Capital structure as an element of the corporate governance system in Ukraine*

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The paper considers the problems of corporate governance in Ukraine during the process of transformation of the structure of corporate ownership. Capital structure, as an element of the system of corporate governance, is investigated. A tight connection between concentration of shareholders equity, equity cost and capital structure (financial leverage) has been found as a result of research. The higher the concentration of shareholders equity, the larger the share of debt in the capital structure and the higher the cost of equity. Thus, the capital structure of Ukrainian companies is an efficient indicator of corporate governance performance.

Der Aufsatz befasst sich mit den Problemen der Unternehmensorganisation im Transformationsprozess der Unternehmensbesitzstrukturen. Die Struktur des Kapitals als Element des Systems wird untersucht. Eine enge Verbindung zwischen der Konzentration von Kapital der Anteilseigner, Kapitalkosten und Kapitalstruktur (dem Verhältnis von Fremd- zu Eigenkapital) kristallisierte sich als Ergebnis der Untersuchung heraus. Je höher die Konzentration von Kapital der Anteilseigner, desto grösser der Anteil an Schulden in der Kapitalstruktur und somit entstehen auch höhere Kapitalkosten. Somit stellt die Kapitalstruktur von ukrainischen Unternehmen einen effizienten Indikator für die Leistung von Unternehmensorganisation dar.

Key words: Capital structure / credit markets / corporate ownership structure / cost of capital / Ukraine

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Introduction

The process of privatization of State property in Ukraine is followed by a transformation of relations between participants of corporate governance, especially executives of the companies and owners. Differences in the level of knowledge of investments and financial management which shareholders and management possess, can influence negatively relations between them. That is why, one of the most important criteria of corporate governance efficiency is an absence of asymmetry of information and conflicts of interests between shareholders and managers (Barberis et al. 1996: 96).

Asymmetry of information exists in a case if executives of the company and its shareholders possess information about the market opportunities of the company of different content and volume. Jensen and Meckling (1976) emphasized that the most important evidence of the existence of asymmetry of information between managers and shareholders are an under-valuation of the company by the market and an increase in the cost of shareholders equity which make managers of the company choose debt to finance company activity.

Changes in the capital structure can be used to monitor asymmetry of information (Berger et. al, 1997: 1418).

Stulz (2000), a famous expert in the area of corporate governance, noticed in his outstanding paper "Globalization of world stock markets" that corporate governance performance under asymmetry of information directly relates to the capital structure.

According to Stulz who supported the point of view of Bearle and Means (1932), the problem of asymmetry of information which happens as a result of the process of concentration of corporate ownership, makes executives finance company activity with debt because the cost of equity grows excessively under asymmetry of information. Managers have to choose debt. This leads to an increase in financial leverage and worsening the company financial stability.

That is why, under asymmetry of information the most important features of efficiency of corporate governance, deriving from capital structure are:

- reduction in the cost of equity;
- reduction in financial leverage.

The above features of efficiency of corporate governance have been supported by research undertaken by Claessens (1997), Frydman, Gray and Rapaczynski (1997), and Demsetz and Lehn (1998).

Methodology of research into capital structure as an element of the corporate governance system in Ukraine and its results

A very detailed investigation of the most active Ukrainian joint stock companies has been undertaken. The total number of the companies being researched is

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270. The period of investigation is from 1998 to 2001. The following data sources have been used to conduct the investigation:

- annual reports of Ukrainian joint stock companies;
- annual reports of the State Securities and Exchanges Commission in Ukraine;
- annual reports of the First Stock Trading System in Ukraine;
- stock market reports, produced by famous Ukrainian investment companies.

As a result of processing the above mentioned data sources the ownership type of companies was determined and the cost of equity was calculated.

The contribution of the companies under investigation to economic development in Ukraine can hardly be over-estimated. The companies under investigation produce about 32 per cent of gross domestic product. Their contribution to the export of goods and services is 68 per cent. They employ 22-23 per cent of the active population in Ukraine (see table 1).

Applying data gathered as a result of the investigation of 270 Ukrainian joint stock companies, it may be concluded that many enterprises have a low-leverage capital structure (Fig. 1).

Table 1: The contribution of Ukrainian companies under investigation to economic and social development in Ukraine

Economic and social develop-ment measures	**Contribution of the companies under investigation to economic and social development in Ukraine, per cent**			
	1998	**1999**	**2000**	**2001**
GDP	32,4	32,8	31,3	32,0
Export of goods and services	69,4	70,3	69,8	68,0
Employment	24,8	24,1	23,2	22,7

With reference to Fig. 1 it is possible to draw the conclusion that remarkable changes happened in the capital structure of Ukrainian joint stock companies during 1998-2001. The most evident change is an increase in the share of debt in the capital structure (from 12 to 22 per cent). The above mentioned trend can be explained by some reasons. First of all, over the above mentioned period of time liquidity of alternative markets for corporate capital - market for bank loans and market for equity - improved but the scale of change was different. Thus, the cost of loans dropped from 60 to 35 per cent. Due to a reduction in the cost of corporate borrowing, the volume of loans, issued by banks to companies in Ukraine, increased by 74 per cent. In comparison to the market for bank loans, the situation on the equity market in Ukraine cannot be taken as promising.

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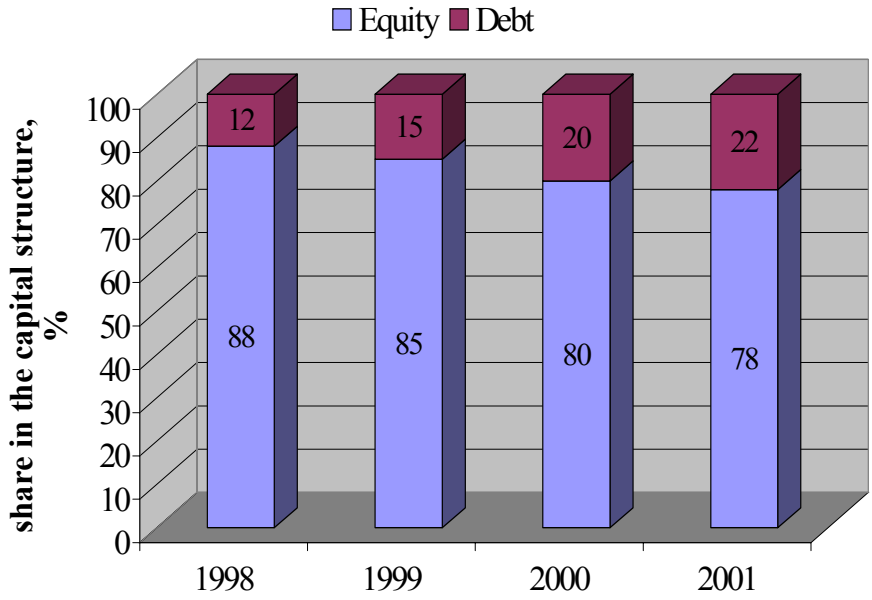
Figure 1: Capital structure of Ukrainian joint stock companies



Thus, despite an sufficient increase in the capitalization of the secondary stock market in Ukraine from U$ 2.1 to 3.8 bil. and an increase in the stock market turnover by 86 per cent, the cost of equity has increased (see table 2).

Table 2: Cost of equity for Ukrainian joint stock companies, whose shares are listed at the First Stock Trade System

Industries	**Cost of equity by years, per cent**			
	1998	**1999**	**2000**	**2001**
Energy	13	16	11	13
Metallurgy	21	19	29	31
Chemistry	29	18	17	19
Oil-gas refinery	24	22	26	24
Machine building	14	24	21	26
The rest	21	28	31	33
Average	21	23	26	28

The following formula has been used to calculate the cost of equity:

$$CE = \frac{D}{P} * 100\%,$$

where D - dividends per share;

P - stock price.

According to Stulz (2000), an increase in uncertainty makes shareholders of the companies require larger dividends. Moreover, an increase in uncertainty leads to a reduction in the stock price. Both factors contribute to an increase in the

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cost of equity and make managers use debt, not equity. So good corporate governance should facilitate a reduction in uncertainty for shareholders and potential investors. The increasing trend in the share of debt in the capital structure was followed by concentration of the shareholders equity in the hands of managers of the companies and institutional investors, mainly residents of Ukraine.

Taking into account the numbers in the table 3 it may be concluded that the performance of capital structure management in Ukraine dropped considerably. The tight connection found between concentration of shareholders equity, its cost and capital structure (financial leverage) gives an excellent opportunity to conclude that on markets under asymmetry of information the structure of corporate ownership directly influences the liquidity of shareholders equity, and as a result, the cost of equity and capital structure. This conclusion confirms the results of investigation undertaken by Estrin and Rosevear (1999).

Generally said, the higher the degree of concentration of corporate ownership the higher the cost of equity and the higher the financial leverage. It should be noted that managers-owners and institutional investors, mainly the foreign investors, who compose the largest groups of insiders at most of the investigated 270 companies have different points of view on what kind of capital structure for the companies is optimal.

Managers, who are shareholders at the same time, are much less inclined to use equity to finance the activity of the companies. Only 26 per cent of the companies controlled by managers issued new equity during 1998-2001. These results support those obtained by Djankov (1999) in six newly independent states. Over the same period of time companies under the control of institutional investors were much more active in financing their activities through issuing equity. About 42 per cent of the above mentioned companies issued new equity.

The same activity was performed by the companies with a dispersed structure of ownership. About 44 per cent of them effected new equity issues during 1998-2001. Despite a high activity of institutional investors in the financing activities of the companies, controlled by them, through issuing equity, some groups of institutional investors remained passive in the way. Fig. 2 shows dynamics of change in a number of the companies, controlled by various groups of institutional investors, which issued new equity.

According to Fig. 2 one can conclude that foreign investors were the most active group of institutional shareholders in financing the companies activities with new equity. Over 1998-2001, more than one half of companies controlled by foreign institutional investors, issued new equity. In contrast to foreign institutional investors, Ukrainian financial-industrial groups and banks were passive in new issuing equity. Only every fourth company under the control of

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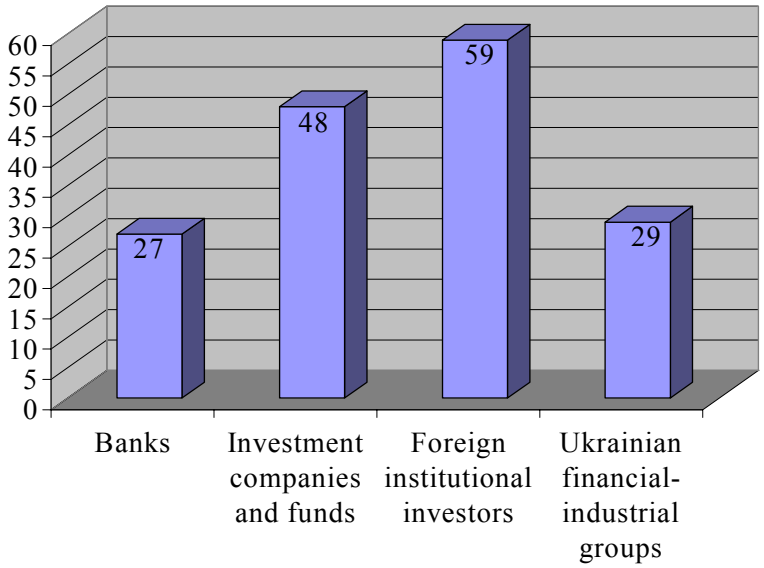
Ukrainian financial-industrial groups and Ukrainian commercial banks issued new equity during 1998-2001.

Figure 2: Changes in the number of companies controlled by various groups of institutional investors, which issued new equity during 1998-2001



The passive behavior of Ukrainian commercial banks on the secondary stock market is very irrational, taking into account the quite liberal investment regulation system in Ukraine in comparison to the East European countries, where there are many restrictive investment regulations for domestic banks, investment companies and institutions. Ukrainian commercial banks may be participants not only on the primary stock market. They may also trade the shares of Ukrainian companies on the secondary stock market.

Most interesting is the fact that Ukrainian commercial banks are active in issuing new equity to finance their own activity, but they do not want to let the companies they control issue new equity. Ukrainian commercial banks obviously care more about keeping control over the companies than about looking for new sources of financing. The different behavior of the above mentioned groups of institutional shareholders (see Fig. 2) with regard to making a decision about issuing new equity can be explained in the following way.

First of all, foreign institutional investors are much more active in new equity issuing because they are much more skilled in stock liquidity management than Ukrainian institutional investors such as the financial-industrial groups or banks, most of which have never operated on the secondary stock market.

Second, foreign institutional investors use a more developed investment strategy which is not focused only on obtaining corporate control. Foreign institutional investors care about having a stock return too.

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Foreign institutional investors are inclined to prefer an investment return in the form of stock rather than in the form of cash dividends. Such behavior of foreign investors facilitates a process of reinvesting earnings. In contrast to foreign institutional investors, Ukrainian financial-industrial groups and banks aspire to obtain the investment return in the form of cash dividends. As a result, a combination of two factors – an aggressive strategy for issuing new equity and an inclination to reinvest earnings - leads to a reduction in the cost of equity for the companies under the control of foreign institutional investors (see Table 2).

Table 2: The cost of equity for the Ukrainian companies, controlled by institutional investors

Groups of institutional investors	**Cost of equity by years, per cent**			
	1998	**1999**	**2000**	**2001**
Ukrainian commercial banks	26	29	32	34
Ukr. financial industrial groups	28	33	31	36
Ukr. investment companies and	24	22	25	23
Foreign institu-tional investors	21	19	18	20
Average	25	27	28	30

Applying the findings of Stulz (2000) it may be concluded that precisely foreign institutional investors, obtaining corporate control, develop a corporate governance system in the most efficient way to avoid provoking such problems of corporate governance as asymmetry of information and conflicts of interests. In doing this successfully, foreign institutional investors reduce the degree of uncertainty of shareholders and potential investors. This lets companies under the control of foreign investors avoid paying dividends in cash and activate a process of earnings reinvestment.

Conclusions

In concluding the research into capital structure as an element of the corporate governance system in Ukraine the following should be underlined.

First, the capital structure of Ukrainian companies is an efficient indicator of corporate governance performance. That means that the higher the cost of equity and the higher the financial leverage, the more acute the problem of asymmetry of information.

Second, foreign institutional investors are the most active in issuing new equity and the most efficient in capital structure management. This leads to a reduction

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in the cost of equity and a resolution of the problem of asymmetry of information.

Third, Ukrainian joint stock companies under the control of Ukrainian commercial banks are the most passive in issuing new equity. Moreover, these companies are the most inefficient (excluding companies under the control of executives) in issuing new equity.

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