

8 January 2009

News in Brief

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Satyam fraud highlights need for vigilance on governance risks



According to George Dallas (pictured), Director of Corporate Governance at F&C, this week's announcement that a serious fraud had been perpetrated at India's Satyam Computer Services is a reminder of the governance risks that can occur when internal controls are weak and an owner/manager is inadequately overseen by independent board directors. A letter dated 7 January by the company's former chairman, B. Ramalinga Raju, provided details on how financial fraud had been perpetuated at Satyam over several years without the directors or auditors having noticed a problem. Dallas commented: "The revelation of this fraud has impacted the company's share price by almost 80% and casts doubt over Satyam's longer term future as an independent company. Satyam is already being referred to as India's 'Enron' and this incident also raises broader concerns about corporate governance in India and the governance of family-controlled firms." While there is no evidence that the Satyam incident will prompt identification of other frauds or governance failures in India, Dallas states that F&C is alert to corporate governance risks in India and emerging markets more broadly – "particularly those that relate to the abuse of minorities by controlling shareholders". Indeed, just last month F&C published a report titled "Corporate Governance in Emerging Markets: an Investor's Roadmap" which includes a review of Indian corporate governance and outlines a range of key governance risks, warning indicators and recommended good governance practice measures that are relevant for emerging market companies. While the F&C report notes that controlling shareholders can be a positive force in many companies, it also focuses specifically on areas where controlling shareholders can negatively impact the company and the interests of minority shareholders. In particular, F&C's report provides guidance for investors and companies in areas that are relevant for family-controlled

companies; these include related party transactions, management entrenchment, board independence and effectiveness, and audit, control and risk management. Dallas concluded: "The Satyam case is very concerning, in part because the company appeared on the surface to have high governance standards, and had even received awards in this respect." "While it would be inappropriate to infer that the fraud perpetuated at Satyam is typical of companies in India or other emerging markets, this incident serves to remind investors of the need to monitor corporate governance standards with diligence and to engage with companies to ensure that governance-related risks are appropriately managed and mitigated."

For a copy of the report "Corporate Governance in Emerging Markets: an Investor's Roadmap" please email paula.garrido@fandc.com

Gazprom not entirely unjustified

The dispute between Russia and Ukraine over gas supplies rumbles on. Despite some European regions declaring a state of emergency, Russia's state-controlled Gazprom have yet to reconnect the supply. Gareth Morgan, manager of the F&C Russian Fund, comments: "It is easy to paint Gazprom as the villain in this debacle. However, whilst their actions have been aggressive, they were not entirely unjustified. This is a complex issue which first occurred in 2006 and has resurfaced again with collapsed negotiations over this year's contract price and the Ukraine's failure to pay November and December's supply to the tune of \$1.7bn." Morgan points out this the debt has now been paid, but the stumbling block remains the contract price. "Central Asian economies are now charging a price near to European netback prices, meaning that Russia are paying more for the gas they buy from Central Asia but losing out where the Ukraine are demanding a significant discount," he said. The situation has been exacerbated by the fact that the gas price is linked to crude oil prices, but lags it by 6-9 months. "Whilst oil prices have fallen in the last 6 months, gas prices have some way to go and will not mirror the decline until at least the summer. Ukraine is delaying its price agreement in the hope that oil price declines will finally feed through into gas prices and they get a better deal – but in the meantime, Gazprom takes a financial

hit."

Morgan states that while the Ukraine and Europe are suffering, the action also bears consequences for Gazprom, both operationally and politically. "Whilst the gas supply remains switched off, this has implications to both infrastructure and operational activities. Gazprom had been seeking to diversify their capabilities in Western Europe away from the Ukraine via construction of new pipelines. However this is still in the developmental stages and will take many years. In the meantime, Gazprom's actions will further sour relations with Western Europe who may now possibly step up attempts to diversify its fuel needs elsewhere. Approaching Central Asian countries to agree a reduced price is not a likely option – with other Asian countries, such as China, looking to secure their supplies from the same source, Gazprom do not want a situation where they cannot guarantee this supply".

Selective high street bargains

As the woes of UK retail sector continue to make headlines with stores such as Woolworths, Zavvi and Adams going bust, opportunities still exist in selective stocks, according to Hilary Aldridge, co-manager of the F&C UK Growth & Income Fund. "Rising unemployment, low savings ratio and the strengthening dollar all threaten to hit margins as well as sales," said Aldridge. "However share prices have gone a long way to adjusting for these negatives. Those people who remain in employment in 2009 should actually be better off than they have been for some time as petrol and food prices fall and significant cuts to interest rates feed through into lower mortgage payments." According to Aldridge the current gloom will encourage more saving but consumers will continue spending money on items they really need. "Retailers of smaller items, such as clothing or the value end of home furnishing retailing, should find life easier than many people think," she commented. Over the recent past, Aldridge has been adding retailers to both Growth & Income and Special Situations. For instance, at the end of last year she added Next to both portfolios given the stock's attractive valuation and yield. Another stock she likes and describes as a long-term winner is furnishing company Dunelm held in Special Situations for some time. "We still prefer those companies with solid balance sheets and good cash generation. Over the next 18 months we expect to see strong businesses getting stronger," she concluded.

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