Long-Term and Short-Term Effects of Unethical Behavior on the Russian Stock Market

Master's Thesis in Banking and Finance

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Executive Summary

Problem

Corporate misconduct is a widely known problem in the Russian business environment. To some managers, it might look like another strategic decision with only one assessment criterion – does it bring value to the company? However, this criterion is far from being exhaustive. Shareholders, whose wealth is directly linked to the company's performance including corporate governance, might have a different view on the value and cost of illegalities committed by the firm. Previous literature has presented various results – some show that the shareholder's response to the corporate crime announcement is significantly negative, some papers record neutral or even positive effect. The majority of the studies focuses on the developed markets and there has not been a study of the developing markets in the Eastern European region. The Russian market being the biggest and more developed one in this area could become a starting point for the research of the perception of corporate crime by the investors in this region.

Methodology

The companies analyzed in the study are listed Russian non-financial companies with above average capitalization. The time period of the dataset is from January 2005 till March 2018. Based on the previous research on the short-term effect, the event study methodology is employed in order analyze the stock price reactions to the announcements of corporate misconduct. The main event window is determined to be 41 days symmetrical around the announcement day with the estimation period equal to 150 days from the beginning of the event window. The abnormal returns and cumulative abnormal returns are determined and tested for significance. Other event windows are employed later in order to analyze the performance of the stock prices in more detail. The events are split by different criteria such as the crime type, the sector in which the alleged company operates, the time period in which the crime was announced and the fact if the crime was repeated or not. For the long-term implications of the effect of misconduct, the companies' return is analyzed by comparison with the industry portfolios. Those industry portfolios are constructed over the course of this thesis and the difference between their performance and the performance of the companies is tested for significance.

Findings

In the analysis of the short-term reaction there has been no significant response to the announcement of corporate misconduct. The analysis included assessing the reactions over a number of timeframes namely: 41, 21, 11, 7 and 3 days symmetrically surrounding the event day along with 10, 10, 5 and 3 days before and after the event as well as the event day itself. CAARs were found to be negative for all the above-mentioned time periods, however, none were significant, preventing the rejection of the null hypothesis of cumulative abnormal returns being different from zero.

The analysis of returns based on the type of crime has shown all CAARs to be negative, except for fraud and embezzlement ones. This might be explained by the specificity of the crimes and the regulatory responses to them in the sample. Here, fraud is mostly "tax fraud", meaning the presence of benefit for the shareholders. As for embezzlement, the embezzled money is small relative to the value of the company and would be returned to the company after litigation.

Environmental and social responses are compared and the difference between them is found to be up to the tune of 2.57%, with environmental violations getting less stock price drop. This could be explained by less attention that environmental issues get in the society. The difference, however, is insignificant.

The industry split analysis has shown that Oil&Gas and Energy CAARs are positive, while Mining and Telecom ones are negative. The results for Oil&Gas as well as Energy might be explained by the fact that the companies are big monopolies with the means to fight off charges, so even if they do commit ethical crimes there would not be significant repercussions. While this holds for Mining as well, the results differ in sign, leaving one to speculate about the reasoning behind it. The reaction to the Telecom companies' misconduct might be explained that telecom providers are significantly smaller than industrial firms and the former depend highly on their relationships with other parties - their clients can more easily switch between them. One also needs to keep in mind the lack of significance of these findings.

The analysis of the crisis period reactions to misconduct has yielded significant reactions on Days -1, the Event Day and Day 1. This can be attributed to two possible factors: the first one would suggest investors' overreaction to dramatic news during crisis times, while the second one would imply that during turbulent times shareholders monitor their holdings more vigorously and choose to punish companies for making times even more difficult for them.

For the long-term effect of misconduct no effect was found during the periods of two years, from two to five years and from five to eight years after the announcement of misconduct. The portfolio of alleged companies outperforms the industry indices almost in all cases, except for the time frame of two years after the illegality. However, the difference between the industry and the portfolio is not significant on any level. It allows one to assume that no long-term effect of corporate illegalities is present in the share prices and the fact that the company commits crimes does not create any advantages or disadvantages for it compared to its peers.

It is therefore concluded that corporate crimes in Russia do not significantly affect the share prices either in the short-term or in the long term, regardless of the industry, repeatedness or type of crime. The only thing that would matter to investors is the overall state of the economy, which is the only time when they punish the company for the illegality. The main underlying reason for this is concluded to be the lack of signs of practice change in the alleged companies. Therefore, both managers and investors should be warned from ignoring the misconduct and its effects, since at some point an illegality might be serious enough to demand revision of the whole system and its reactions.