


INFOSYS & POWER OF CORPORATE GOVERNANCE

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Infosys, a leading I.T. and consulting multinational originated in India, hit the headlines several months ago as their CEO Mr. Vishal Sikka had resigned. The issue came out as a consequence of a different approach to leadership between the founders of Infosys and management of the company. On the day of the news, Infosys stock was down 9.6%. In summary, this is what happened: Founder Mr. Narayana Murthy was questioned if he had been doubting the value system of Infosys in the wrong way and if the founder's influence on the management was being too strong." Mr Sikka, formerly the CTO of German software company SAP, had been the first Infosys leader and CEO who had been attracted from beyond the group's seven founders.

A number of media sources have depicted the news of the resignation as a consequence of a corporate governance problem, as Indian businesses are trying to make a shift towards professional management and away from the dominant role of founders and their families.

In our view, what really happened in this story has been a bit misunderstood by some media sources. Infosys is actually a company with very strong corporate governance practices, arguably among the best in all of Asia. Infosys' reputation at Nasdaq is one associated with excellence. It quickly discloses information and complies with Nasdaq norms, in some cases even better than its western peers.

The real problem (which may not have been emphasized enough in the media in our view) is that Mr. Sikka's management style was not only confrontational to the founders' approach to leadership but it also went against the unique culture that enabled Infosys to thrive over many years. The founders were concerned about Mr. Sikka's management style because they feared value loss as a result of erosion of Infosys' core philosophy, which is centered at modesty, transparency and hard work. This is the value system that has led the company from its foundation into a multi-billion dollar enterprise.

Indeed, the recent Infosys did reveal a weakness in corporate governance. However, in this case it was not related to the concept of "dominant shareholders" – which happens when powerful founders and families in India interfere with managements' reasonable decisions. What we saw here was, in fact, a classic agency-manager problem you would more likely find in the U.S. A number of executives who were priorly in charge of positions overseas were paying themselves in a rather careless way and doing deals, which, by Infosys ethics, were questionable. Then the board got blamed for allowing a shift towards a U.S.-style corporate culture where salaries for top executives grew faster than for other employees. The founding partners, including Mr. Murthy, finally stepped in to steady the ship.

Mr. Sikka rationalized some of his traveling expenses when he explained how he used a jet only 17 of his 116 flights during last year. This explanation may be perfectly admissible at a company with a different corporate culture. It isn't however the best argument to be made to Infosys' iconic founder and former CEO (Mr. Murthy) who is known for his humility such as standing in food queues together with regular employees during the time he used to run Infosys.

India is abundant with examples of good governance and is accepted as a place with higher than average corporate governance practices compared to the rest of EM. Investors often attribute traditionally higher valuations to Indian multinationals like TATA group or Godrej due to better corporate governance.

The private sector in India has always been there to begin with – but new reforms in 1991 worked to improve corporate governance. These reforms un-shackled the private sector from a plethora of rules and regulations, which had been constraining their growth.

Then, the legal system in India provides the right framework for the establishment of best possible corporate practices to start with. Legal systems in most countries have their roots in one of the four distinct legal systems – the English common law, French civil law, German civil, law and Scandinavian civil law. Countries whose legal systems stem from the common law tradition tend to protect investors considerably better than do countries whose systems are based on civil law, especially French civil law. Countries whose systems are based on German and Scandinavian civil law take an intermediate stance toward investor protection. The Indian legal system is obviously built on the English common law system. The evidence points to a stronger stance favoring all investors in common law countries. [i]

Lastly, one of the main reasons for governance strength in the Indian private sector is strong property rights. When an entrepreneur builds a business, puts his or her name on it, and passes it on to the next generation, it becomes a matter of prestige. Good governance structures help with smooth transitions and enable the running of a growing multi-business empire by several family members while discouraging family disputes seeping into business operations. But it is not always the case. The Reliance group in India is an example of a group, which could not handle inter-generation transfer well and has left investors with governance concerns, resulting in discounted valuations.

All this helps explain how India has evolved better corporate governance practices. When investors see this right framework it encourages them to stronger market participation leading to a more fair distribution of shares and a lower risk for the problem with "dominant shareholders". India is one of the very few EM countries where family owned businesses have successfully crossed borders to become world class multinationals. It may be fair to say good corporate governance paved the way in this achievement.

References: [i]**https://pdfs.semanticscholar.org/86b2/ced6e208f761ea67a7ff1d...**