company
- Material non-listed company is one whose turnover or net worth exceeds 20% of the consolidated turnover or net worth.

Prevention of Money Laundering Act, 2002 (PMLA)

PLMA to combat money laundering in India

PMLA (which came into effect on 1 July 2005) is aimed at combatting money laundering in India with three main objectives - to prevent and control money laundering, to confiscate and seize the property obtained from laundered money and to deal with any other issue connected with money laundering in India.

According to PMLA every banking company, financial institution and intermediary shall have to maintain a record of

Financial institutions to maintain records of all transactions above Rs1m

- all cash transactions over Rs1m
- all cash transactions integrally connected to each other which have been below Rs1m where such transactions have taken place within one calendar month and
- all suspicious transactions
- Information of these transactions shall have to be furnished to Director, Financial Intelligence Unit, which has been set up as a multi-disciplinary unit for establishing links between unusual financial transactions and underlying criminal activities.

Dr JJ Irani Committee report on the new Company Law

Simplification of the Companies Act

The Dr JJ Irani Expert Committee was set up in December 2004 to advise the government on proposed revisions to the Companies Act, 1956. The committee submitted its report in May 2005, which has been appreciated by government, industry and media and is likely to be the basis for the new Company Law. Some of the recommendations by the committee are to:

- Simplify the Companies Act and reduce the number of sections from 781 to just 300 as many provisions are out of sync with the current times.
- Allow faster incorporation and liquidation of companies, in line with other emerging and developed countries. Allow 'one-person companies' to be set up.
- All directors and key executives should sign the accounts of the company even if they are not present in the meeting where these accounts are presented.
- The expert panel has also recommended that non-executive directors and independent directors should not be punished for day-to-day actions of the company that have not been brought to their notice.

Preventive action against 'vanishing' companies

- Preventive action against 'vanishing' companies to begin with the registration itself. Heavy penalties for companies found inadequate in their disclosure and filings. Inter-agency coordination should be enabled to track down people behind such companies and law should be amended make them disgorge their ill-gotten gains.
- Review the system of name-change by the companies to avoid cheating minority shareholders by changing their name.
- The Committee wants the Company Law to clearly spell out the duties of directors, with civil consequences to follow for non-performance.

Committee to monitor redressal of shareholder grievances

- To set up a "Stakeholder's Relationship Committee" to monitor redressal of shareholder grievances.
- Promoting greater use of technology - all statutory filings should be made compatible to e-filing by devising suitable e-filing forms
- To do away with the requirement of government approval for fixing the remuneration of managers and directors.

CG developments in individual companies

Infosys continues to lead . . . despite losing a point on cash accumulation

Infosys has maintained its top rank in terms of CG scores among Indian companies, despite losing one point on a question related to cash accumulation. In FY04, the company had announced a special dividend, raising dividend payout to ~69% of profits. However, the dividend payout fell to 18.6% in FY05 as hopes of another special dividend did not materialise. Infosys continues to accumulate significant amounts of cash (US$770m cash as at end of June 05 quarter) that are way above capex needs (US$260-290m capex in FY06CL).

Changes in CG scores

Figure 3

Companies with changes in CG scores: 2004-05

	Chg in CG score (ppts) (%)	2005 quartile ranking
Zee Telefilms	7.1	3
Canara Bank	6.9	4
GAIL	5.6	4
ACC	4.6	2
ICICI Bank	4.3	3
Gujarat Ambuja	4.2	2
Bharti	4.1	1
Reliance Energy	4.1	3
Dr Reddy	(4.4)	1
Cummins India	(4.5)	2

Source: CLSA Asia-Pacific Markets

HCL Tech - a bit too bullish

While access to management has been good, persistent volatility of performance has continued. We believe these trends have not been conveyed accurately enough by management.

TCS - visible improvements required

TCS has been ranked for the first time with score of 61.1 – significantly lower than other frontline software companies. While all IPO companies suffer on account of poor historical record of management actions, some points on TCS are worth noting. The share price has moved noticeably ahead of results and in the direction of results in the past three quarters. The transfer of the TCS business division to TCS Limited pre-IPO, too is negative. We also believe that TCS's long term strategies will intersect with other Tata group entities such as Tata Technologies (a Tata Motors subsidiary) and Tata Elxsi.

NTPC, another new entrant, is in the second quartile

NTPC, India's largest power generation utility, too was ranked for the first time with a score of 61.1. NTPC is well respected for its operational excellence as well as corporate ethics. The company has maintained good communication with investors post listing. However, being a public sector undertaking, the company's scores suffer on a few points. The company's chairman is not an independent director and independent directors do not form over 50% of the board and it is unable to publish its annual report within three-and-a-half months of the end of the financial year.

Bharti continues its impressive CG track record

Bharti continues its impressive CG track record. Its IFRS compliant quarterly reports include balance sheet, cashflow and segmental breakdowns which remain best-of-breed in terms of transparency. Disclosure levels are commendable considering that Bharti's efforts are voluntary, and the fact that Bharti operates in an inherently competitive business, where key competition is from unlisted players.

Pharma - overall good CG scores

In the pharma sector, Cipla scores low because of the lack of meetings and interaction with investors and analysts as well as limited disclosures after quarterly results. GSK has seen an improvement in scores primarily because of the share buy back. Sun Pharma has seen a marginal decline in scores because of the delay in its Annual Report. Biocon is the new entrant in the sector after its IPO and scores well given the timely disclosures.

Banks – decent improvements

Among the financials, ICICI Bank and Canara Bank have shown the strongest improvement in their CG rankings. ICICI Bank score has risen with improving level of disclosure and reporting by the company. Canara Bank CG scores have improved as number of independent directors on its Board has increased over the past three years.

Cummins, Tisco scores down due to reduced access to senior management

CG scores of Tata Steel and Cummins India have fallen on account of reduced access to the senior management for both these companies. Though the companies continue to hold regular post result conference calls/analyst meetings, access to senior management outside these calls/ analysts meetings has become relatively difficult. Cummins India management has become fairly inaccessible after the change in top management last year.

L&T - accounting policy for other income is an irritant

Cummins India's score has also suffered as the company's profit margins have been squeezed with rising export to the parent company. Tata Steel scores low, despite having one of the best management teams in corporate India, because its disclosures, especially with regards to selling price of key products, remain well below that of regional peers Posco and China Steel. L&T has seen significant improvement in overall investor communication, but its policy of classification of operating other income is a bit confusing and makes it difficult to assess the operating performance.

Reliance dispute brought to fore a number of CG issues

The highly publicized ownership dispute between Ambani brothers during 1H 2005, brought to fore a number of corporate governance issues that have surfaced in the past. Questions were raised on the independence of Reliance's board as well as transparency of financial accounts of subsidiaries/associate companies and cross-holdings among various group companies.

Reliance has consistently featured in the lower quartiles of our corporate governance report analyses on exactly these parameters. Crucial details on its operating details (full production details), financial accounts (sales and raw material breakdowns), related party transactions (investment flows into its group companies) and exposure to derivative instruments for example are not reported. However, the vertical split in the group and untangling of cross-holding currently underway will hopefully address some of the above mentioned issues.

QARP stocks beat just high CG for performance

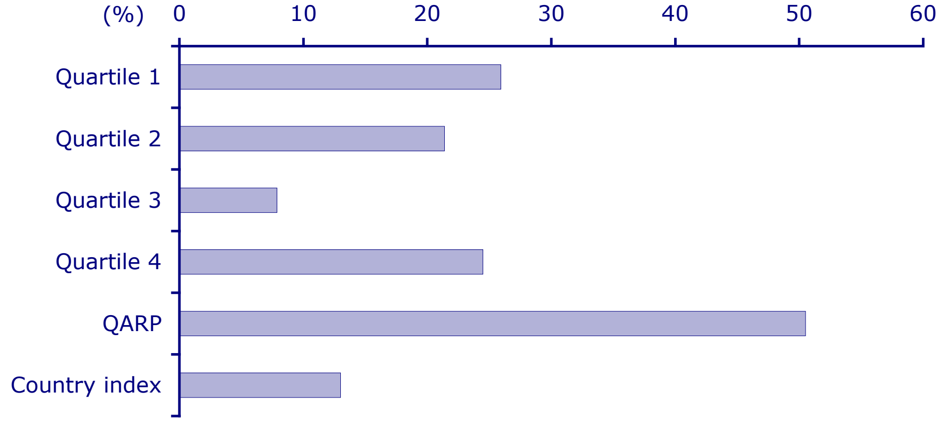
First quartile stocks have been the best performers in 2004

Among the stocks under our core coverage, the stocks in the first quartile of CG scores have reported the best performance during 2004. However, stocks under second and fourth quartiles have not been far behind. Thus, it is difficult to draw any conclusions from this analysis. However, our QARP picks (see the definition on pages 4-8) for 2004 have significantly outperformed the average of all the four CG quartiles and the Indian market.

QARP did substantially better than Sensex in 2004

Figure 4

2004 performance of CG quartiles, QARP and country index



Source: CLSA Asia-Pacific Markets

QARP has been eerily accurate in predicting the 2004 stars

The QARP picks in India were up by an average of 50% in 2004 compared to the 13% rise in the Sensex and 26% average rise in the first quartile CG stocks. What is even more interesting is that the stock with the highest theoretical upside as per the QARP exercise – HCL Infosystems – also turned out be the best performer in the list. Similarly, the stocks with the lowest theoretical upside – Gujarat Gas and Hero Honda – were also the worst performers in this list!

Figure 5

QARP list: Jan-2004 valuations and stock performance

Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 stock perf (%)
Concor	28.4	11.8	6.5	4.1	3.1	32	2	38.0
Gujarat Gas	27.5	11.1	3.0	3.0	2.7	11	1	(4.0)
HCL Infosystems	49.3	11.9	6.0	7.3	3.2	128	2	109.0
Hero Honda	67.2	12.5	5.5	8.8	7.9	11	1	27.0
Sun Pharmaceuticals	45.7	10.9	7.0	9.8	6.5	51	1	86.0
Wockhardt	25.4	11.1	6.0	3.8	2.7	41	2	47.0
Ave performance								50.5

Source: CLSA Asia-Pacific Markets

Concor and HCL Infosystems are India CG picks for 2005

India QARP picks 2005

With the sharp rise in Indian markets in 2005, the valuations are no longer cheap for most stocks and our QARP exercise throws just two picks – Concor and HCL Infosystems. Both these companies also figured in the top picks for 2004. Despite their 38-109% out-performance during 2004, these stock still offer theoretical upside of 32-78% from June-05 levels. As of 30 September Concor was up 39% from 30 June levels, while HCL Infosystems is up 20%, both outperforming the market, which is up 19%. Even at current levels, we continue to rate both as BUYs.

Figure 6

2H05 QARP picks

Co.	CG Quartile (1-4)	Avg ROE 05-06 (%)	COE (%)	Ascribed gr (%)	Theoretical P/B (x)	Mkt P/B(x) (%)	Upside (%)
Concor	2	26.53	11.8	6.5	3.76	2.84	32.4
HCL Infosystems	2	46.39	11.9	6.0	6.79	3.81	78.2

Source: CLSA Asia-Pacific Markets

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Indonesia - Limited progress

Little progress on CG issues in past year

The past year has seen little substantive progress on the CG front in Indonesia. In terms of the overall country CG score, Indonesia fell slightly but this was due to a slightly changed questionnaire. While the lack of progress is disappointing, the election of the new president was a milestone for Indonesia. He has identified corruption as a major issue for his government and has made some progress in his first year. If the drive continues in the long term, this should lead to improved business practices. It has already resulted in the arrest of the president director and two other directors at Bank Mandiri, with a number of other government-run company directors also looking worried.

Individual companies provide a mixed picture. Unilever again ranks no.1 in Indonesia

Individual companies were mixed with Unilever again polling top. Since 2004 most companies have now instituted audit and remuneration committees although some look to be relatively powerless. That remains a problem in Indonesia and the region. Companies may be meeting strict legal requirements but in reality there is little independence in boards and committees. Many rely on ex-staff members as independent members.

INCO made large gains in 2005

There were some large changes from the 2004 results, with a number of winners and losers. Among the winners, INCO was a standout. This subsidiary of the Canadian mining company has begun to hold regular analyst briefings and has improved disclosure. Other substantial gainers included Bank Niaga, now part of CIMB of Malaysia and Bumi Resources which is continuing to focus on its core mining business. Losers included Indocement due to a perceived lack of independence and low scores on responsibility. Salim Group companies Indofood and Indosiar also saw their CG scores drop sharply as markets remain wary of the group. Finally Antam which has been a leading light of CG in the government sector saw its score drop, partly due to possible moves to acquire a stake in Freeport that looks less than independent.

Combination of CG score and VCARP was a good predictor of out performance in 2004, However there are few targets in 2005

We have also looked at the CG scores in relation to VCARP to get the QARP stocks (see pages 4-8 for full definitions). Where companies have high CG scores and also good upside under VCARP, out-performance was significant in 2004. The problem in 2005 is that only two stocks now show up as having positive upside on these criteria. This suggests a market that offers little obvious value for investors.

Figure 1

Indonesia ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	33	53	Almost no changes to rules in past 12 months. Improvements stalled
Enforcement	29	27	Little new in the way of enforcement
Political & regulatory environment	30	38	Signs of drift
Adoption of international accounting/auditing standards	68	60	Indonesian accounting standards generally follow international standards
CG culture	28	27	CG culture in Indonesia remains largely formalistic with limited evidence of change in underlying behaviour.
Weighted score	37	40	Disappointing lack of progress in 2005

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

Country score fell slightly in 2005 on lack of progress

Country CG score

Indonesia's country CG score declined slightly in 2005, largely due to slightly changed questions. The key issue here is the almost total lack of new measures in the past year. With a score of 37% on our macro-determinants for CG, Indonesia is lowest among the markets surveyed in this report. The score for accounting standards is reasonable and comparable to other markets in the region; but the scores for other categories are generally lower.

Very little progress made in 2005

Regulatory environment

While the legal framework looks reasonably strong enforcement remains the key issue in Indonesian corporate governance. There have been few, if any changes in the regulatory environment in 2005. In fact the English language part of the regulators website (www.bapepam.go.id) contains no updates since 28 May 2005. The Indonesian version contains little additional information, although it does include the 2005-2009 Bapepam Masterplan. This document focuses on improving capital market practices but seems to lack much in the way of concrete action.

With few changes in the regulatory environment it has also been a quiet year for companies in terms of CG news. Telkom continues to struggle to meet NYSE reporting deadlines (in fact they are now looking to delist their ADR which is unlikely to be seen as a positive) but otherwise little has changed. On a positive note, Matahari, part of the Lippo Group, recently divested shares in a listed company at high prices, actually benefiting minorities.

Astra is well represented for its strong CG culture

Companies – the good, the bad and the ugly

Among the top CG companies, we see the Astra Group very well represented. They appear to take corporate governance seriously and it has resulted in strong price performance in recent years. Unilever again takes top spot, despite its limited disclosure. In other ways (responsibility, social etc) they are clearly the top company in Indonesia.

Figure 2

Companies in the top 2 CG quartiles for Indonesia (CLSA coverage)

Top quartile	Second quartile
Unilever Indonesia	Bank Danamon
Astra Agro	HM Sampoerna
United Tractors	Bank Niaga
Astra Intl	Berlian Laju Tanker
Astra Otoparts	Indocement
Bank Central Asia	Trimegah Securities
INCO Indonesia	Gudang Garam
Ramayana	Indosat
Bank NISP	Tempo Scan Pacific

Source: CLSA Asia-Pacific Markets

Some large moves in CG scores in 2005

Changes in CG scores

There have been some improvers in CG terms in 2005. While large drops were recorded by Indocement and Indosiar this was not due to any specific poor corporate governance. In Indocement's case, the score was affected by poor scores for independence and responsibility. Other companies that did poorly included Indofood and Semen Gresik. Indofood remains a mystery. It has excellent disclosure but there are many questions abut its finances. Semen Gresik is nominally in control of three subsidiaries but the two ex-Java businesses may not be aware of this!

Inco has been a large gainer

On the plus side, several companies have progressed in the past year. INCO Indonesia may have trouble paying out a dividend but they have strong disclosure and are well managed. It is now one of the top CG stocks in Indonesia. Bumi Resources may raise eyebrows as an improver, but disclosure is reasonable and their track record is being established. They moved into the second-tier of companies while Bank Danamon also saw a big improvement as Temasek's team are now in full control.

Figure 3

Companies with changes in CG scores: 2004-05

	Chg in CG score (ppts)	2005 quartile ranking
Astra Autoparts	17.7	1
INCO Indonesia	16.1	1
Bank Niaga	9.8	2
Bumi Resources	8.3	3
Bank Danamon	7.7	1
Indocement	(16.5)	2
Indosiar	(15.9)	3
Indofood	(8.4)	4
Semen Gresik	(7.1)	4

Source: CLSA Asia-Pacific Markets

Does QARP work?

Stocks that showed up well in the 2004 CG survey and which also showed upside under VCARP performed very strongly in 2004 with several producing gains of over 100%. The top stock here was Astra subsidiary United Tractors which gained 133% in 2004 and has continued to perform in 2005. The top 2004 picks came from a range of industries, with banks well represented. In most cases their theoretical PBs were reached.

Figure 4

QARP list: Jan-2004 valuations and stock performance

Company	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 stock performance (%)
Bank Danamon	30.02	13.0	4	2.90	1.46	99.4	2	108.3
Bank NISP	21.64	9.7	3	2.80	1.41	98.4	2	112.3
United Tractors	38.48	20.0	4	2.15	1.32	62.7	1	133.6
Astra Agro	35.03	15.6	3	2.54	1.76	44.7	1	74.6
Bank Rakyat Indonesia	32.67	15.9	3	2.29	1.64	40.3	2	125.5
Bank Central Asia	24.88	15.2	3	1.80	1.61	11.4	1	78.9
Astra Intl	34.43	19.3	3	1.92	1.73	11.3	1	88.2

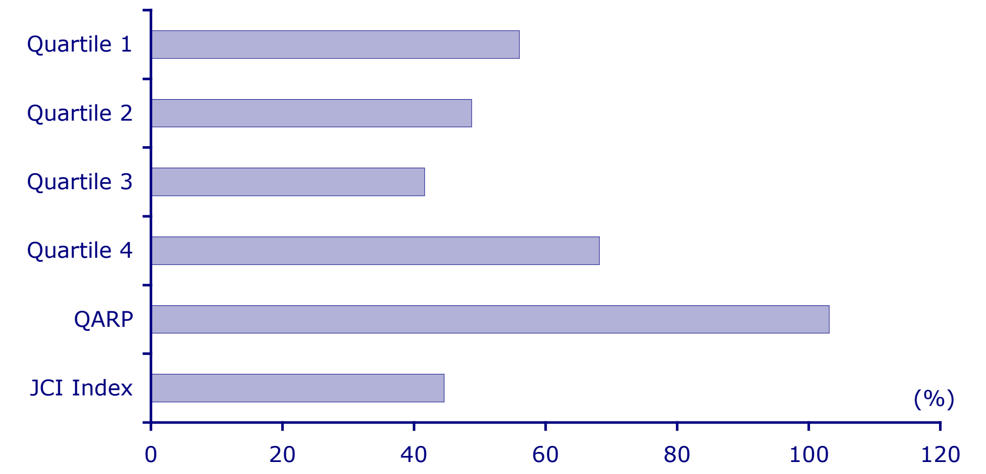
Source: CLSA Asia-Pacific Markets

The QARP picks rose on average 108%, well above the market segmented by CG quartiles. Interestingly, when broken down by CG scores, the bottom quartile stocks were the top performers. Quartile 1 came second followed by quartiles 2 and 3. The outperformance of poor CG companies was driven by strong share price moves by Ciputra Surya (property) and Semen Gresik (cement).

QARP stocks clearly outperformed in 2004

Figure 5

2004 performance of CG quartiles, QARP and country index



Source: CLSA Asia-Pacific Markets

2005 QARP picks

With the Indonesian market rising over 60% from January 2004 until mid 2005 the market now looks unattractive. On current valuations on FY05-06 ROE there are only two Indonesian stocks showing upside potential when combining CG and VCARP methodologies. Of the two, INCO trades at a massive discount to its Canadian-listed parent. It has repaid its debts and is generating massive cash flow. However, it is at the mercy of nickel prices. Our view is that nickel process are likely to be substantially lower by 2008, reducing the ROE to perhaps 12%, and removing the theoretical upside. Bank Niaga is interesting and trades at a large discount to local peer banks. Even with its rights issue, the stock remains attractive.

Among last year's top picks, all show downside ranging from 12% for Tempo Scan to 50% at United Tractors. United Tractors is affected by its very high Beta which pushes its COE to over 20% and may unfairly penalise the company. However, applying an average COE would still leave the stock with 30% downside under this methodology.

Figure 6

2H05 QARP list

Co.	FY05-06 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (30-Jun-05) (x)	Upside to theor. PB (%)	CG quartile (1-4)
INCO Indonesia	25.13	10.7	2	2.65	1.20	120	1
Bank Niaga	27.38	15.2	4	2.09	1.29	62	2

Source: CLSA Asia-Pacific Markets

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Korea - Still misunderstood

Thankfully, Korea did not suffer any any major corporate 'blowups' over the past 12 months

Unlike some of the other markets reviewed in this year's edition of *CG Watch*, Korea did not suffer from any corporate 'blowups' this year. Investors have long memories for bad news, however, and Korea Inc is still being punished for the Daewoo, Hynix and SK Global debacles, all of which had their genesis in the pre-crisis years. The state of Korean corporate governance therefore remains misunderstood, at least relative to other Asian markets. This is reflected in the 2005 country ranking: using the more comprehensive scorecard developed this year by Jamie Allen of the Asian Corporate Governance Association, Korea ranks sixth among the 10 countries scored.

The top quartile CG stocks outperformed the benchmark, but the QARP stocks did even better

The companies we cover in Korea saw a marginal rise in average corporate governance score from 58.1 last year to 61.4 this year. Stocks in the top quartile last year returned 14% in 2004 versus a 9% return from the Kospi; the outperformance, however, was much greater for companies under our QARP criteria; these stocks increased by an average of 23% in 2004.

Samsung Electronics stands out as the stock in the QARP portfolio with the strongest fundamentals

Five names make the QARP list for 2005. These are Kogas, KT&G, Posco, Samsung Electronics and SK Telecom. These stocks are either the first or second CG quartile and have theoretical PBs that are 10% higher than the current PBs. We have a BUY on only one however: Samsung Electronics.

Country CG score

The Korean country CG score of 50% is down from the 2004 score of 58%. This reflects our more comprehensive survey this year which brought down the scores of all markets other than Hong Kong. The relative position of Korea slips slightly. Overall Korea is in the middle of the pack, ranking slightly behind Taiwan.

The most interesting comparison is with Taiwan: although the PE gap is closing between the two markets, Taiwan continues to trade at a premium. There is little justification for this on grounds of a corporate governance differential between the two markets.

Figure 1

Korea ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	51	61	Disclosure laws need to be improved
Enforcement	40	50	New 5% rule brings down this score
Political & regulatory environment	43	50	Too much regulatory fragmentation
Adoption of international accounting/auditing standards	82	80	Strong here
CG culture	39	50	More work to be done

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

There is ongoing improvement in the governance environment in Korea

There is ongoing improvement in the governance environment in Korea, and well-known governance activist Hasung Jang of Korea University recently expressed to CLSA that he is much more optimistic than in the past. There has been a mixture of forward and backward steps with regulation, but the trend towards greater discipline at the board level is increasing.

This is driven both by market forces – meaning management fear of shareholder activism a la Sovereign/SK Corp - and ongoing improvements to the regulatory environment.

Controversies in 2005 were relatively minor, such as Dongkuk Steel's acquisition of Youeal Electronics

Governance controversies that made the press in the past 12 months were relatively minor (such as Dongkuk Steel's acquisition of Youeal Electronics) or related to pre-crisis issues (such as alleged bribes made by Samsung Group to escape illegal donations made to a presidential candidate in 1997).

Regulatory environment

The controversial '5% rule' was introduced in January 2005

The most important regulatory change in the past 12 months was the introduction of the so-called 5% rule in January 2005. Under this rule, shareholders owning more than 5% of a company must declare whether they bought the shares for 'simple investment' or to 'influence management'.

The rules also introduced a 'cooling off period' of five days following the reporting of a 5% stake, during which time the new shareholder may not exercise voting rights attached to the shares and may not acquire any additional shares.

Critics claim the 5% rule amounts to a poison pill

The rule proved controversial. Critics claim that the cooling-off period effectively provides incumbents with a window for introducing poison pills (such as issuing new shares to friendly parties), thereby stifling the fledgling market for corporate control. The declaration of intent (ie, passive investment or influencing management) also telegraphs to the market investor intentions, lowering the potential profit from legitimate investments and discouraging risk-taking.

The timing of the new rules was unfortunate

The timing of the new rules was unfortunate: the government was seen by some investors to be pandering to incumbent establishment interests and erecting new barriers to investment. This reinforced the view in some circles that Korea would continue to tilt the playing field against foreign investors and the Korea discount is deserved.

In January 2005, another new law was introduced to reduce the ability of chaebol financial companies to exercise their voting rights attached to shares in affiliate companies. Under the new law, the existing restriction of 30% would be lowered by 5% per year over the next three years until it reached 15% in 2008.

Therefore a securities company which owned 10% of an affiliated company would only have voting rights equal to 1.5% after 2008. While this move is positive from a minority standpoint, it is very controversial and Samsung has brought a petition to the courts claiming it is unconstitutional.

In practice, the rule is unlikely to have much long term impact on the way markets function or on valuations

In CLSA's view, the 5% rule is certainly not a step forward. However, neither is it a significant step back. In practice, the rule is unlikely to have much long term impact on the way markets function or on valuations. And one silver lining from the 5% rule is that it might provide investors and regulators with greater transparency on chaebol plans to invest more in certain affiliate companies.

Figure 2

Companies in the top two CG quartiles for Korea (CLSA coverage)[1]

First quartile	Second quartile
Hana Bank	AmorePacific
Hankook Tire	Daelim Ind
Hynix Semiconductor	DSME
Hyundai E&C	Hana Tour
Kookmin Bank	Hanjin Shipping
KT	Hyundai Development
KT&G	KOGAS
KTF	LG Chem
LG Household & Healthcare	LG Corp
LG Philips LCD	NHN
POSCO	S1
Samsung Electronics	Samsung Corp
Samsung Fire & Marine	Samsung SDI
Shinhan Financial Group	SKT
	Webzen

[1] Listed in alphabetical order. Source: CLSA Asia-Pacific Markets

Changes in CG scores

Improved access to independent directors led to an increase in the scores of Samsung Corp and Hanwha Corp

As in 2003 and 2004, many companies were able to increase their corporate governance scores by increasing the level of disclosure and co-operation with CLSA. Some of this amounts to 'box checking' and cannot necessarily be taken to reflect a genuine change of mindset towards the spirit of corporate governance. However, companies do deserve credit for seeking to engage investors and analysts on this issue, particularly with respect to providing access to independent directors. This has been a bone of contention for some Korean companies in the past, which considered it outrageous for an analyst to request even a 10-minute phone call with an outside director.

The number of independent directors is also increasing

Such access to the independent directors accounts for a large part of the change in the rankings of Samsung Corp and Hanwha Corp, whose scores increased by 25 and 19 points respectively. Samsung Corp was also helped by a new English website, a corporate governance mission statement and an increase in the number of outside directors. Hanwha Corp also increased its number of independent directors.

DSME lost points for a controversial investment made in October 2004

One company showed a major decline in score: DSME. DSME lost points for a controversial investment made in October: the company invested 25.7bn won to acquire 7.7% of compatriot shipping line Korea Line. Although the company holds that the move was a financial investment, the acquisition came just after Norwegian shipping company Golar LNG had built up his stake in the firm from 20% to 31% in 8 weeks. Local media reported that the financier was likely to influence management or attempt greenmail. DSME's investment therefore appeared to be motivated by the desire to support another Korean company, rather than to maximise returns for shareholders.

Figure 3

Companies with the largest change in CG score

	Chg in CG score (ppt)	2005 CG quartile
Samsung Corp	24.9	2
Hanwha Corp	19.1	3
Daelim Ind	13.0	2
S-Oil	12.0	3
Hyundai Motor	11.6	4
SK Corp	11.4	4
LG Chem	6.9	2
DSME	(10.5)	2

Source: CLSA Asia-Pacific Markets

QARP stocks beat just high CG for performance

The top quartile CG stocks lagged the CLSA coverage universe but beat the Kospi

On average stocks under coverage in Korea gave a return, excluding dividends, of 19.2% (not weighted by market cap) in 2004. The top quartile CG stocks performed 5-ppts behind of this with an average return of 13.7%. Although this lagged the CLSA coverage universe average return, it exceeded the Kospi return of 9.1%.

A poor corporate governance ranking remains something of a proxy for beta in Korea

In 2004, stocks with poor governance (those in the bottom half of the ranking) outperformed stocks with good governance. This reflects the fact that the low governance remains something of a proxy for beta in Korea. The company with the best governance tend to be large and well held by foreign investors. These companies tend to be in relatively mature industries and are growing earnings more slowly than younger companies with weaker governance structures.

However, by adding a value screen to the CG rankings, performance improves. To qualify for the QARP portfolio, stocks must be in the upper half of our CG rankings, have an ROE above cost of equity and have more than 10% upside to theoretical P/book value as implied by the Gordon growth model. (Note we used the average of current and forward years ROE as a proxy for the sustainable ROE in the Gordon Growth model). Stocks with ROE above cost of equity and with upside to theoretical value are considered value-creators at a reasonable price (QARP).

The 'high benchmark' QARP screen portfolio provided a 23% return versus 9% for the Kospi and 19% for the CLSA coverage universe

The QARP Korea portfolio for 2004 provided a better return of 15.7%, outperforming the market return of 9% but underperforming the CLSA coverage universe return of 19.2%. However, increasing the hurdle rate for the QARP from 10% upside to 100% produced a portfolio that provided a 23% return. This performance was driven by a 50% return in KT&G and a 25% return from Woori Financial Holdings.

Adding a value screen to the CG scores seems to produce better returns

The 9.3-ppts of outperformance shown by the second QARP portfolio is significant. Although this is based just one year's performance, Korea is one of the nine markets last year, of the ten that we survey in this report, where the QARP portfolio outperformed top-quartile CG stocks. It is one of the eight markets where the QARP stocks outperformed the country index. Adding a valuation dimension (PB) to picking stocks with good financials (ROE above cost of equity) and high CG intuitively should give better performance than simply choosing stocks with high CG irrespective of financials and valuations.

QARP portfolio screened for stocks that were in the top half of the CG rankings and had more than 100% upside to theoretical PB

Figure 4

2004 performance of CG quartiles, QARP and country index

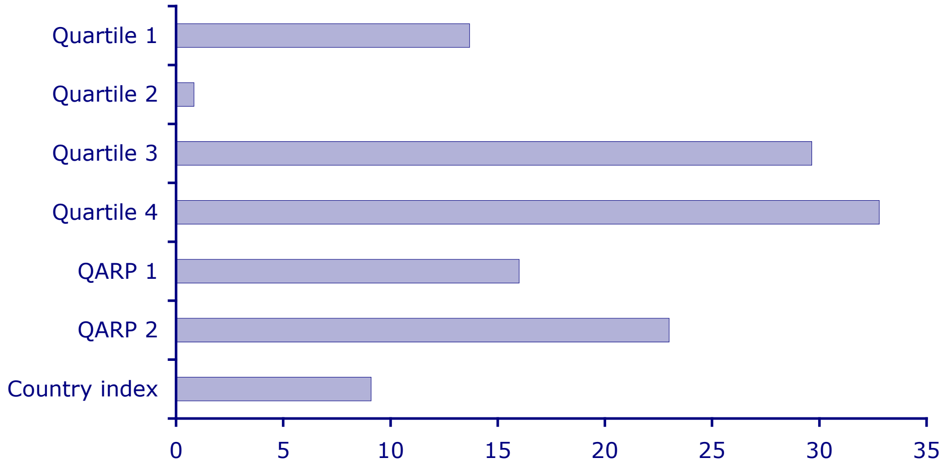

Figure 5

QARP list 1 (More than 10% upside to theoretical PB): Jan-2004 valuations and stock performance

Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 perf (%)
Hana Bank	21.7	12.3	5	2.3	0.8	180	1	17
Hanjin Shipping	42.1	12.8	3	4.0	1.2	228	2	9
Hankook Tire	14.5	11.7	4	1.4	1.1	21	1	13
KOGAS	8.3	7.7	3	1.1	0.6	91	1	30
KT	14.6	9.8	0	1.5	1.3	18	1	(7)
KT&G	16.6	6.9	1	2.6	1.1	141	1	50
POSCO	26.0	11.4	3	2.7	0.8	226	1	15
Samsung Electronics	30.1	12.3	5	3.5	2.3	51	1	(0)
Shinhan Financial Group	18.8	12.5	5	1.8	1.1	65	1	23
SKT	22.5	9.8	2	2.6	2.3	15	2	(1)
Woori Financial Holdings	16.9	13.1	5	1.5	0.7	108	2	25
Average								**15.7**

Figure 6

QARP list 2 (Over 100% upside to theoretical PB): Jan 2004 valuations and stock performance

Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 perf (%)
Hana Bank	21.7	12.3	5	2.3	0.8	180	1	17
Hanjin Shipping	42.1	12.8	3	4.0	1.2	228	2	9
KT&G	16.6	6.9	1	2.6	1.1	141	1	50
POSCO	26.0	11.4	3	2.7	0.8	226	1	15
Woori Financial Holdings	16.9	13.1	5	1.5	0.7	108	2	25
Average								**23.0**

Source: CLSA Asia-Pacific Markets

Six stocks pass the QARP screen for 2005

Korea QARP picks 2005

Following Korea's strong performance this year, far fewer stocks are trading at large discounts to theoretical PB values. We are unable to reproduce the 'high-hurdle' QARP index referred to above this year. Even using 10% upside to fair value as` the cutoff produces list of only five stocks.

These are companies which rank in the upper half for CG within the market, with high ROE and at least 10% upside to theoretical value. The companies that make it for the current list for Korea, as shown in Figure 7, are Kogas, KT&G, Posco, Samsung Electronics and SK Telecom.

Figure 7

QARP list: June 2005 valuations

Co.	FY05-06 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (30-Jun-05) (x)	Upside to theor. PB (%)	CG quartile (1-4)
KOGAS	6.6	7.7	3.0	0.8	0.6	16.6	2
KT&G	17.7	6.9	1.0	2.8	1.9	50.0	1
POSCO[1]	13.8	11.4	3.0	1.3	0.8	55.0	1
Samsung Electronics	24.2	12.3	5.0	2.6	2.4	10.5	1
SKT	20.6	9.8	2.0	2.4	1.9	22.9	2

[1] For Posco, we use the 10-year average return on equity. Source: CLSA Asia-Pacific Markets

The key inputs for the VCARP criteria, the financials leg of QARP, are ROE, cost of equity and ascribed long-term growth. The ROE used should reflect what is sustainable long-term, which is somewhat subjective. We use average FY05-06 projected ROE as an approximation, except in the case of Posco where we use the average ROE generated over the past ten years. This is because we believe that Posco's ROE is near to peak-cycle levels and unsustainable. Still, Posco still makes the QARP cut.

Cost of equity is derived from CAPM with 5% as the risk-free used for this exercise (approximately the 10-year Treasury yield), a 4% general equity risk premium across markets and an additional 1.5% country risk premium for Korea. This give a 5.5% market risk premium and a market cost of equity of 10.5%. Beta is derived from Bloomberg. The ascribed long-term growth used in general is between 0-5%, depending on the perceived sustainability of growth.

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Malaysia - Work in progress

Following the accelerated rate of reforms introduced in 2001 and implemented in 2002 and 2003, the Malaysian CG environment over the past year did not see much major change. It remains a work in progress. No major issues were confronted in the country. This is reflected in a flat CLSA CG score of 62.4% versus 62.5% in 2004. The country score, however, was reduced to 56% from 60% as the scoring criteria got more stringent.

Moving in the right direction, but no major changes in the past year

Generally, we note positive momentum on the GLC reform front and firm political will to increase corporate transparency. Enforcement remains a major CG issue, as has been the case for some time. More could always be done on this front, but this is a subjective element.

As for stock picks, QARP has not worked as well as other markets in the 2004 period. This was a function of an upward trending market with focus on higher beta stocks. The focus on this method should be long term and also incorporate the risk of the stocks held. On current valuations of FY05-06F ROE, the following top half quartile CG stocks have upside: JTI, IJM, SP Setia, BAT, and Guinness.

Country CG score

Figure 1

Malaysia ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	59	71	No major changes – work in progress
Enforcement	49	50	Enforcement publicly demonstrated, eg Fountain View Dev share manipulation case
Political & regulatory environment	60	50	Firm political will to improve accountability and transparency
Adoption of international accounting/auditing standards	75	90	Efforts continuing to keep reporting standards in-line with international standards, including Employee Benefits and Retirement Benefit Plans. IFRS adopted progressively by companies from 2004 – a more conservative accounting approach. Malaysia is ahead of many Asian countries in adopting these
CG culture	38	46	Generally no major change

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

Malaysia's overall country score was basically flat at 56%. Malaysia still scores highly for accounting standards. However, the category for rules and regulations also now captures to what extent the rules are practiced, and this pulled down the score for that segment. The score for CG culture – ie the general practice of good governance, and influence of market intermediaries – is lowered by our new criteria. (See Appendix 1 for full details). Of companies covered by CLSA in this survey, the average company score was also about flat at 62.4% versus 62.5% last year.

Regulatory environment

Malaysia has not seen any major changes in the regulatory environment over the past year specific to corporate governance. A minor point perhaps, but it is worth noting that Malaysia joined the Independent Directors Register

Implementation is a work in progress still but some signs of tougher enforcement

(*www.icaew.com. my/idregister*) in April 2005, putting the country into a global network and longer term helping raise standards locally, notably in companies' efforts to source independent directors. The register was first launched in the UK in November 2004 (and has 1,200+ members).

The recommendations in the Finance Committee Report on Corporate Governance – as published in March 1999 and triggered by weakness exposed by the Asian Crisis - remains a work in progress. As at 31 December 2004, 42.5% of the recommendations had been completed. A year earlier, the same proportion had been implemented, suggesting the momentum has stalled for now. Previous implementation has been achieved through reforms of regulations (eg the revamp of Listing Requirements of Bursa Malaysia and securities law amendments), institutional reforms (eg the establishment of MSWG) as well as the introduction of relevant industry best practices.

There was however some progress on the Capital Market Masterplan (CMM, released February 2001), an effort meant to further contribute to the development of Malaysian corporate governance reforms from 2001 to 2010. As at 30 June 2005, 96 recommendations of the CMP's list totaling 152 had been completed. This brings the number of completions to 63% versus 59% as of September 2004. Of the remaining recommendations, 3% are not due in Phase 2 (2004-5).

On the whole, new recommendations completed in the past year under the CMM did not have much CG significance for the market. Measures implemented were more structural in nature, eg the issuance of five new licenses to foreign stock broking houses.

On the enforcement front, the SC has issued various warnings & fined companies for accounting irregularities. Plus, the SC also criminally prosecuted and secured conviction of two individuals/directors for share manipulation of Fountain View Development Berhad. This was the key fall-out from the share margin finance debacle of mid-2005. The SC also secured conviction against individuals in cases relating to (1) P&D Bhd and (2) Omega/Energro/Milan Auto. These cases relate to misutilisation of public issue proceeds and submission of false information to the SC, respectively. Taken together, these represent enforcement milestones.

Companies – the good, the bad and the ugly

Some transparency issues, but generally the bigger companies were well-behaved in terms of CG

During the year, Malaysia's bigger companies were generally 'well-behaved' without any major scandals, partially driven by the positive momentum behind the Khazanah GLC revamp. The latter is gradually firming up management transparency, notably on the procurement front.

On the other hand. we note general transparency issues in recent results by MAS and Proton, especially the latter. MAS saw a surge in "other" costs, while at Proton, there were two write-offs which were not properly explained (relating to exports of autos and loans forwarded to jointly controlled entities). It is possible that there were not enough protective clauses to safe-guard Proton's interests in both transactions. The upshot here is however positive – both MAS and Proton are now undergoing changes in management with MAS having hired a new MD and embarked on a multi-year rationalisation/restructuring drive. Proton, meanwhile, is in talks with VW over future cooperation and the possibility of VW taking an equity stake.

Elsewhere, high profile CG-related cases during the year primarily involved smaller companies – eg Goh Ban Huat, Setegap, MP Technology Resources, Oilcorp, Fountain View (as described above) and Aktif Lifestyle. The three former ones involved non-issuance of annual audited accounts within the stipulated time. The Oilcorp and Aktif Lifestyle cases also involve annual audited accounts, but it is more of a transparency/accuracy issue.

Minorities are taking a more active interest in corporate moves, however this is coming off a low base. For example, the Kumpulan Guthrie restructuring came under much scrutiny as minorities felt prices offered for the privatisation of Guthrie Ropel and Highlands & Lowlands were too low. Subsequently, the Guthrie consolidation was halted in early 2005, pending a review of the next course of action.

Going forward we expect to see improvement in CG scores, primarily among the government-linked companies (GLC), eg Tenaga, Telekom and Commerce Asset. This is on the back of the comprehensive Khazanah-led GLC reform which is entering its second year. Commerce Asset and CIMB have already seen strong improvements, as per below.

Figure 2

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

Top quartile	Second quartile
Public Bank	SP Setia
Tanjong	IJM
Commerce Asset	Sime Darby
Road Builder Holdings (RBH)	Courts Mammoth
Maybank	Guinness
CIMB	Malakoff
Nestle	Transmile Group
Maxis	Hong Leong Bank
BAT	Unisem
IOI Corp.	Naim Cendera
Carlsberg	JTI
Gamuda	Astro
KL Kepong	Media Prima

Source: CLSA Asia-Pacific Markets

Changes in CG scores

Top CG improvements came from the finance sector

The top three stocks reporting the highest CG improvements were all finance sector members: Commerce Asset, Hong Leong Bank and CIMB.

Figure 3

Companies with changes in CG scores (improvements): 2004-05

	Chg in CG score (ppts)	2005 quartile ranking
Commerce Asset	12.0	1
Hong Leong Bank	9.2	2
CIMB	8.9	1
Maxis	6.9	1
Tanjong	5.6	1
Telekom	5.6	3

Source: CLSA Asia-Pacific Markets

Commerce's senior management had been steadily increasing operational transparency and investor access over 2004, culminating in a kitchen-sinking exercise in 4Q04 that saw the group adopt a slew of industry best practices regarding collateral recognition, NPL classification. The positive newsflow continued into 2005 with Khazanah increasing its stake and a well-received restructuring which will see the group's investment bank CIMB CEO Nazir Razak take the helm of the combined commercial and investment banking platform.

Hong Leong Bank had a rocky CG2004 on the back of departure of senior management and negative provisioning surprise depressed sentiment on the stock, the new management team is bedding down. Investor access still leaves much to be desired but underlying governance improvements have been implemented such as an increase in the number of independent directors and the setting-up of remuneration and nominating committees.

Already among the most transparent and accessible companies in Malaysia, **CIMB** nonetheless managed further improvements over the past year. The number of independent directors was increased while speed of conveying price-sensitive information to the market improved further. It is expected CEO Nazir Razak will progressively transplant similar practice to parent Commerce.

Maxis have always been in the forefront of CG. Maxis continued to improve on its transparency and management accessibility. Maxis have disseminated information at face value despite knowing the repercussion to its share price. Furthermore, it has also very few and immaterial direct-related party transactions with major shareholder or any directors.

A long-time corporate governance poster-child for Malaysia, **Tanjong** is still showing incremental improvement. Besides increasing the number of independent directors on the board, senior management has made it a point to convey price-sensitive information ie maintenance issues re its power plants, problems with its Tropical Island investment in Germany, to the investment community as clearly and speedily as possible

Telekom, being a proxy of GLC restructuring, has taken the lead in CG improvements in 2004. Continuing this trend, it had revamped the procurement process by implementing competitive bidding and reducing middlemen dealings. Furthermore, to improve staff compliance, it has intensified its compliance activities and had its entire staff sign a compliance agreement.

Figure 4

Companies with changes in CG scores (deterioration): 2004-05

	Chg in CG score (ppts)	2005 quartile ranking
AMMB	(10.8)	4
EON	(5.1)	4

Source: CLSA Asia-Pacific Markets

The biggest deterioration in CG scores were at AMMB and EON. MAS saw a drop, but that was because of changes in independent directors between FY03-04. In the recently announced FY05 annual report, the number of independent directors increased, raising its score. Hence we do not include it in the above list.

AMMB and MAS saw deterioration

AMMB has had a terrible year with the crystallisation of numerous corporate governance overhangs going hand-in-hand with a sharp de-rating of the stock. Management operational guidance has consistently turned out to be overly-bullish while an otherwise sensible group restructuring was marred by the allocation of "cheap" shares in the group's investment bank (which has since IPO-ed) to the AMMB group chairman and major shareholder.

Does QARP work?

The top half of CG scores, as per Figure 5, delivered a 10.9% average performance in 2004. The market (KLCI) gave a return of 15% during the same period. From this perspective, QARP does not work. But there are many factors involved. In a market which is trending up, higher beta stocks benefit. These are sometimes higher beta because of quality issues. See performance of Quartile 3 in Figure 6. In a down market and in the longer term, the QARP method would probably do better.

Figure 4

QARP list: Jan-2004 valuations and stock performance

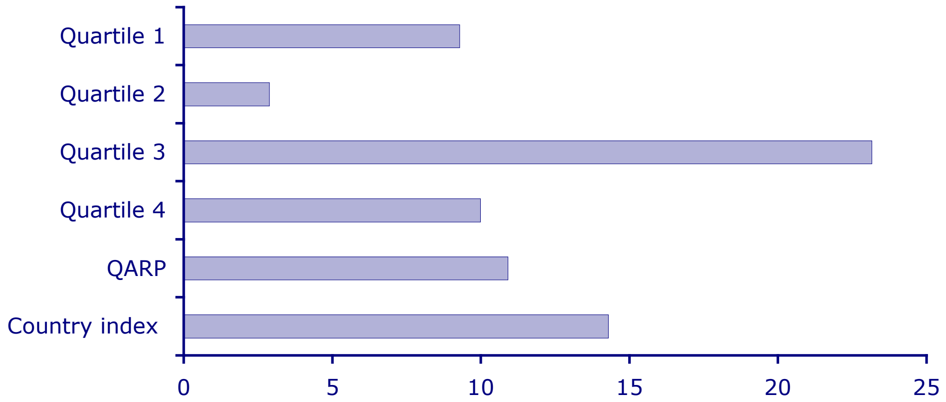
Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 stock perf (%)
BAT	300.1	6.3	3.0	88.9	60.7	46.52	1	5.2
Guinness	33.1	7.7	3.0	6.4	4.6	37.65	2	20.9
Tanjong	18.7	10.0	5.0	2.7	2.0	37.00	1	30.6
JTI	18.8	7.5	3.0	3.5	2.9	23.66	2	(3.1)
CIMB	20.2	10.0	4.0	2.7	2.2	22.73	1	28.4
Carlsberg	17.2	7.0	3.5	3.9	3.3	18.20	1	(3.6)
KL Kepong	10.5	8.9	3.5	1.3	1.1	17.41	1	3.0
Nestle	54.7	6.6	3.0	14.2	12.8	11.20	1	6.0
Ave performance								10.9

Source: CLSA Asia-Pacific Markets, Bloomberg

Neither higher CG stocks nor QARP basket gave outperformance in 2004

Figure 5

2004 performance of CG quartiles, QARP and country index



Source: CLSA Asia-Pacific Markets

QARP picks: 2005

On current valuations of FY05-06F ROE, the following top-half quartile CG stocks have upside: JTI, IJM, SP Setia, BAT, Guinness. The lack of significant upside elsewhere is a reflection of the Malaysian market's valuation. Also, we note that some stocks do not lend themselves well to VCARP analysis – eg Astro which is a J-Curve story better valued using DCF.

Figure 6

Current QARP list: end-2005 valuations

Co.	FY05-06 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (30-Jun-05) (x)	Upside to theor. PB (%)	CG quartile (1-4)
JTI	18.2	7.1	3	3.7	2.4	58.25	2
Naim Cendera	20.7	10.9	5	2.7	1.9	42.51	2
IJM	10.8	9.2	5	1.4	1.1	24.36	2
SP Setia	13.8	9.9	5	1.8	1.5	19.05	2
BAT	230.3	7.5	3	50.5	45.3	11.48	1
Guinness	33.7	8.5	3	5.6	5.1	10.68	2

Source: CLSA Asia-Pacific Markets, Bloomberg

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Philippines - Chugging along

The laws are in place but there is still work to be done to instil the right culture and commitment to CG

The Philippines has taken measures to improve CG with the implementation of the Securities Regulation Code (SRC) in 2000 and the Code of Corporate Governance (CCG) in 2002. The Central Bank, by virtue of its regulatory powers, has been at the forefront in mandating CG briefings for banks covering the anti-money laundering act (AMLA). Additional legislation to prevent corporate fraud and abuse, in the form of the Corporate Reform Act, however, is still finding its way through Congress.

Still, in practice, a lot needs to be done to instil the right culture and commitment to CG. Specifically, the laws and policy framework look good on paper but there is more to be desired in terms of implementation and enforcement of these laws.

QARP works in the Philippines

QARP seems to work in the Philippines. The stocks in our QARP list outperformed the market in FY04. Specifically, the stocks namely PLDT, First Philippine Holdings, and Banco De Oro appreciated by an average of 48% in FY04 as against market performance of 27%.

For 1H05, there are no stocks in the top 2 CG quartiles with at least 10% upside potential. Manila Water is the closest with 3% upside

For 2H05, there are no stocks in the top two CG quartiles with at least 10% upside potential. This is mainly due to the fact that we are using a high cost of equity for the market (15.3%) and hence none of the stocks now have more than 10% upside, but Manila Water is the closest with 3% upside. Manila Water landed in the second quartile in the CG survey. FY05-FY06 average ROE is at an impressive 23.9%. We also have Manila Water as one of our top picks in the market due to its strong market franchise, low PEs of only 5.6x in FY05 and 8.4x in FY06, and possibility of acquiring Maynilad Water from the government sometime in 1H06. We have a 12-month target price of P7.60/share suggesting 18% upside from current share price of P6.40/share.

Country CG score

Slight deterioration in country score due to emphasis on implementation of rules

Figure 1

Philippine ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	53	58	More rigorous scoring with emphasis on implementation of rules in addition to rules on paper.
Enforcement	22	31	Score reduced due to focus on regulatory enforcement on insider trading / market manipulation and disclosure on regulatory track record.
Political & regulatory environment	50	50	Government still lacks a clear and credible policy in support of corporate governance reform. However, disclosure on laws and regulations are good. Stock exchange has good on-line data base.
Adoption of international accounting/auditing standards	82	85	Accounting and auditing standards are close to international standards. Philippines accounting and auditing in line with international norms.
CG culture	31	31	Average listed company does not believe that good governance will bring tangible benefits. Limited progress on improving transparency and internal checks and balances. Market discipline also weak.

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

Ranking within the ten markets covered unchanged

The Philippines shows a slight deterioration in country score to 46% this year from last year's 50%. It is ranked eighth of the ten countries tracked by CLSA, the same as last year's rankings. Overall, the rules and regulation are good in the Philippines but the country score fell since a more rigorous approach was taken this year with emphasis on implementation and execution of rules. Moreover, the government still lacks a clear and credible policy in support of corporate governance reform. Further, the average listed company does not believe that good governance will bring tangible benefits. We note limited progress on improving transparency and internal checks and balances.

Regulatory environment

The salient points of the SRC and CCG introduced in 2000-02 are:

- ❑ Publicly listed companies are required to have at least two independent directors or at least 20% of its board size in its board.
- ❑ Higher qualifications and ethical standards have been set for board directors. For instance, directors should at least be college graduates.
- ❑ A tender offer to all shareholders is mandatory should any person or group acquire 35% or more of the existing shares of a public company. Previously, there were no tender offer rules in the country.
- ❑ External auditors are required to be rotated or replace every five years.
- ❑ Companies are required to form committees for audit and compliance, nomination and compensation, and risk management.
- ❑ Corporations must have an independent auditor and audit committee reporting to an independent director.
- ❑ Disclosures must be made within five business days on the acquisition of more than 5% of the stock of a company.
- ❑ It is unlawful for any person to manipulate the share price of a company and for brokers/dealers to execute orders for such share price manipulation.

Additional legislation to prevent corporate fraud and abuse, in the form of the Corporate Reform Act (CRA) is likewise still lodged in Congress. The CRA is patterned after the Sarbanes-Oxley Act of the US. The political campaign season for the May 2004 elections that kicked off early in late 2003 as well as the ongoing political uncertainty in the country has held up the CRA in Congress. With Congress busy in tackling the proposed change in the country's constitution, the CRA may take some time to get enacted.

The salient points of the CRA are:

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

Companies – the good, the bad and the ugly

CG stars

As usual, the Ayala Group of companies leads the pack

The Ayala Group, spearheaded by Ayala Corp (AC) and including Ayala Land (ALI), Globe Telecom (Globe), Bank of the Philippine Islands (BPI), and newly listed Manila Water are at the top of our CG rankings for the Philippines, given the group's excellent reputation and deep commitment to CG practices. Note that in FY04, the Ayala Group of companies were also represented in the top two quartiles of our CG survey. Maintaining its position in the top two quartiles were PLDT, Equitable PCI Bank, Banco De Oro, and First Philippine Holdings. Finally, ABS-CBN was able to make it the second quartile from third quartile in FY04.

CG disappointments

Some big names have been CG disappointments in our view

The major CG disappointments include Jollibee, Metrobank, Semirara Mining, and San Miguel Corporation. For Jollibee note that the company released its audited financial statements after the April 15, 2005 deadline. Management mentioned that they requested for an extension with the Securities and Exchange Commission (SEC) as it needed more time to review its financial statements. On Semirara Coal Corporation, the company failed to make timely and appropriate disclosures related to its dependence on main buyer Calaca plant and the status of its operations. San Miguel Corporation and Metrobank are also disappointments as we find their disclosure standards below that of other big-cap names in the Philippines.

Figure 2

Companies in the top two CG quartiles for the Philippines

Top quartile	Second quartile
Ayala Corporation	Banco De Oro
Bank of the Phil. Islands	ABS-CBN
Equitable-PCIBank	Manila Water Company
Ayala Land	First Philippine Holdings
Globe Telecom	PLDT

Source: CLSA Asia-Pacific Markets

Changes in CG scores

Figure 3

Companies with changes in CG scores: 2004-05

	Chg in CG score (ppts)	2005 quartile ranking
Ayala Corp.	(5.6)	1
Meralco	0.8	1
Banco De Oro	1.5	2
San Miguel Corp.	1.7	4
Ayala Land	1.8	1

Source: CLSA Asia-Pacific Markets

The scores of Philippine companies did not change that much in FY04-FY05. The biggest change in score came from Ayala Corporation which decreased by 5.6 points due to a lower score in the accountability section, eg a reduction in directors compared to three years ago.

Does QARP work?

Stocks in our QARP list outperformed the market in FY04

QARP seems to work in stock picking for the Philippines. The stocks in our QARP list outperformed the market in FY04. Specifically, the stocks namely PLDT, First Philippine Holdings, and Banco De Oro appreciated by an average of 48.33% in FY04 as against market performance of 27%. Going to stock specifics, First Philippine Holdings share price appreciated by 58% in FY04 followed by Banco De Oro which rose 48% and then by PLDT which gained 39%.

A quick look at Figure 5 highlights that top-tier stocks in our CG survey (Tier 1 and 2) did very well in terms of share-price performance vis-à-vis lower-tier stocks in our CG survey (Tier 3 and 4). Specifically, Quartile 1 stocks appreciated by an average of 30.25% whereas Quartile 2 stocks were the best performing stocks in FY04 appreciating by an average of 44.8%. Quartile 3 stocks appreciated the least at 7.8% whereas Quartile 4 stocks appreciated by 19%.

QARP stocks outperformed stocks in Quartile 1 and 2 of our CG survey

It is worth highlighting that QARP stocks beat Quartile 1 and Quartile 2. Specifically, QARP stocks appreciated by 48% as against 30.3% for Quartile 1 stocks and 44.8% for Quartile 2 stocks.

Figure 4

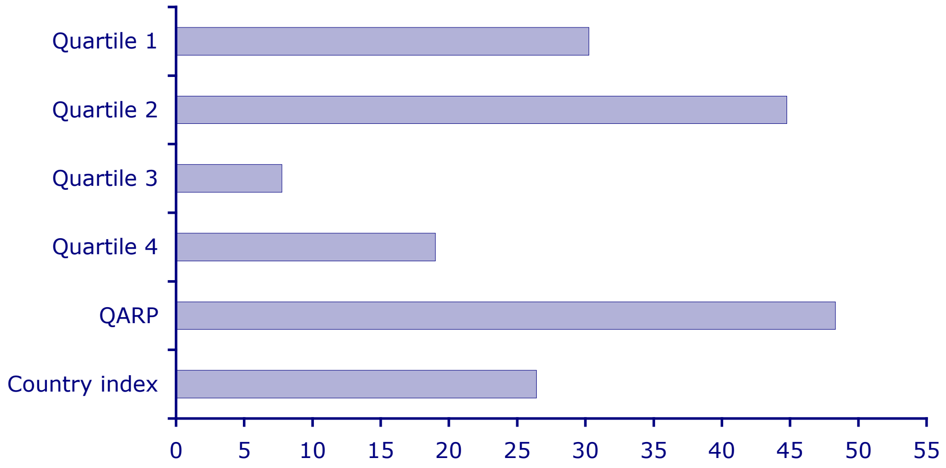
QARP FY04 picks

Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 stock perf (%)
PLDT	63.8	17.06	3	4.32	3.8	13	2	39.0
First Phil. Holdings	17.8	17.61	3	1.01	0.4	135	2	58.0
Banco de Oro	12.2	11.67	5	1.07	0.9	26	2	48.0
Average								48.3

Source: CLSA Asia-Pacific Markets

Figure 5

2004 performance of CG quartiles, QARP and Philippine composite index



Source: CLSA Asia-Pacific Markets

QARP picks

For 2H05, there are no stocks in the top two CG quartiles with at least 10% upside potential. Manila Water is the closest with 3% upside

Figure 6

2H05 QARP picks

Co.	FY05-06 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (30-Jun-05) (x)	Upside to theor. PB (%)	CG quartile (1-4)
Manila Water	23.9	16.07	4	1.64	1.6	3	2

Source: CLSA Asia-Pacific Markets

For Manila Water, we have a 12-month target price of P7.60/share suggesting 18% upside from current share price of P6.40/share

For 2H05, there are no stocks in the top two CG quartiles with at least 10% upside potential. This is mainly due to the fact that we are using a high cost of equity for the market (15.3%) and hence none of the stocks now have more than 10% upside, but Manila Water is the closest with 3% upside. Manila Water landed in the second quartile in the CG survey. FY05-FY06 average ROE is at an impressive 23.9%. We also have Manila Water as one of our top picks in the market due to its strong market franchise, low PEs of only 5.6x in FY05 and 8.4x in FY06, and possibility of acquiring Maynilad Water from the government sometime in 1H06. We have a 12-month target price of P7.60/share suggesting 18% upside from current share price of P6.40/share.

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Singapore - Emerging from mishaps

Notwithstanding recent CG mishaps, Singapore companies have generally improved their CG practices

Over the past year, Singapore has had more than its fair share of CG problems. This raised investor concern, however the country retains its pole position in CLSA's annual CG survey – although the gap has narrowed significantly with HK based on the more stringent country questionnaire adopted this year. In Singapore's favour are greater independence for the board of directors and widespread CG awareness at local firms. Regulators are tightening rules, but perhaps more can be done. Average CG score for Singapore companies has improved from 61.1% last year to 62.8% in 2005. Long-term value creators like SingTel, Keppel Corp, ST Engineering, MobileOne and Singapore Exchange have strong CG records. In this year's study, we have combined CG with VCARP (value-creators at a reasonable price) to find quality companies at the right price.

Country CG score

Singapore retains its pole position in Asia

Singapore retains its pole position in CLSA's annual CG rankings, although its overall scores declined marginally from last year's 75% to 70% in 2005. Most countries saw a decline in their scores this year, as we generally took a more stringent view of the macro-determinants. Singapore's regulatory, accounting and auditing standards and disclosure levels remain fairly high, compared to rest of Asia. However, its enforcement track record and reputation have suffered in view of recent CG debacles.

Figure 1

Singapore ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	74	79	Financial reporting and disclosure standards remain fairly high
Enforcement	56	65	Enforcement track record and reputation suffered in view of recent CG scandals
Political & regulatory environment	73	81	Regulators remain proactive in constantly reviewing securities laws and listing rules
Adoption of international accounting/auditing standards	95	95	Accounting and auditing standards are fairly evolved and remain the best in Asia
CG culture	57	58	Large-cap and small-cap companies making genuine effort to improve CG and communication with shareholders

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

Regulatory environment

Partly in response to recent quick-pace debacles at Accord Customer Care Services (ACCS), Citiraya, China Aviation Oil and Informatics, the Singapore Exchange (SGX) is proposing tightening of listing norms. It issued a consultation paper in the last week of June 2005 inviting public response, with likely implementation by end of this year. The new measures proposed by SGX will make it onerous on companies to have at least two independent directors at all times.

As is generally the case, many progressive companies are expected to voluntarily opt for greater disclosures and compliance than is required by statue or code of conduct.

New measures are focused on greater independence of the board

Proposed amendments to SGX's listing rules regarding CG

- All listed companies required to have at least two independent directors on a continuous basis and not just at listing.
- Board of a foreign company listed in Singapore must have two independent Singapore resident directors on a continuing basis.
- Board of a foreign company must also have one of the following:
  - A qualified person in Singapore to advice on local laws
  - Another director resident in Singapore (in addition to two independent directors)
  - An executive officer resident in Singapore
- For interim results, boards must provide a "negative assurance" confirmation that there is nothing that may render the financial results to be false or misleading.
- Boards and CEOs must provide an annual confirmation that staffing, procedures and reporting channels relating to internal controls are in order, and that there is nothing in the internal controls that would have a materially adverse impact on the company.

In August 2005, the Monetary Authority of Singapore (MAS) tightened the regulatory norms for banks and life insurers specifically to reflect the special role they play in the economy. Under a new law that is mandatory, a majority of board members must be independent and the roles of chairman and chief executive must be separate.

Moreover, an independent director will now have to satisfy three criteria instead of two. The director must be independent from the management, substantial shareholders and from business relationships.

Companies – the good, the bad and the ugly

Lapses at the four erring companies – ACCS, Citiraya, China Aviation Oil (CAO) and Informatics - ranged from mismanagement to misappropriation. While the larger listed companies are not free from fraud and accounting lapses, recent corporate failures have been mostly concentrated among the smaller cap companies. Ironically their disclosures and transparency seemed sufficient.

Erring companies lacked effective governance, risk management and compliance

These cases highlight the fact that misconduct at senior management level is extremely difficult to detect – even for the company's auditors. What the companies also lacked were effective governance, risk management and compliance.

Figure 2

CG debacles in Singapore

Company	Auditors	Indep directors	Issues	Current status
ACCS	Deloitte & Touche	4/12	Overstatement of revenue and profit in previous years	Chairman, CEO and CFO changed. Company appears to have a sound business model and is a going concern
China Aviation Oil	Ernst & Young	3/9	Poor internal risk control; use of inappropriate methodology to value outstanding derivatives	Five senior officials, including the CEO, face criminal charges; Creditors approved debt repayment plan; new investors may inject capital; stock remains suspended
Citiraya	Deloitte & Touche	2/6	Suspected tampering of waste material meant for recycling; investigations inconclusive	Two white knights, Oei Hong Leong and Heshe Holdings stepped in at the 11th hour with a S$20m investment; stock remains suspended
Informatics	Arthur Andersen/Ernst & Young	na	Overstatement of revenue and profit in previous years; management not implicated	Going concern but cashflow not yet stable; timely entry of a white knight saved the company from complete collapse

Source: CLSA Asia-Pacific Markets

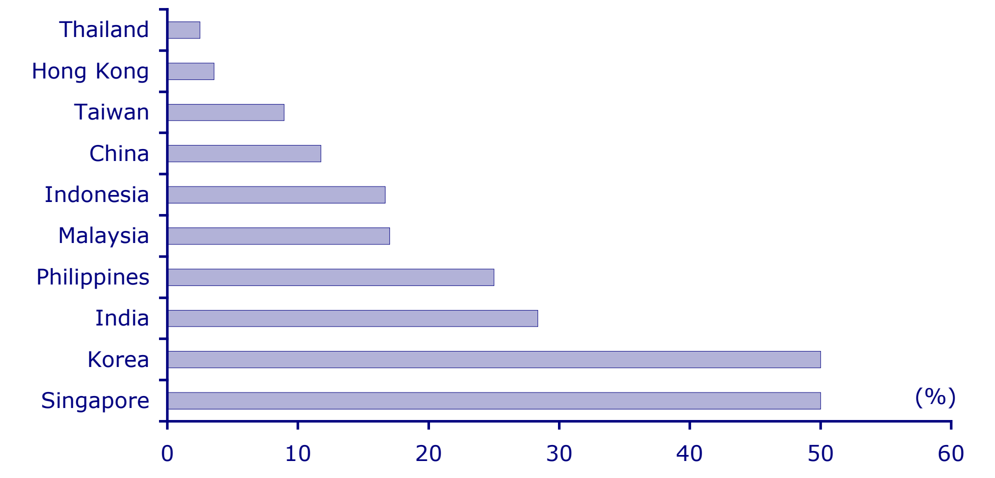
A key positive differentiator for Singapore companies is the greater independence of their boards, since independent directors are seen as having an important role in protecting minority interests. While this is by no means a guarantee against CG lapses, independence of the board is certainly a big step in the right direction.

Independents make up more than half of the board for 40% of companies

Boards of Singapore companies are more independent than their peers across Asia, with independents making up more than half of the board for 40% of companies. Also 80% of companies here have increased the number of independents since 2000. While the Singapore CG code encourages a more independent board, this is not binding on listed companies here, and the move is largely voluntary.

Figure 3

Percentage of companies where independents make up more than half the board



Source: CLSA Asia-Pacific Markets

Figure 4

Percentage of cos that increased the no of independent directors since 2000

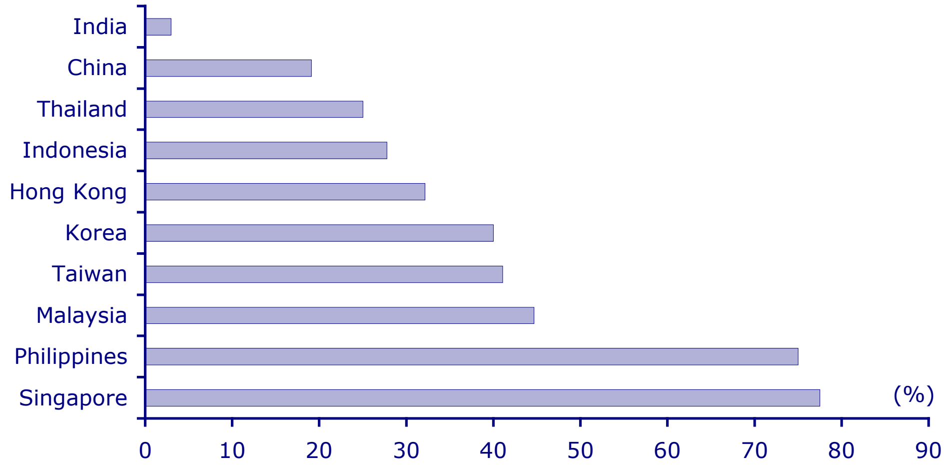
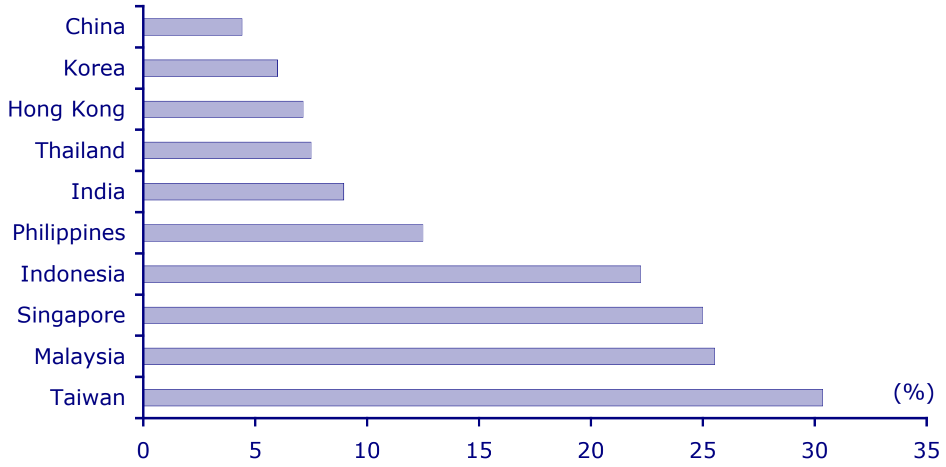


Figure 5

Percentage of companies with independent non-executive chairman



Source: CLSA Asia-Pacific Markets

It is required to have a stricter definition of independent directors

While a largely independent board is comforting for investors, what is now required is perhaps a stricter definition of independent directors, so that they are actually independent of management and substantial shareholders. This is still lacking in Singapore, as it is elsewhere in Asia.

One way to ensure the independence of directors is to be nominated by minorities. Regulators would do well to come out with some sort of guideline on that front. Nomination of directors by minorities is not a widely practised phenomenon across Asia, but it does happen for select companies in markets such as Hong Kong, Korea, Philippines and Taiwan.

Some companies are voluntarily formulating a whistleblowing policy for their employees

Besides independent directors, whistleblowers can play an important role in revealing corporate fraud. Introducing legislation to protect whistleblowers has been suggested but, in the meanwhile, a few companies are voluntarily taking steps in this direction. OCBC has initiated a programme to train its 8,000 employees on the whistleblowing policy, whereby the identities of whistleblowers and employees under investigation are kept confidential. The whistleblower is kept informed of the status and outcome of investigations.

CG stars and long-term value creators

Companies with good CG records also make for good investments

SingTel, Keppel Corp, ST Engineering, MobileOne and SGX all feature in the top half of CLSA's CG rankings. The first three are Temasek-linked companies (TLCs). The TLCs earlier suffered from a perception of having made expensive overseas acquisitions at Temasek's behest. Consequently, these TLCs were penalised in our CG rankings. This perception has now somewhat abated.

There are two reasons for this change in perception about TLCs: First, in hindsight many of these acquisitions do not appear value-destroying as they looked at the time of the acquisitions, eg, SingTel-Optus. Second, Temasek is now on an acquisition spree by itself, without involving the TLCs and in some cases actually competing with these fellow companies. This should result in further improvements to the CG scores of TLCs in the future.

Excellent disclosure, guidance, management access and highly independent board make these companies sound investments

Excellent disclosure, guidance, management access and highly independent board make these companies sound investments on a sustained basis.

Figure 6

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

Top quartile	**Second quartile**
SingTel	MobileOne
OCBC	Cosco Corp Singapore
ST Engineering	Keppel Corp
Singapore Exchange	DBS Group Holdings
Jurong Tech	Singapore Press
Unisteel Tech	SembCorp Marine
Singapore Post	ComfortDelGro
	NOL

Source: CLSA Asia-Pacific Markets

Changes in CG scores

Which companies have had more than 5% changes in CG scores from last year. Comments on which have seen the biggest improvements and those that have seen declines.

SingTel, OCBC, NOL and Cosco have all significantly improved their CG scores

SingTel was penalised in earlier years due to some controversy over its Optus acquisition. This has now been ameliorated. SingTel's rankings also improved due to an increase in percentage of independent directors. Out of an eleven-member board, ten directors are independent, making SingTel's board perhaps the most independent in the region.

Independent directors now constitute majority of the board in case of OCBC. NOL has reduced its board to a total of 11 members and now has a clearly stated dividend policy. It also has a stated environmental policy.

Sing Post was penalised due to controversy over proposed ACCS transaction where directors had interests in the target company.

Figure 7

Companies with changes in CG scores: 2004-05

	Chg in CG score (ppts)	2005 quartile ranking
Singtel	12	1
OCBC	8	1
NOL	20	2
Cosco	8	2
Singapore Post	(6)	1

Source: CLSA Asia-Pacific Markets

Does QARP work?

The QARP Singapore portfolio for 2004 gave a much superior return of 31.5%

The Straits Times Index (STI) appreciated by 15% (excluding dividends) in 2004. The top quartile CG stocks performed 4.5-ppts ahead of this with an average return of 19.6%. The QARP Singapore portfolio for 2004, however, gave a much superior return of 31.5%. These are the stocks in the upper half of our CG rankings within the market last year, which have an ROE above cost of equity and have more than 10% upside to theoretical value by the Gordon growth model. Stocks with ROE above cost of equity and with upside to theoretical value being what we define as value-creators at a reasonable price (VCARP). A full definition and explanation of these criteria is on page 4-8 of this report.

The nine QARP names for Singapore last year rose 31.5% on average. The performance was almost evenly spread out, with ComfortDelgro rising by 90% and Creative and SembLog rising by over 30% each. Only one of the nine stocks selected by these criteria last year gave a return less than STI's 15% rise, viz OCBC.

Figure 8

QARP list: Jan-2004 valuations and stock performance

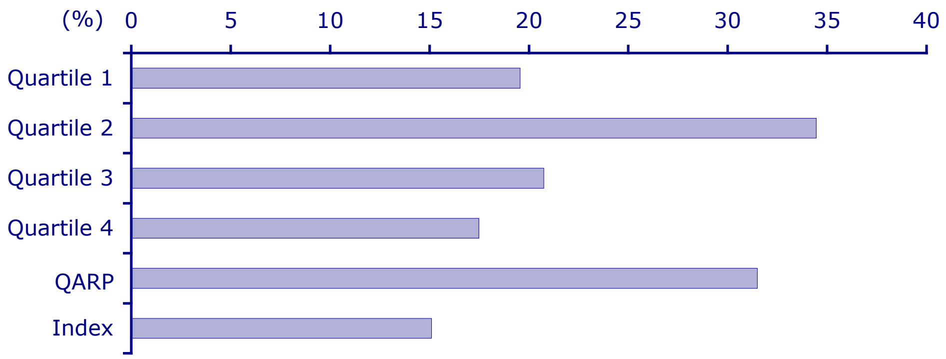
	FY04-05 avg ROE (%)	COE (%)	Est LT growth (%)	Theo. PB (x)	Mkt PB end 03 (x)	Upside (%)	CG quartlie	2004 stock perf (%)
SembCorp Log	108.32	7.9	4	26.58	1.98	1,245.9	2	33.9
Creative	12.03	7.7	4	2.19	0.86	155.4	2	36.3
ComfortDelGro	15.41	6.8	5	5.78	2.52	129.3	2	90.2
SingTel	22.99	7.8	3	4.20	2.61	61.0	1	21.7
Great Eastern	15.98	6.5	4	4.71	3.01	56.2	2	21.5
SingPost	34.53	5.6	2	9.02	6.52	38.2	1	28.1
M1	36.80	6.7	2	7.40	5.48	35.2	1	20.3
SPH	31.02	7.5	3	6.16	5.19	18.6	1	20.0
OCBC	11.60	7.6	3	1.87	1.59	17.7	1	11.6
Average								**31.5**

Source: CLSA Asia-Pacific Markets, Bloomberg

QARP picks for 2004 vastly outperformed STI

Figure 9

2004 performance of CG quartiles, QARP and country index



Source: CLSA Asia-Pacific Markets, Datastream, Bloomberg

We expect our 10 high QARP stocks to deliver good performance even if markets are volatile

Singapore QARP picks 2005

After the 7% rise in the STI from the beginning of 2004 to mid-2005, there are 10 stocks that qualify for our QARP criteria based on mid-2005 valuations. These are companies which rank in the upper half for CG within the market, with high ROE and at least 10% upside to theoretical value. The companies that make it to the current list as shown below include Jurong Tech, ComfortDelgro, M1, SingPost, COSCO, SingTel, Keppel Corp, ST Eng, SPH and OCBC.

Figure 10

QARP list: 2005 valuations

Company Name	FY05-06 ave ROE (%)	COE (Ke) (%)	Est LT growth (%)	Theo. PB (x)	Mkt PB (30-Jun-05) (x)	Upside to theo. PB (%)	CG quartile (1-4)
Jurong Tech	45.9	9.44	5	9.2	3.5	163.0	1
ComfortDelGro	15.6	6.80	5	5.9	2.4	149.4	2
M1	37.8	6.70	2	7.6	4.4	72.9	2
SingPost	34.6	5.61	2	9.0	5.3	71.6	1
COSCO Corp	30.7	8.65	5	7.1	4.7	48.7	2
SingTel	17.8	7.76	3	3.1	2.1	47.3	1
Keppel Corp	18.4	8.30	4	3.3	2.6	28.3	2
ST Engg	29.7	7.11	3	6.5	5.5	18.9	1
SPH	26.3	7.55	3	5.1	4.4	16.8	2
OCBC	11.5	7.59	3	1.9	1.7	12.0	1

Source: CLSA Asia-Pacific Markets, Bloomberg

The key financial inputs for the QARP criteria are ROE, cost of equity and ascribed long-term growth. The ROE used should reflect what is sustainable long-term, which is somewhat subjective. We use average FY05-06 projected ROE as an approximation, except for companies where current ROEs are clearly not sustainable.

Cost of equity is derived from CAPM with 4% as the risk-free used for this exercise (100bps over current 10-year Singapore Government Bond yield) and a 4% equity risk premium. Beta is derived from Bloomberg. The ascribed long-term growth used in general is between 2% to 5%, depending on the perceived sustainability of growth.

CLSA has a BUY/Outperform recommendation on half of the above stocks including, SingTel, Keppel Corp, ST Engineering, Jurong Tech and Sing Post. For other stocks the downside is protected by high dividend yield, in most cases. This list of high QARP stocks should provide good performance even if markets are volatile, as they have steady earnings and predictable dividends.

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Taiwan - Watch out for the government

Sometimes the government looks out for itself rather than minorities

In Taiwan the government is dealing with multiple different objectives. On more than one occasion this year, the national interest did not seem to coincide with good treatment for minority shareholders. The most obvious case in point is the consolidation of the financial sector where we notice the following two points:

1. When the government was selling Chung Hwa Bank to foreign investors, they were told that they had to bid for two parcels of stock. The first was existing shares held by the government and the second was new securities convertible to ordinary shares. However, bidders were supposed to pay much more for the government shares than they were for the new shares. Not really fair to minority shareholders and of course there was to be no bid for the rest of the bank at the price paid to the government. That deal fell through as the bids came in at about half what the government offered.
2. Right now the largest banks in Taiwan are all state banks. These are the ones which have the most deposits and branches. Traditionally their role has been to aggregate savings to finance industry. The government wants to consolidate the banking sector so as to eliminate NPLs/improve CARs, reduce overcapacity and create some regional champions. Unfortunately the whole process involves well run, well capitalised banks taking over badly run, poorly capitalised banks at artificially high prices. This is because private banks are not allowed to open more branches unless they take over another bank, therefore their existing franchises will be sub-scale if any of the large state banks were to be taken over and run along private sector lines. A bit like the British government designing a bidding system for 3G that forced BT to pay the value of its existing franchise to stay in business, private banks are being forced into paying high prices. Unfortunately unlike during the TMT bubble, the stockmarket does not look willing to support them with lots of cheap capital.

Using state companies to finance projects that no private party would support

The other issue with the government is using state companies to finance projects that no private party would support. The most obvious example here is Taiwan High Speed Rail Corp (THSRC) where it seems clear that companies such as China Steel have only invested because of government pressure. They have bought preference shares and we hope that ultimately the government will do the right thing by the buyers of preference shares when it ultimately sorts out what to do with the cost over-runs and additional financing requirements in THSRC.

During the year the FSC suffered a major embarrassment when the head of the enforcement division was indicted for insider-trading. The prosecutor alleges that he would tip-off speculators in advance of announcing a probe into a company. Before he made his announcement, the speculators would short the stock. Prosecutions do happen in Taiwan that would not happen elsewhere but unfortunately justice can be slow once the initial indictment has been made. Sophie Yeh, the former chairwoman of Procomp Informatics (last year's big scandal) stands accused of stealing about NT$7bn from the company but has been released on bail and is back running her company.

This year saw significant progress on accounting issues in Taiwan. Rules were introduced which require that fixed assets and equity investments be subject to a fair value test. From the end of this year, all other investments must also be subject to a fair value test. In addition from June this year all companies must file consolidated accounts half yearly instead of annualy.

While progress is being made, work still needs to be done in the area of asset sales. For instance when Hon Hai subsidiary FIH listed in Hong Kong, Hon Hai group employees owned 889m shares (12.8% of FIH) purchased at a cost of US$0.082 or HK0.64 (an 84% discount to the offer price). The difference between the purchase price and the issue price to new investors of HK$3.88 represents an unrealised gain of US$369m. If these shares had not been granted to them at this price, this share of the company would still be owned by Hon Hai. Therefore, this US$369m is a gift/payment from Hon Hai to the management and directors of FIH. Now Hon Hai has delivered exceptional returns for shareholders as has FIH since listing. However, it was not as if shareholders got to approve this payment to management. There was a similar issue with Hon Hai at the time of the AGM where without prior notice shareholders were asked to approve on a show of hands an investment in a related party TFT project. So far no investment has been made and based on Hon Hai's track record, it likely won't make a bad investment, however, good corporate governance is about process as much as it is about the end result.

Country CG score

Minor slippage in scores on more stringent criteria

Figure 1

Taiwan ratings for macro-determinants of CG

(%)	Rating (%)	2004 rating	Comments
Rules & regulations	53	63	Audit committees should be required
Enforcement	49	46	More prosecutions in the last 12 months
Political & regulatory environment	65	63	Regulatory environment has improved for private companies
Adoption of international accounting/auditing standards	59	70	Taiwan is moving ahead but so are IGAAP
CG culture	33	35	No real change

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

Rankings move up within Asia as score slipped less than other countries

The market score for CG has moved slightly from 55% in 2004 to 52% this year. However, other countries in the region had a larger decline in their CG ratings so Taiwan moves to fifth out of the 10 countries we rated and most significantly it pulled ahead of Korea. The slight decline in the absolute rating was due to declines in scoring in three categories below. In reality, there is not much of a change in the overall CG environment amongst private companies in Taiwan. However, when the government weighs up its obligations to minority shareholders in listed companies and its other obligations the conflict of interest seems to result in CG losing out in Taiwan.

Scoring for the rules and regulations category declined as the government failed to get its proposed rule on disclosure of corporate compensation passed. Also audit committees are still only recommended in the CG code and not mandatory. This year the questions were the same as last year but there the answer "marginally" was added to "yes", "no" and "somewhat". As this new category only gave 0.25pts instead of 0.5pts, four downgrades to "marginally" saw the country score go down.

The score for "enforcement" improved this year mainly because it is a low score anyway and the answer for some questions went from "no" to "marginally".

Scoring fell in the area of the adoption of international accounting standards. Taiwan has quite a good score in this area and it did implement a number of important new rules this year. However, accounting rules continue to advance and the idea of expensing bonus shares at market value in the ROC GAAP accounts would not appeal to Taiwanese companies.

Best CG companies in Taiwan

Figure 2

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

Top quartile	Second quartile
Formosa Plastics	Asustek
Nan Ya Plastics	Catcher Tech
TSMC	Advantech
Formosa Chemical	ZyXEL
UMC	Nien Hsing
SinoPac	Twn Green Point
Sunplus	Acer
Hung Poo	CTCI
Depo Auto Parts	Siliconware Precision
Chinatrust	Yulon Nissan
PCSC	Quanta
Phoenixtec Power	Chi Mei Opt
Merry Electronics	MediaTek
Cathay	Tong Yang
Fubon Financial	Taiwan Mobile
Vanguard	Hotai Motor
Taiwan Fertilizer	MiTAC

Source: CLSA Asia-Pacific Markets

The table above shows the Formosa Group companies all in the lead. Their scores remained unchanged from last year but slight reductions in scoring for the foundries saw them move to the top of the table.

Changes in CG scores

Figure 3

Companies with changes in CG scores: 2004-05

Far EasTone made the largest improvement in CG score and moved to the main board from the OTC

	Chg in CG score (ppts)	2005 quartile ranking
Far EasTone	16.9	3
Hon Hai	12.1	3
Advantech	10.0	2
Acer	(5.4)	2
China Motor	(15.3)	3

Source: CLSA Asia-Pacific Markets

China Motor guided badly on dividend policy

The largest increase in CG score was achieved by Far East Tone which moved from the OTC market to the main board this year. It also substantially increased its cash dividend payout ratio and significantly improved investor relations.

Hon Hai also made a large improvement over last year primarily due to points deducted in 2004 for events such as the last minute vote at the AGM on a show of hands to purchase shares in a family owned TFT company. This was an unpopular investment and the company did not move ahead with it this year. Hon Hai also improved investor relations this year.

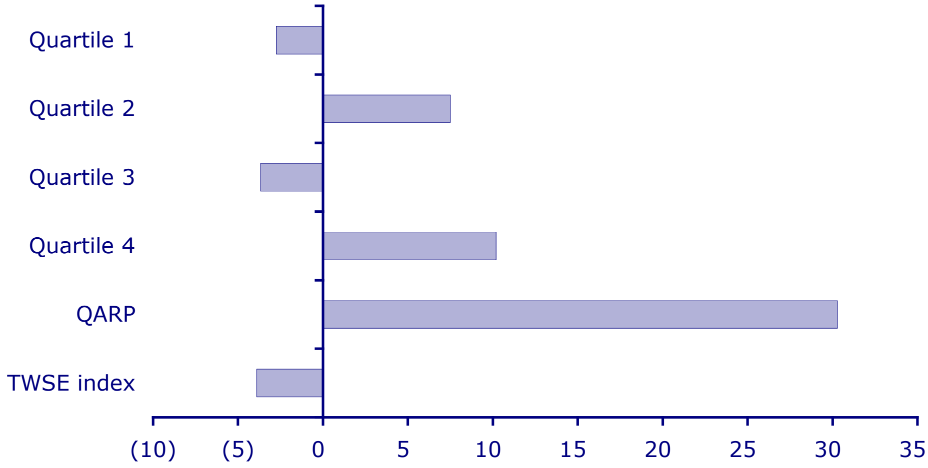
Advantech's score improved as it foreswore currency speculation and much improved its investor relations. Acer's score declined as it became more selective in meeting with investors. China Motor made big fall due to poor guidance on dividend policy and other issues in 2004.

QARP stocks beat the market

Top performing in TaIwan last year was the bottom CG quartile. However, QARP stocks were strong performers

Figure 4

2004 performance of CG quartiles, QARP and country index



Source: CLSA Asia-Pacific Markets

Based on CG rankings alone, there was no clear outperformance of higher CG stocks; on the contrary as the chart above shows, it was the lowest CG quartile that had the better performing stocks. The companies in the table below however were in the top half of our CG survey for 2004 and had attractive valuations at the beginning of the year, on the QARP criteria. They subsequently delivered stellar performance represented by the QARP bar in the chart above.

Figure 5

QARP list: Jan-2004 valuations and stock performance

Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theoretical PB (x)	Mkt PB (end-03) (x)	Upside to theor. PB (%)	CG quartile (1-4)	2004 stock perf (%)
Asustek Computer	19.6	9.57	3	2.5	2.3	9.8	2	24
Formosa Chemicals	32.8	9.37	3	4.7	2	133.3	1	15
Hotai Motor Company	26.1	8.08	2	4	1.4	187.7	2	68
Chinatrust	18.4	9.27	4	2.7	2	38.5	1	18
Chunghwa Telecom	15.9	7.71	2	2.4	1.2	107.1	2	27
Ave performance								30.3

Source: CLSA Asia-Pacific Markets

A small list of QARP picks currently

Taiwan QARP picks 2005

Our QARP picks for 2005 come from a range of sectors. They all benefit from a low cost of equity with the exception of ZyXEL. They are also all businesses with good ROE track records. Basically they are quality companies at modest valuations. We currently have BUYs on ZyXEL, Formosa Chemical, Hotai Motor and Chinatrust of the QARP picks.

Figure 6

2H05 QARP list

Co.	CG Quartile (1-4)	Avg ROE 05-06 (%)	COE (%)	Ascribed gr (%)	Theoreti-cal PB (x)	Mkt PB(x) (%)	Upside (%)
Asustek Computer	2	19.4	9.57	3	2.5	2.3	10.9
ZyXEL	2	27.4	10.71	3	3.2	2.4	30.1
Formosa Chemical	1	28.1	9.37	3	3.9	1.6	139.4
Hotai Motor	2	26.1	8.08	3	4.5	2.8	61.3
Chinatrust	1	18.7	9.27	4	2.8	1.8	58

Source: CLSA Asia-Pacific Markets

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Thailand - Enforcement issues

Several corporate governance scandals have rocked the Thai market over the last year

The Thai market has had its share of corporate governance scandals this year. The most heavily publicised were the bribes allegedly taken by Airports of Thailand and Italian-Thai Development over the selection of baggage scanners in the New Bangkok International Airport. Concerns were increased by the restatement of Picnic Gas' accounts after the discovery that it was hiding losses by selling to a subsidiary which was then selling on to the public at a loss, and therefore avoiding consolidating the loss. Furthermore the failure of the SET to investigate a 20% rise in ITV's share price the day before better than expected 1Q05 results were released damaged credibility.

Despite these scandals, the companies we cover in Thailand (which includes both AOT and Italian Thai development) have seen a small rise in their CG scores from 62.0 last year to 63.5 this year. The greatest out performance of stocks sorted by CG quartiles in 2004 was from those with the lowest CG scores (the bottom quartile of our CG rankings). These outperformed by 19.2 ppts. Against that, the stocks in the top CG quartile outperformance of 7.4ppts pales in significance. However, the outperformance was much greater for the four stocks which in early 2004 met our QARP criteria (Egco, PTTEP, SCCC and NFS). These on average rose 27.7% against MSCI-Thailand which was down 5%. After the market decline from the end of 2003 to mid-2005, the list of QARP stocks that meet our criteria going into 2H05 has increased to eleven names: Aeon, Egco, NPC, PTTEP, AIS, AP, SCCC, SCC, NFS, Tisco and Kiatnakin. These are high CG companies, with strong ROE and reasonable valuations which should help portfolio performance even in a potentially volatile market.

Country CG score

Thailand country rankings unchanged from last year

The country score for macro-determinants of CG for Thailand has declined slightly from 53% in 2004 to 50% this year. Thailand continues to score weakly in enforcement and corporate governance culture. No sections have seen any real improvement from last year. The score for accounting standards has fallen significantly although this is largely due to more stringent criteria. Overall, every market except Hong Kong largely has a higher score on our new scoring. Thailand now ranks joint sixth with Korea, up one place from last year, ahead of China, the Philippines and Indonesia in our market ratings.

Figure 1

Thai ratings for macro-determinants of CG

	Rating (%)	2004 rating	Comments
Rules & regulations	58	61	Slight downgrade
Enforcement	40	38	Marginal improvement
Political & regulatory environment	50	50	No change
Adoption of international accounting/auditing standards	73	85	On stricter criteria score has come down
CG culture	35	35	No change

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

New policies and initiatives by the SET regulatory bodies have yet to yield any significant results

Regulatory environment

Under Thirachai, the new secretary general of the SET, a series of measures and initiatives to improve the level of corporate governance in Thailand have been implemented. Although his critics may cite his own political ambitions as the main reason behind the new programmes, awareness of corporate governance has increased. However, enforcement still remains weak. As part of these initiative several new steering committees have been set up. These include the 'Director responsibility steering group' which lists those deemed fit to serve on the board of a company or as a member of senior management. Currently there are around 4,000 approved persons and less than 10 'black listed'. Publishing the approved list but not the names of those black listed limits the effectiveness of this measure. An accounting and governance steering committee was also set up to consult with Thailand's auditors and accounting bodies over the interpretation of accounting standards and the relevant sanctions to impose on those who fail to comply. Several press releases urging the adherence by companies to these principles have been issued. The 2005 Action Plan outlining the strategy for the next three years encourages companies to follow the guidelines.

While many of these policies have yet to yield significant results, the establishment of several new departments and units to enforce regulations may be more effective. A new unit within the SEC to survey financial statements and require the re- issuance of those reports which do not comply may prove to be effective. The newly created Department for Special Investigation to which the SEC refers cases could lead to a higher number of prosecutions.

The profile of corporate governance has been raised over the last year but an equivalent increase in enforcement has not been seen. Some of the measures taken may yet yield results but the SET still needs to take significant measures to increase the level of corporate governance in Thailand today.

Changes in CG scores

Figure 2

Companies with changes in CG scores: 2004-05

	Chg in CG score (ppts)	2005 quartile ranking
Banpu	5.6	1
NFS	3.8	2
Ratch	1.9	3
Tisco	1.9	1
TRUE	1.7	4
SPL	(1.9)	3
Shin	(2.1)	4
AIS	(3.8)	4
PTT	(3.8)	3

Source: CLSA Asia-Pacific Markets

Banpu's score has improved the most. AIS and PTT have seen a marked deterioration in CG

Banpu had the biggest change in CG score. This is due to the accountability and responsibility reasons, largely from the increase in number of independent directors as well as reduction in size of company's board. The latter also accounted for the increase in the score for responsibility at Ratch, thereby increasing the corporate governance score. NFS and Tisco's accountability has also improved as they added more independent directors, whereas SPL and AIS's have worsened. 'Fairness' accounted for the improvement in True's corporate governance score and the decrease in Shin's. PTT suffered from both deteriorating accountability and responsibility.

Improvements in CG scores came from an increase in the number of directors and the reduction in board sizes

Figure 3

Companies in the top 2 CG quartiles for Thailand (CLSA coverage)

Top quartile	Second quartile
Siam Commercial	NPC
SCC	EGCO
Kasikornbank	LH
Banpu	NFS
Kiatnakin	SCCC
Tisco	AP
Bangkok Bank	ATC
PTTEP	VNT
TOC	Aeon

Source: CLSA Asia-Pacific Markets

The QARP portfolio outperformed the MSCI Thailand by 32%

QARP stocks beat just high CG for performance

On average stocks under coverage in Thailand gave a return, excluding dividends, of -5.2% (not weighted by market cap) in 2004. The top quartile CG stocks underperformed this by 2.1ppts (although it out performed the local SET index which fell 13.5% during the year). The worst CG scores produced the best returns of the quartiles, outperforming the index by 9.7ppts. However the QARP Thailand portfolio for 2004 surpassed this and returned 27.7%, outperforming the index by 31.7%. These are the stocks in the upper half of our CG rankings within the market, which have an ROE above cost of equity and have more than 10% upside to theoretical value by the Gordon growth model. Stocks with ROE above cost of equity and with upside to theoretical value being what we define as value-creators at a reasonable price (VCARP). A full definition and explanation of this criteria is on pages 4-8 of this report.

Figure 4

QARP 2004 portfolio

Co.	FY04-05 ave ROE (%)	COE (%)	Est LT growth (%)	Theor PB (x)	Mkt PB end-03 (x)	Upside (%)	CG quartile	2004 stock performance (%)
Egcomp	21.7	10.1	5	3.26	1.8	78.4	2	11.1
PTTEP	29.7	10.1	5	4.83	3.8	28.0	1	55.4
NFS	14.6	12.3	5	1.32	1.2	14.5	2	6.5
SCCC	22.4	9.7	5	3.69	3.3	12.8	2	37.9

Source: CLSA Asia-Pacific Markets

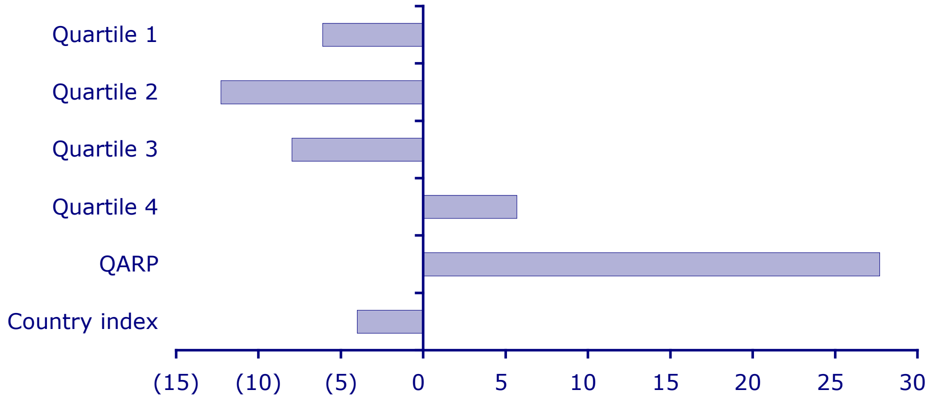
The four stocks in the QARP basket for Thailand last year rose 27.7% on average. However this portfolio, with just four names, was very concentrated. The outperformance was driven by PTTEP returning 55% and SCCC returning 38%.

Thailand was one of nine markets where the QARP portfolio outperformed

The QARP portfolio last year outperformed the top CG quartile by a very significant 33.8-ppts. Although this is based on just one year's performance, Thailand is one of nine markets last year, of the ten that we survey in this report, where the QARP portfolio outperformed top-quartile CG stocks. It is one of the eight markets where the QARP stocks outperformed the country index. Adding a valuation dimension (PB) to picking stocks with good financials (ROE above cost of equity) and high CG intuitively should give better performance than simply choosing stocks with high CG irrespective of financials and valuations. This is corroborated by the evidence from Thailand, most of the other markets we cover, as well as for the region's largest caps (see pages 8-10 for our findings on the large caps in the region).

Figure 5

2004 performance of CG quartiles, QARP and country index



Source: CLSA Asia-Pacific Markets

Thailand QARP picks 2005

The number of stocks that qualify on our QARP criteria based on mid-2005 valuations has increased to eleven names. These are companies which rank in the upper half for CG within the market, with high ROE and at least 10% upside to theoretical value. The companies that make it for the current list for Thailand, as shown in Figure 6, are Aeon, Egcomp, NPC, PTTEP, ATC, NFS, AP, SCCC, SCC, Tisco and Kiatnakin.

Figure 6

Current QARP list end-June 05 valuations

Co.	FY05-06 ave ROE (%)	COE (%)	Est LT growth (%)	Theor PB (formula)	Mkt PB (30-Jun-05) (x)	Upside to theor. PB (%)	CG quartile (1-4)
Aeon	35.2	8.4	5	8.82	5.0	77.4	2
Egcomp	17.1	10.1	5	2.37	1.4	71.3	2
NPC	21.2	12.0	5	2.31	1.5	57.2	2
PTTEP	31.4	10.1	5	5.15	3.3	55.1	1
ATC	62.7	15.9	5	5.31	3.5	53.4	2
NFS	13.8	12.3	5	1.21	0.9	40.6	2
AP	27.0	13.4	5	2.61	1.9	33.8	2
SCCC	26.2	9.7	5	4.50	3.6	23.8	2
SCC	25.9	12.1	5	2.94	2.6	14.5	1
Tisco	18.8	13.7	5	1.58	1.4	11.9	1
Kiatnakin	16.8	14.3	5	1.26	1.1	10.5	1

Source: CLSA Asia-Pacific Markets

This method assumes average ROEs are sustainable

The key financial inputs for the QARP criteria are ROE, cost of equity and ascribed long-term growth. The ROE used should reflect what is sustainable long-term, which is somewhat subjective. We use average FY05-06 projected ROE as an approximation, except for companies where current ROEs are clearly not sustainable. The high ROE for PTTEP is a result of the current oil price environment – the medium to long-term ROE for the company will depend on oil prices going forward. For ATC, ROE is high as a result of strong product pricing.

Cost of equity is derived from CAPM with 6% as the risk-free used for this exercise, a 6% general equity risk premium across markets for a 12% cost of equity for the market. Beta is derived from Bloomberg. The ascribed long-term growth used in general is 5%. This list of high QARP stocks should provide good performance even if markets fall further in 2006 as is our current market view. Of the stocks that meet our criteria, Kiatnakin, Asian Property, Tisco and EDGO are BUYs, Aromatics Thailand and PTTEP rate as Outperform.

Appendix 1: CLSA/ACGA country macro-QARP determinants

1 - CG rules & regulations--and their implementation

		China	HK	India	Indo	Korea	Malay	Pines	Sing	Twn	Thai
1	Do financial reporting standards for listed companies compare favourably against international best practices? (eg, in terms of consolidated annual, interim and quarterly accounts, international accounting standards and so on)	S	Y	Y	M	Y	Y	Y	Y	S	Y
2	Do non-financial reporting standards for listed companies compare favourably against international best practices? (ie, the MD&A, Report of Directors, and corporate-governance statements in annual reports)	M	S	S	M	S	S	S	Y	S	S
3	Do companies report their annual results within two months or 60 days?	M	M	Y	S	M	S	N	Y	M	Y
4	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	S	Y	S	Y	S	Y
5	Do securities laws require disclosure of ownership stakes above 5%?	Y	Y	Y	S	Y	Y	Y	Y	S	Y
6	Do securities laws require disclosure of share transactions by directors, controlling shareholders and substantial shareholders within two working days?	S	Y	Y	M	N	Y	Y	Y	N	S
7	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	Y	Y	S	Y	Y	Y	Y	Y	Y
8	Do securities laws provide a credible deterrent against insider trading and market manipulation?	N	Y	S	N	S	S	N	Y	M	N
9	Are class-action lawsuits permitted?	S	N	N	M	S	N	S	N	S	N
10	Is voting by poll mandatory for resolutions at AGMs?	S	S	N	N	S	N	N	N	S	N
11	Is there a national code (or codes) of best practice largely based on international CG standards?	Y	Y	Y	S	Y	Y	Y	Y	Y	Y
12	Do the national CG code and/or local listing rules contain a clear and robust definition of "independent director"? (ie, one that says independent directors should be independent of both management and the controlling shareholder; and which does not make it easy for former employees and former/current professional advisors to become independent directors)	S	S	S	M	S	S	Y	S	Y	S
13	Must companies disclose the exact remuneration of individual directors and senior executives (top 5) by name (or do they)?	M	Y	Y	N	N	M	N	S	N	S
14	Are audit committees mandatory and implemented?	S	Y	Y	S	S	Y	Y	Y	M	Y
15	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?	N	S	S	M	M	S	N	S	M	M
16	Can minority shareholders easily nominate independent directors and are these candidates likely to be elected?	N	S	S	N	S	S	N	S	S	N
17	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?	S	S	S	M	S	N	N	Y	Y	Y
18	Are pre-emption rights for minority shareholders firmly protected? (ie, enshrined in the company law and requiring a super majority—75%--to disapply them)	S	S	S	S	S	S	S	S	S	S
19	Do companies release their AGM notices (with detailed agendas and explanatory circulars) at least 28 days before the date of the meeting?	S	S	S	S	M	S	Y	S	Y	M

Y = Yes; N = No; S = Somewhat; M = Marginally; Note: The questions are targetted at main-board listed companies in your country. Please answer with the average company in mind, except where otherwise specified. Continued on the next page

Appendix 1 (Continued)

2 - Enforcement

		China	HK	India	Indo	Korea	Malay	Pines	Sing	Twn	Thai
1	Do financial regulators in your country have a reputation for vigorously and consistently enforcing their own CG rules and regulations?	S	S	S	N	N	S	N	S	S	M
2	Have their efforts improved tangibly in recent years?	Y	Y	Y	Y	M	Y	S	Y	Y	Y
3	Are securities regulators seen to treat all companies and individuals equally?	S	S	S	M	N	M	S	S	M	S
4	Are the regulatory authorities sufficiently resourced—in terms of funding and skilled staff—to do their job properly?	M	S	S	N	S	S	N	S	S	S
5	Do the regulatory authorities have effective powers of investigation and sanction?	S	Y	Y	M	Y	Y	S	Y	Y	S
6	Has the securities commission 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)	S	Y	Y	S	S	Y	M	S	Y	Y
7	Has it had a successful track record prosecuting cases of insider trading and other market manipulation in recent years?	S	S	S	N	S	S	N	S	S	N
8	Does the stock exchange have effective powers to sanction breaches of its listing rules?	S	S	S	M	S	Y	S	Y	S	S
9	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years?	S	S	S	S	N	N	M	S	S	S
10	Do the regulators (ie, the securities commission and the stock exchange) disclose detailed and credible data on their enforcement track records?	S	Y	Y	N	M	Y	S	M	M	S
11	Do most institutional investors (domestic and foreign) exercise their voting rights?	S	S	S	S	S	S	S	S	S	S
12	Are institutional investors actively voting against resolutions with which they disagree?	S	Y	M	M	M	M	N	S	M	M
13	Do institutional investors (domestic and foreign) often attend annual general meetings?	M	M	M	M	M	M	M	M	S	S
14	Do minority shareholders (institutional or retail) often nominate independent directors?	N	N	N	N	M	N	N	M	N	N
15	Do retail shareholders see the annual general meeting as an opportunity to engage with companies and ask substantive questions?	N	M	M	S	S	M	M	S	N	S
16	Are minority shareholder activists willing to launch lawsuits against companies and/or their directors?	S	N	M	N	Y	M	N	M	S	N
17	Are minority shareholders adequately protected during takeovers, privatisations, connected transactions, and very substantial acquisitions or disposals?	M	S	Y	Y	S	M	N	S	S	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?	N	Y	S	N	S	M	N	Y	S	N

Y = Yes; N = No; S = Somewhat; M = Marginally; Note: Enforcement covers both "public enforcement" by regulatory authorities of CG rules and regulations and "private enforcement" by investors of their rights as shareholders Continued on the next page

Appendix 1 (Continued)

3 - Political & regulatory environment

		China	HK	India	Indo	Korea	Malay	Pines	Sing	Twn	Thai
1	Does the government have a clear, consistent and credible policy in support of corporate governance reform?	S	S	S	M	M	S	M	S	S	M
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	M	S	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, nor is unduly influenced by government)?	M	S	S	N	N	S	S	S	N	M
4	Has the government and/or the statutory regulator been actively reviewing and modernising company and securities laws in recent years (ie, to improve corporate governance and bring local rules and regulations up to international standards)?	Y	Y	Y	M	S	S	S	S	Y	S
5	Has the stock exchange been actively reviewing and modernising its listing rules in recent years (ie, with a view to improving corporate governance)?	Y	Y	S	S	S	Y	M	Y	Y	Y
6	Do the regulators (ie, securities commission and stock exchange) have informative websites, with English translations of all key laws, rules and regulations easily accessible?	M	Y	S	M	Y	Y	Y	Y	Y	Y
7	Does the stock exchange provide an efficient, extensive and historical online database of issuer announcements, notices, circulars and reports?	Y	Y	Y	S	S	Y	Y	Y	Y	S
8	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	S	N	S	M	N	M	S	M
9	Is the judiciary independent and sufficiently skilled in handling securities cases?	N	Y	S	N	M	M	M	Y	N	M
10	Is the media free to report on and investigate corporate governance abuses among listed companies?	M	Y	Y	Y	S	S	Y	Y	Y	S

Y = Yes; N = No; S = Somewhat; M = Marginally; Note: This section addresses the level of political will within a country to improve corporate governance as well as the nature of the regulatory and legal environment.

4 – IGAAP (or "accounting & auditing")

		China	HK	India	Indo	Korea	Malay	Pines	Sing	Twn	Thai
1	Does the government or the accounting regulator have a policy of converging national accounting standards with IAS/IFRS (or US GAAP) standards?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
2	Are local accounting rules and practices largely in line with international standards and practices?	S	Y	S	S	Y	Y	S	Y	S	S
3	Do the rules require disclosure of consolidated accounts?	Y	Y	Y	Y	Y	Y	Y	Y	S	Y
4	Do the rules require segment reporting?	Y	Y	Y	S	S	Y	Y	Y	S	Y
5	Is disclosure of audit and non-audit fees paid to the external auditor required?	Y	Y	Y	N	Y	Y	S	Y	Y	Y
6	Does the government or the accounting regulator have a policy of converging national standards on auditing with the international standards promulgated by the International Federation of Accountants in New York?	S	Y	S	Y	Y	Y	Y	Y	S	S
7	Are local auditing rules and practices in line with international standards and practices?	S	Y	S	S	S	S	S	Y	S	S
8	Is the government or the accounting regulator taking account of and 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 and so on)	S	Y	Y	S	S	S	Y	Y	Y	Y
9	Must the CEO, CFO or directors sign and certify a company's annual accounts?	Y	S	Y	Y	Y	M	Y	S	S	Y
10	Is the government strengthening the regulation of the accounting profession?	S	S	M	S	S	S	S	Y	S	S
11	Is the expensing of share-based payments mandatory?	N	Y	S	Y	Y	S	Y	Y	N	N

Y = Yes; N = No; S = Somewhat; M = Marginally; Note: This section addresses the nature of accounting and auditing rules and practices, as well as the regulation of the accounting profession. Continued on the next page

Appendix 1 (Continued)

5 – CG culture

		China	HK	India	Indo	Korea	Malay	Pines	Sing	Twn	Thai
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	M	M	M	M	M	N	S	M	M
2	Are large-cap stocks 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)	S	S	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'?	M	Y	Y	Y	M	M	M	Y	N	N
4	Are large-cap stocks actively seeking to improve their communication with shareholders and providing more substantive disclosure? (eg, through more regular briefings; detailed online disclosure; better reports; and webcasts)	S	Y	Y	S	Y	Y	Y	Y	Y	Y
5	Are most other listed companies also actively seeking to improve their communication with shareholders and providing more substantive disclosure?	M	S	S	M	S	S	M	S	S	S
6	Do company boards generally have separate chairmen and CEOs, with the Chairman being independent of the CEO and controlling shareholder?	M	N	M	N	N	M	N	S	N	N
7	Are listed companies increasing the pay of independent directors in line with the latter's growing responsibilities and liabilities?	M	Y	S	M	M	M	M	S	M	S
8	Do listed companies provide adequate disclosure of their internal-control and risk-management functions in their annual reports?	M	N	S	M	M	M	N	S	M	M
9	Is there a trend towards large-cap stocks voluntary voting by poll at their AGMs and making the results public afterwards?	M	Y	N	N	M	M	N	N	M	M
10	Do "reputation intermediaries" (ie, investment banks, accountants, lawyers) promote high standards of corporate governance in clients about to undergo an IPO?	N	N	M	N	N	N	N	N	N	N
11	Are institutional investors (domestic and foreign) actively engaged in promoting better corporate governance practices?	M	S	S	M	M	M	M	M	M	M
12	Have institutional investors formed their own private CG activist organisations?	N	N	N	N	N	N	N	N	N	N
13	Have institutional investors set up any corporate governance "focus funds"?	N	N	N	N	M	N	N	N	N	N
14	Are retail investors engaged in promoting better corporate governance practices?	M	Y	M	N	S	M	N	Y	N	S
15	Have retail investors formed their own shareholder activist organisations?	N	N	S	S	Y	M	N	Y	S	M
16	Is there an institute of directors that is actively engaged in director training?	S	Y	M	S	S	Y	Y	Y	M	Y
17	Are other professional associations—of accountants, company secretaries, financial analysts and so on—promoting corporate governance training and awareness raising?	M	Y	S	S	Y	Y	Y	Y	Y	S
18	Does the media actively and impartially report on corporate governance reforms and developments?	M	Y	Y	M	M	S	Y	Y	Y	S

Y = Yes; N = No; S = Somewhat; M = Marginally; Note: This section looks at the extent to which corporate governance has penetrated company and market behaviour and decision-making. Source: CLSA Asia-Pacific Markets, ACGA

Appendix 2: CLSA CG questionnaire

Note: Questions in bold carry negative scoring.

Discipline (15% weight)

1. Has the company issued a "mission statement" that explicitly places a priority on good corporate governance or has the company or management publicly articulated principles of good corporate governance that it is committed to maintaining? 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.)
3. **Does management stick to clearly defined core businesses?**
4. A) What is management's estimate of its cost of equity?

   B) What is management's estimate of its weighted average cost of capital?

   C) Is management's estimate of its cost of capital and of cost of equity within 10% of our estimate based on its capital structure? (Answer "No" if either estimate is beyond 10% of our estimate.)
5. **Over the past five years, is it true that the company has not issued equity, or warrants/options for new equity, for acquisitions and/or financing new projects where there was controversy over whether the acquisition/project was financially sound, 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 Annual Report within three and a half months of the end of the financial year?
12. Does the company publish/announce semi-annual results within two months of the end of the half-year?
13. Does the company publish/announce quarterly results within two months of the end of the quarter?
14. A) In the past 12 months, what is the longest time period between the Board meeting to accept results for a period (quarterly/half-year/finals), and the announcement of the results?

    B) Has the public announcement of results been no longer than two working days after the Board meeting? Is it true that there has not been any case in the past five years when the share price moved noticeably just before the release of results and in a direction that anticipated the results?
15. **Are the reports clear and informative?** ("No" if consolidated accounts are not presented; or if over the past five years there has been occasion when the results announced lacked disclosure subsequently revealed as relevant; if key footnotes to the accounts are unintelligible; if negative factors were downplayed when presenting the company's results that were important in assessing the business value; or if there is inadequate information on the revenue/profit split for different businesses, or regions/countries and product lines; or inadequate disclosure and/or provisions for contingent liabilities, NPLs and/or likely future losses; or inadequate details of group/related company transactions and their rationale.)
16. **Are accounts presented according to internationally accepted accounting standards (IGAAP)? Are the accounts free of substantial non-IGAAP compliant qualifications and of any controversial accounting policies?** (If the company provides two or more sets of accounts and at least one that is readily accessible is according to IGAAP, answer "Yes". If the company has changed accounting policies, or adopted a controversial accounting practice which has boosted stated earnings, answer "No".)
17. Does the company consistently disclose major and market-sensitive information punctually? Is it true that the company has not in the past five years failed to disclose information that investors deemed relevant in a timely fashion? ("No", eg, if there is any instance over the past five years of share price movement ahead of and anticipating an announcement which was believed to be insider buying.)
18. Do analysts have good access to senior management? Good access implies accessibility soon after results are announced and timely meetings where analysts are given all relevant information and are not misled.
19. Does the company have an English-language website where results and other announcements are updated promptly (no later than one business day)?
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 2000?

    B) And at the end of 2003?

    C) Has the company increased the number of independent directors over the past three years? (Plans to increase independent directors will count as a negative answer.) **If the company has reduced the number of directors, answer "No";** if number of independent directors are the same insert "0".

34. Are full Board meetings held at least once a quarter?
35. Are Board members well briefed before Board meetings? Are they provided, as far as the analyst can tell, with the necessary information for effective scrutiny of the company, prior to the meeting, in a clear and informative manner? (Answers 35-37 must be based on direct communication with an independent Board member. If no access is provided, and no verification of an independent director is provided, answer "No" to each question.)
36. Does the audit committee nominate external auditors and conduct a proper review of their work as far as the analyst can tell?
37. Does the audit committee supervise internal audit and accounting procedures as far as the analyst can tell?

Responsibility (15% weight)

38. If the Board/senior management have made decisions in recent years seen to benefit them at the expense of shareholders (cf Q22 above), has the company been seen as acting effectively against individuals responsible and corrected such behaviour promptly, ie within six months? (If no such case, answer this question as "Yes".)
39. Does the company have a known record of taking effective measures in the event of mismanagement? Over the past five years, if there were flagrant business failures or misdemeanours, were the persons responsible appropriately and voluntarily punished? (If no cases, the company does not have such a record, then answer this question as "No.")
40. **Is it true that there is no controversy or questions over whether the Board and/or senior management take measures to safeguard the interests of all and not just the dominant shareholders?** (Eg if EGMs with genuine independent advice for related-party transactions were not held, or independent verification of appropriate pricing for recurrent related-party transactions was not obtained, answer "No".)
41. Is it true that there have been no controversies/questions over whether share trading by Board members has been fair, fully transparent and well intentioned? (Are announcements made to the exchange within three working days, and do the major shareholders reveal all transactions including those under nominee names? Any case where it is believed by some that parties related to major shareholder were involved in transactions not disclosed to the exchange, or allegations of insider trading, would mean "No".)
42. A) How many members are on the Board?

    B) Is the Board small enough to be efficient and effective? (If more than 12, answer "No".)
43. **Is it true that the company does not engage in material related-party transactions?** (Eg sourcing key materials from a related party, or using a related party that is not part of the listed group as a distribution channel, or placing funds in deposit or for investments in a related party that is not part of the listed group, or where the annual report discussion of related party transactions runs over two short paragraphs, or where the listed company has invested in businesses where the controlling

shareholder has interests in the past three years, would count as a negative answer. Note that a related party that is not part of the listed group would include a unit under the parent which may be separately listed.)

44. Is it true that the controlling shareholder (whether an individual or company) is not known or widely believed to be highly geared?

45. **Is the controlling shareholder's primary financial interest the listed company?** (Ie not a government-controlled entity, or a listed company where the ultimate shareholder has various other business interests. Answer "No" if the company is a subsidiary of a separately listed parent.)

Fairness (15% weight)

46. **Is it true that there has not been any controversy or questions raised over any decisions by senior management in the past five years where majority shareholders are believed to have gained at the expense of minority shareholders?** (Management fees paid from the listed group to a parent company, or to a private company controlled by the major shareholders on the basis of revenues or profits would be deemed a negative.)

47. Do all equity holders have the right to call General Meetings? (Any classes of shares that disenfranchise their holders would mean a "No" answer.)

48. Does the company have cumulative voting for Board representation? (Ie where minority shareholders with say a 20% interest will be able to appoint directors representing one-fifth of the Board.)

49. Are all necessary (ie not just obligatory, but also relevant in the view of the analyst regarding accounting etc) information for General Meetings made available prior to the General Meeting?

50. Is senior management unquestionably seen as trying to ensure fair value is reflected in the market price of the stock, by guiding market expectations about fundamentals in the right direction through frank discussion on risk/returns, actions like share buybacks and investor meetings, etc?

51. **Is it true there have been no questions or perceived controversy over whether the company has issued depositary receipts that benefited primarily major shareholders, nor has the company issued new shares to investors near peak prices, nor have the major shareholders sold shares near peak prices without prior guidance to the market on why shares are seen as fully valued? Also, the company has not issued shares to friendly parties just prior to AGM/EGMs where there are controversial matters being voted on at the shareholder meeting?**

52. A) Does the controlling shareholder group own less than 40% of the company?

    B) Please provide the stake owned by the controlling shareholder.

53. Does the head of Investor Relations report to either the CEO or a Board member?

54. A) What is total remuneration of the Board as a percentage of net profit after exceptionals?

    B) **Over the past five years, is it true that total directors' remuneration has not increased faster than net profit after**

exceptionals as far as an analyst can tell? (Answer "No" if directors' remuneration has increased faster than profits or if company does not make any declaration to clarify.)

Social responsibility (10% weight)

55. Does the company have an explicit (clearly worded) public policy statement that emphasises strict ethical behaviour: ie, one that looks at the spirit and not just the letter of the law, and the company is not run by senior executives who have been convicted of crimes that reflect negatively on their integrity? (Internal employee-conduct manual that emphasises ethical behaviour and no grounds to believe otherwise in the company's corporate culture would count as "Yes".)
56. Does the company have a policy/culture that prohibits the employment of the under-aged as far as the analyst can tell?
57. Does the company have an explicit equal employment policy: ie, no discrimination on the basis of sex, race, religion etc?
58. Does the company adhere to specified industry guidelines on sourcing of materials as far as the analyst can tell?
59. Is the company explicitly environmentally conscious? Does it promote the use of environmentally efficient products, or takes steps to reduce pollution, or participate in environment-related campaigns? (If there are no concrete examples of this, answer "No".)
60. Is it true that the company has made no investments/acquisitions and not entered into deals that raised questions of propriety (eg any allegations of bribery or dealing with regimes that do not have legitimate authority like Myanmar) and there is no known litigation against the company and/or associates/subsidiaries that reflects negatively on the integrity of management?

Appendix 3:
Performance of markets, CG quartiles and QARP basket

2004 performance (%)

	China	HK	India	Indo	Korea	Malaysia	Pines	Spr	Taiwan	Thai	Asia ex-Jpn large caps
CG quartile:											
Q1	9.6	25.5	22.6	56.0	13.7	9.3	30.3	38.0	(2.7)	(6.1)	20.7
Q2	6.8	22.6	17.2	48.8	0.8	2.9	44.8	31.0	7.5	(12.3)	16.5
Q3	11.8	19.4	3.6	41.6	29.6	23.2	7.8	30.0	(3.7)	(8.0)	22.6
Q4	(9.0)	22.6	28.1	63.1	32.8	10.0	19.0	12.0	10.2	5.7	22.3
Ave of quartiles	4.8	22.5	17.9	52.4	19.2	11.3	25.4	27.8	2.8	(5.2)	20.6
QARP portfolio	11.1	31.1	51.0	108.0	15.7	10.9	40.3	31.5	30.3	27.7	28.9
Country/regional index	(0.8)	20.8	16.5	44.5	20.0	11.8	24.1	18.8	6.5	(4.0)	14.4

Source: CLSA Asia-Pacific Markets

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Appendix 4: About ACGA

The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership organisation working on behalf of all investors and other interested parties for the improvement of corporate governance in Asia. ACGA is funded by a network of sponsors and corporate members, including many of the region's leading investment funds, financial institutions and intermediaries (see below for a full list).

ACGA advocates the competitive benefits of better corporate governance and works closely with institutional investors, regulators and companies to achieve concrete improvements. It is one of the few organisations systematically researching corporate governance developments around Asia, tracking 11 markets and producing independent analyses of new laws and regulations, investor action and corporate initiatives. ACGA has also launched a special service for institutional investors—a confidential "Investor Discussion Group" on corporate governance in Asia. It meets quarterly and discusses issues of practical importance to investors.

ACGA is incorporated under the laws of Hong Kong and is managed by a secretariat based there. Its governing Council comprises directors from around Asia.

Website

For further information about ACGA and comprehensive coverage of corporate governance developments in Asia, go to: ***www.acga-asia.org***

Members

Members include (in alphabetical order):

1	Aberdeen Asset Management Asia	24	Lloyd George Management
2	AIG Investment Corp (Asia)	25	Lombard/APIC
3	Alliance Trust PLC	26	Maple-Brown Abbott
4	Asian Development Bank	27	Marsh Inc.
5	British Columbia Investment Management	28	Mekong Capital
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7	CalSTRS	30	Neptune Orient Lines
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17	Hong Kong University of Science and	40	Sun Life Financial Asia[1]
18	IMC Solution Shipping	41	SUNDAY Communications
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20	Jardine Lloyd Thompson	43	TIAA-CREF
21	Kookmin Bank	44	Vtech Holdings
22	Li & Fung	45	Watson Wyatt
23	LIM Advisors		

[1] Also a Founding Corporate Sponsor of ACGA. Source: CLSA Asia-Pacific Markets

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Key to investment rankings: BUY = Expected total return greater than >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

13/09/2005