Institute for Development of Freedom of Information (IDFI)

"Corporate Political Responsibility (CPR) and its Impact on Companies' Financial Performance – The Case of the Georgian Insurance Sector"

By

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<u>Abstract</u>

The current paper explores Corporate "Political" Responsibility (CPR) by considering the case of Georgia. It also attempts to discuss the impact of CPR on the economic development of the Georgian state by analyzing the Georgian insurance sector in general and the sector's companies' short-term financial results, in particular. In order to establish a positive or negative influence of the CPR on a company's performance, an additional theoretical component was introduced to the given research; for the purposes of the given article the theory of politically connected firms has been applied to the research. The outcomes of the study strengthen the validity of the pre-formulated hypothesis; the pace of the growth of the intrinsic value of the industry after CPR project has slackened. Moreover, as a result of CPR activities most of the financial indicators (ROA, Net Income and Financial Leverage) of the companies under discussion have visibly deteriorated. Findings consent to the second hypothesis of the authors as well. Companies with less political connections were forced to carry out major changes in the composition of their shareholders as a result of the company's decision to apply the CPR. From the given evidence, it might be concluded that CPR positively impacts those with the strongest political connections. Once engaged in the CPR project, the company with the strongest political connections turned into a major player of the insurance market as of 2012.

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1. Introduction

Georgia started its formation as a state twenty years ago. The so-called “Modernization Hypothesis” (Lipset, 1959), whose main characteristic is the initial growth of GDP per capita, has been dominant in Georgia since 2003 and will in turn cause democratic development of the country. As a result, the political elite of the country made the growth of foreign direct investments (FDI), privatization of the property owned by the state and acceleration of the process of liberalization of the economy their main priorities (Papava, 2006).

An incomplete list of implemented reforms and the positive results (theoretically) thereof is as follows: (1) the quality of enforcement of the Georgian Tax Law has increased (Papava, 2009), which, as a rule, is empirically followed by growth in the values of enterprises and improvement in the quality of corporate governance (Desai et al., 2007); (2) corruption, which has a negative influence on the economic growth of the country, in the values of enterprises, capital expenses and corporate governance, have considerably diminished since 2003 (“Global Competitiveness Report 2012-2013”, 2012); (3) the opening of financial markets and their liberalization is a declared policy of the Georgian government and the instruments of this policy (Djankov et al., 2002), which were successfully implemented in Georgia (“Doing Business 2012”, 2011), positively correlate to the growth of FDI in the country, especially in the so called Emerging Markets (Agosi / Machado, 2007) and also causes growth of enterprise value (Chua et al., 2007).

Despite these improvements in separate sectors of the economy, overall, the Georgian model of economic development exhibits a certain peculiarity. As a result, it has not been possible to develop some important elements for the economy, for example, the capital market (“Global Competitiveness Report 2012-2013”, 2012; Christophe, 2006); the innovative component of this country’s economy is very small and, with regard to Business Sophistication Georgia holds one of the last places, furthermore, regarding the quality of its anti-monopolistic policy Georgia occupies the 141th place out of 144 countries in the world (“Global Competitiveness Report 2012-2013”, 2012). As a result of this, the share of the Vita Economy (Papava, 2002; 2005; 2010) in the GDP remains very low.

The goal of our research is to determine an additional factor that will partially explain this peculiar and unilateral model of development. In the following section we analyze what we consider to be one such defining factor of the Georgian model of economic development, namely, the phenomenon of so-called Corporate ‘Political’ Responsibility (CPR). Our objective is to examine the influence of this phenomenon on the country’s model of economic development by analyzing the Georgian insurance sector and the short-term financial results of several specific and representative companies in this sector.

2. Theoretical Foundation and Forming the Hypothesis

2.1 Corporate Political Responsibility (CPR)

The term "Corporate Social Responsibility (CSR)", which implies the norms of conduct of the companies, has established itself since 1950s; voluntary observance [(Initially by businessmen (Bowen, 1953), and later by companies (Davis, 1967)] of the mentioned norms speaks of the existence of social responsibility in the companies towards the society. The process of development of the last decade in Georgia has been accompanied by a (political-economical) phenomenon very similar to the CSR, but at the same time, its vector is directed at absolutely different actors and types of responsibilities. This phenomenon is referred to as **Corporate Political Responsibility (CPR)** and can be seen when an ordinary private player on the market faces a necessity to complete a "political-economical" activity, usually financially harmful, ruled by the government.

When seeking the reasons for such a phenomenon, it is first of all necessary to discuss historical factors. Such factors capable of causing this kind of political-economical phenomenon could be found in the totalitarian regime within the framework of the Soviet command economy and again later in the late Soviet period when in the conditions of lightened "command economy" elements of market economy in the face of "Soviet Businessman" (so-called "Делец") started developing (Papava, 2002; Papava / Khaduri, 1997). It is known that the main activity of this type of businessman was building a relationship with the government within the framework of semi-legal economic activity and it is easy to imagine that even after the final collapse of the "command economy", useful rational aspects of the renewed "partnership" for both institutional actors[3] are a subject of interest.

The second important defining aspect of CPR-phenomenon is an unstable political situation in the country, such as when we are dealing with a non-democratic social-political environment, the so-called hybrid regime, where democratic and autocratic components of governance replace each other (Levitsky/Way, 2010) and this environment is reflected on the existing economic relationships in the country.[4]

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[3] Especially in the conditions of an uncertain model of capitalism in an young state.

[4] The deciding factors of such a generally unstable political-economic situation are, for example, an unstable situation concerning property rights, especially concerning business-property [According to the index of global

The next stage requires listing the main characteristics of CPR conduct norms:

1. CPR conduct norm is related to investment, which requires taking on financial obligations by the involved company.

2. A company must engage in CPR conduct unexpectedly, meaning that oftentimes, it is not ready to take up this kind of financial obligation and has not weighed the risks related to said obligation. As a result, this kind of activity is accompanied by the problems of the company's liquidity.

3. Activity within the framework of CPR does not represent the main business of the company. From this follows that the company, along with the task of overcoming the risks related to the company's liquidity, is confronted by the absence of know-how of a concrete direction, which further complicates the completion of the so called CPR-project.

Moreover, within the framework of CPR, the company receives different types of concessions/encouragement, which should make completing CPR-obligation easier. These types of concessions/encouragement can be: additional purchase orders made by the government, the government granting the company certain privileges during the process of privatization, the toleration of the company's monopolistic positions in the local market, government support of the company's competitiveness (e.g. creating tax barriers for the entry of foreign competitors in the local market, adopting national regulation that is beneficial to the company and/or a relatively weak enforcement of existing regulations in the case of a specific company).[5]

2.2 Politically Connected Firms (PCF)

From all the above we can hypothesize that the completion of CPR can have positive, as well as negative effects on the long-term development of a specific company, the whole industry and the economy of the country. For the purpose of finding these positive or negative

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competitiveness published on the „World Economic Forum" in 2012, Georgia stands on the 131st place among 142 countries) (World Economic Forum, "Global Competitiveness Report 2012-2013", 2012)]; weak institutional development of the country, especially concerning those institutions that should provide a better business environment, like local financial markets, government offices, etc. [According to the index of global competitiveness published on the „World Economic Forum" in 2012, Georgia stands on the 93rd place among 142 countries in regards to the development of financial markets and 99th place out of 142 in regards to judicial freedom) (World Economic Forum, "Global Competitiveness Report 2012-2013", 2012)]; political-economic and/or social factors, for example, approaching parlamential or presidential elections; a new Force-majeure regime (e.g. revolutionary change of the government), which essentially changes the existing political landscape and places not only quality, but the existence itself of the above-mentioned aspects, meaning democratic peace, institutions, property rights, under question.

[5] Considering the fact that, according to the report of "World Economic Forum", Georgia is on the 127 place out of 142 countries by the degree of competitiveness on the local market and 141 place by the effectiveness of the anti-monopolistic policy, the existence of the above-mentioned "government encouragement/concessions" becomes the most important component for the establishment of the company on the market and makes the company even more susceptible to CPR.

effects, we consider it necessary to include further theoretical elements which might have an additional effect on the influence of CPR in the case of taking up such obligations (activities done as a result of CPR). The theory of politically connected firms (PCFs) is fitting in such a case.

A large amount of international research (Fisman, 2001; Johnson / Mitton, 2003; Faccio et al., 2006; Fan et al., 2007; Claessens et al., 2008) offers evidence of the importance of the influence political connections can have on the country's economy and the development of the performance of its actors. As a result, firms often try to establish political connections to achieve important economic goals. For example, politically connected enterprises have lower capital costs (Boubakri et al., 2012), and the reason for this may be considered lower risks in case of such connections, which in turn causes the growth in the price of the enterprise (Faccio et al., 2006; Leuz / Oberholzer-Gee, 2006). Chaney et al. (2011) note that it is easier to attract the so-called "Debt Capital" for politically connected firms. De Soto (1989) notes that another important benefit for the companies can be the acceptance of regulations unilaterally favorable for the firm; at the same time, in case of companies owned by the government, such as banks, manufacturers of raw materials, etc., privileged attitude can be noted by the companies with this kind of political connections (Backman, 1999). In our case, the positive effect of such political connections could be receiving maximum government encouragement in the process of meeting CPR-obligations and/or taking minimal CPR.

The degree and intensity of these benefits varies across the firms and countries. For instance, according to international research (Faccio et al., 2006), 7.72% of the capitalization of the world stock markets are PCFs. However, in Russia, the share of the capitalization of such companies is 86.75% of the capitalization of the whole market.[6]

2.3 Formulation of the Hypothesis

Papava (2010) writes about the threat of zombification of the Georgian economy and its private actors. In this case, we elaborate on his idea and point out the danger that, now under the conditions of CPR and political connections (Fisman, 2001; Faccio, 2006), threatens the actors of, using his terms, the so-called "Vita Economy" in Georgia[7]; specifically, we express a doubt that under the conditions of CPR and political connections, financial health in the market and correct decisions made by the management no longer represents the decisive factors of a company's success.

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[6] This fact allows us to assume that the number of politically connected firms in Georgia will be very high.

[7] Here, we mean modern and competitive actors on the Georgian market.

Our Hypotheses are:

1. In the short run, CPR negatively correlates with the financial results of both the company and the industry as a whole.

2. The Georgian economic model, under the conditions of CPR, supports the absorption/weakening of politically, as opposed to financially, weak firms.

3. Institutional Background

Within the framework of case study, the CPR-phenomenon will be studied and analyzed based on the examples of the large-scale reform in Georgia's healthcare sector and the involvement of Georgian insurance companies in this reform.

One important reason for selecting the insurance sector as a subject of this study was the strong government position in the insurance market, especially within the health insurance sector. This circumstance in turn increases the likelihood of the existence of the CPR phenomenon in the insurance market.

Government Share in the Insurance Industry		
2009	2010	2011
38.9%	47.8%	44.1%
Health Insurance Share in the Insurance Industry		
2009	2010	2011
68.6%	68.0%	62.5%
Government Share in the Health Insurance Sector		
2009	2010	2011
53.7%	68.4%	68.0%

Source: The National Budget of Georgia, the National Bank of Georgia, financial accounts of the insurance companies

For the first time, the discussion concerning large-scale reforms in the hospital sector of healthcare in Georgia began in 1999, when the existing hospitals were divided into three categories. The first category included the hospitals that were planned to remain in government possession, the second category of hospitals were to be sold on the condition of maintaining the profile. In the case of the third category, the plan was to sell them without maintaining the profile ("Transparency International - Georgia", Georgian Hospital Sector, 2012, p. 8). In 2004, the plan was discontinued and in October, 2006 the Ministry of Labor, Health and Social Security as well as the Office of the Minister for Reform Coordination published a new concept for the reform in the healthcare sector[8]. This was followed by the Georgian government's resolution of 26 January, 2007,[9] which contained a detailed discussion of the changes to be made through privatization of the governmental property in the Georgian hospital sector. Specifically, it discussed transferring the existing hospitals throughout the entire country to the investors, their renewal by the investors and simultaneously, the building of new hospitals[10]. The terms were decided and the project was supposed to last three years in total. As a result, on 29 January, 2009, through direct negotiations, a sales agreement was signed between "Block-Georgia" and its affiliate companies, on the basis of which the hospitals determined by the project were transferred for approximately 1500 USD (the equivalent in national currency)[11]. Shortly thereafter, the process of reparation and management of the hospitals began. Simultaneously, the erection of new hospitals across the country was planned, but unfortunately, due to financial hardship[12], the company could not start the construction of the new hospitals and this large-scale privatization project practically failed[13]. As a result, the government removed "Block-Georgia" and its affiliated companies from the part in the so-called "Project of a Hundred Hospitals" in the spring of 2010[14].

At the same time in the spring 2010, the government offered insurance companies involvement in the project of the hospital sector. The Georgian government divided the country into 26 districts and a tender was announced in which insurance companies could compete to win the rights to build or renovate hospitals in specific regions of Georgia; ten insurance companies participated in the tender. Parallel to this process, in 2010, the government changed the vouchers system of the state insurance program started in 2007[15],

[8] "Transparency International - Georgia", Georgian Hospital Sector, 2012, p. 8.
[9] http://psidiscourse.ge/files/files/21may2010/1gengegma.pdf (The information was acquired on the resource on 5th September 2012).
[10] "Transparency International - Georgia", Georgian Hospital Sector, 2012, p. 8.
[11] http://www.geworld.ge/View.php?ArtId=1787&lang=ge&Title=%E2%80%9Cblok-jorjiam%E2%80%9D-100-axali-saavadmyofos-proeqti-sabolood-daasamara? (The information was acquired on the resource on 5th September 2012).
[12] The bank guarantee and loan that could not be acquired from the "Export-Import" Bank (The Czech Republic).
[13] http://www.resonancedaily.com/index.php?id_rub=5&id_artc=467 (The information was acquired on the resource on 5th September 2012).
[14] http://commersant.ge/index.php?id=4104 (The information was acquired from the resource on 5th September 2012); In the fall of 2011, "Aldagi-BCI" decided to purchase the assets of "Block-Georgia" and in November, 2011 the agreement was made, as a result of which the acquired assets were put on as a property of the affiliate company (JSC "My Family Clinic" - 2011 financial statements of JSC "Insurance Company Aldagi-BCI", p. 30).
[15] Since 2007, a state run insurance program has existed in Georgia where the Georgian government has provided health insurance to its citizens at and below the poverty line using a voucher system. The citizens could take their voucher and go to their insurer of choice ("Transparency International - Georgia", Georgian

announced an open contest whose winner would acquire all insurance program participants of a certain region in Georgia (26 regions in total) to insure, thus depriving its citizens of their freedom of choice[16].

As a result of such changes in regulation, most of the insurance companies were forced to engage in CPR by entering the project of the development of the hospital sector. Financial benefit/encouragement of the insurance companies, in addition to the guaranteed insurance of the citizens in the region, was the right of the companies to send people insured by them to the hospitals they had built, and with the help of such policy maximally reduce their losses by compensating the damage according to the insurance.[17]

The government, as a result of the open competition in medical insurance, selected nine insurance companies. We can assume that one of the conditions for winning the tender was entering the project of the development in the hospital sector because, in the end, the companies that built the hospitals in the regions and insured the citizens were, in fact, the same insurance companies in 95% of the cases.[18]

All of the above mentioned circumstances support our conviction that the CPR-phenomenon was present in the healthcare reform. Therefore, our case study presents further motive to better study this phenomenon and determine its influence on the financial standing of specific companies and of the entire industry.[19]

The importance of the research is enhanced by the fact that according to the resolution #165 of 12 May 2012, an extended program of national insurance will be enacted in September 2012. The program will additionally include the retired, children under the age of six and

Hospital Sector, 2012, p. 4, p. 7); “Transparency International - Georgia“, Health Insurance in Georgia, 2012, pp. 13-15.

[16] Currently, the number of citizens involved in the national insurance project is almost 800,000.

[17] “Transparency International - Georgia“, Georgian Hospital Sector, 2012, p. 16; later it could be well observed that after CPR the degree of the enforcement of the state regulations weakened considerably, which made refusing beneficiaries for the insurance companies easier, which is clearly seen in the research conducted by “Transparency International - Georgia” in 2012, which confirms the positive correlation between the increasing dynamic of refusal of beneficiaries and the involvement of the insurance companies in the hospital sector development project (“Transparency International - Georgia“, Georgian Hospital Sector, 2012, p. 19).

[18] “Transparency International - Georgia“, Georgian Hospital Sector, 2012, p. 4, p.22; “Transparency International - Georgia“, Health Insurance in Georgia, 2012, p. 17; our assumption that the involvement of the insurance companies in the project was a typical example of CPR is further confirmed by the fact that the absolute majority of the hospitals built had 50 or less beds and it is known that these kinds of hospitals are, as a rule, in the category of unprofitable institutions (Transparency International - Georgia“, Georgian Hospital Sector, 2012, p. 18).

[19] As already mentioned, existing political connections of the company could play an additional part in the effect of the CPR phenomenon. We express a doubt that, in the framework of the above mentioned peculiar privatization project and “Social Insurance Program”, the leading players of the market would receive a strong stimulus to use their existing political connections for their benefit in the process of completing CPR. Therefore, we consider it necessary to additionally determine the political connections of the companies in the framework of the research and during the analysis of the financial indicators reveal the potential profit/concession resulting from these connections.

students. As a result of the program, the number of people insured by the government will be almost 2.1 million.[20] Therefore, we consider it of the utmost importance to analyze the economic results of the previous program before moving to larger-scale program.

4. Analysis

4.1.1. Sample

Our research attempts to determine the influence of the CPR-phenomenon on the Georgian insurance sector. More specifically, we are trying to analyze the influence of the CPR-phenomenon on four main players, the sum of whose revenues is more than that of 65% of the sector.

These companies[21] are: Aldagi-BCI[22], GPI Holding[23], Imedi-L[24] and Irao[25].

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[20] "Transparency International - Georgia", Health Insurance in Georgia, 2012, p. 4, p.26; again, beneficiaries insured in its framework will not have a right to independently choose an acceptable insurance company ("Transparency International - Georgia", Georgian Hospital Sector, 2012, p. 4, p. 7).

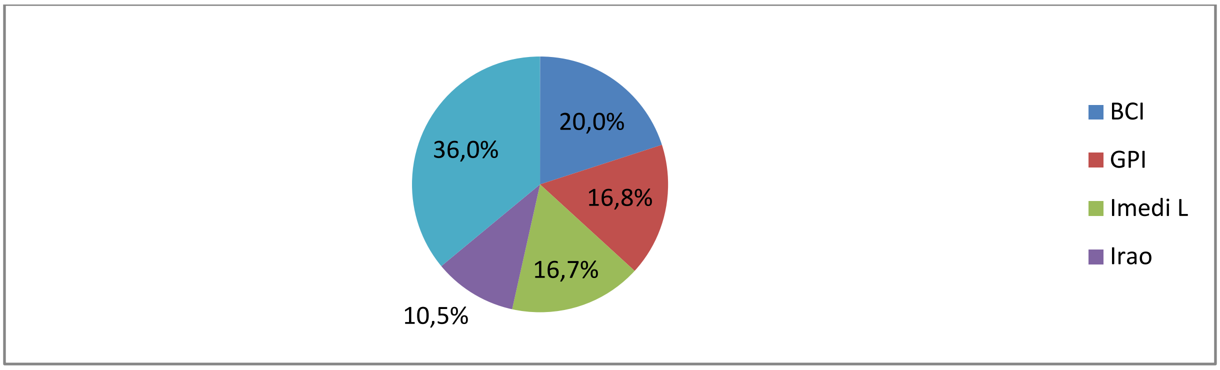
[21] The research did not include the fifth big player, the insurance company "Alpha". This was determined by two reasons. First, it turned out impossible to acquire the financial accounts of "Alpha" from the relevant years. The second reason was the parent company of "Alpha", which is a big player of the pharmaceutical sector of Georgia, the firm "Aversi-Pharma". We believe that if we had included "Alpha" in the research, this circumstance would have affected the results negatively because the engagement of the pharmaceutical sector in the insurance sector could have completely different reasons than those circumstances accentuated in this research.

[22] JSC "Insurance Company Aldagi-BCI" got involved in the hospital sector development project in the spring of 2011, after it decided to purchase the assets of the company "Block-Georgia". The final agreement was reached in November, 2011, as a result of which the acquired assets of the company were put on as a property of the affiliate company (JSC "My Family Clinic" - 2011 financial statements of JSC "Insurance Company Aldagi-BCI", p. 30). For the purpose of financing the project, the company has opened a credit limit of 10,515 million GEL in ING Bank N.V. since 31 December, 2011 (As of 31 December, 2011 the company had already acquired almost 7 million GEL). Also, in the framework of the project, the affiliate company of "Aldagi-BCI" JSC "My Family Clinic" took a long-term loan (almost 27 million GEL) from JSC "TBC Bank" (2011 financial statement of JSC "Insurance Company Aldagi-BSI", pp. 40, 72).

[23] JSC "Insurance Company "GPI Holding" undertook the obligation of constructing-rehabilitating 10 hospitals across Georgia on the basis of the agreement signed with the government within the framework of the hospital sector development project. The total investment of the company in the project is about 29 million GEL. For the purpose of financing the project, the firm took long-term loans from its parent companies (TBIH, Vienna Insurance Group) (2011 consolidated financial statement of "GPI Holding", p. 33). The construction-rehabilitation ended on April 1st, 2012 (2011 consolidated financial statement of "GPI Holding", p. 47).

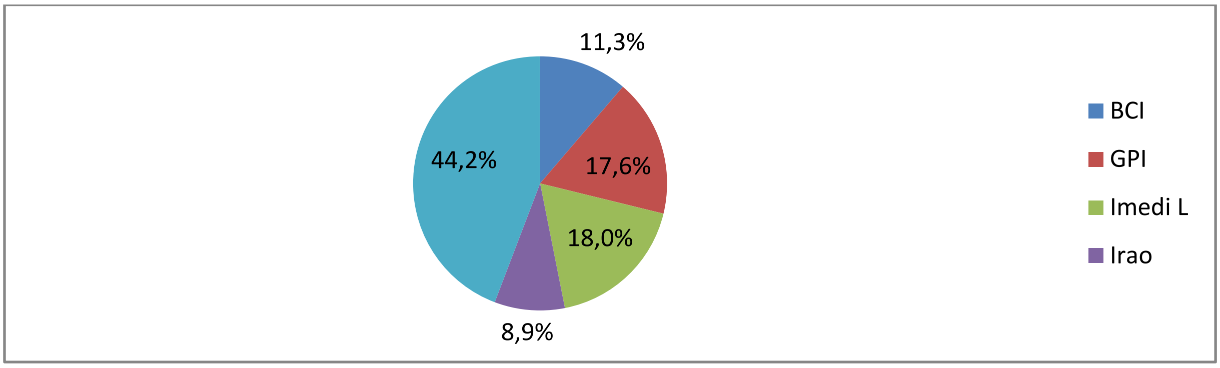
[24] The insurance company "Imedi L" undertook the obligation of constructing-rehabilitating 11 hospitals across Georgia in 2010 on the basis of the agreement signed with the government in the framework of the hospital sector development project (2011 consolidated financial statement of "Imedi L", p. 59). For the purpose of financing the project, the "Bank of Georgia" approved a credit limit of 30 million USD for "Imedi L". "To acquire the loan, the Group had to satisfy a predetermined coefficient of capital maintaining" (2011 consolidated financial statement of "Imedi L", p. 36).

[25] The insurance company "Irao" undertook the obligation of constructing-rehabilitating 6 hospitals across Georgia in 2010 on the basis of the agreement signed with the government in the framework of the hospital sector development project. The total investment of the company in the project is about 17 million GEL. For the purpose of financing the project, the firm took long-term loans from its parent companies (TBIH, Vienna Insurance Group) (2011 consolidated financial statement of Insurance Company "Irao", p. 33). The construction-rehabilitation started in 2011 and ended on January 1st, 2012 (2011 consolidated financial statement of Insurance Company "Irao", p. 47).



Source: http://nbg.gov.ge/index.php?m=488 (Financial Index of the Insurance Market)

Sector Diagram 1. Market share - year 2011 (According to Net Revenues)



Source http://nbg.gov.ge/index.php?m=488 (Financial Index of the Insurance Market)

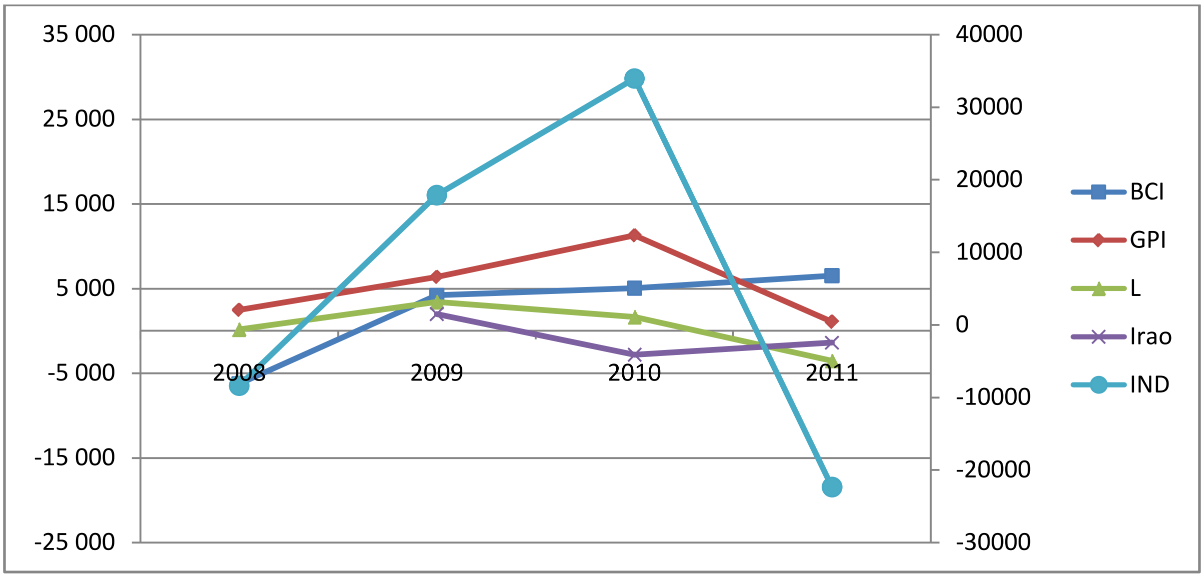
Sector Diagram 2. Market share in the sphere of health insurance – year 2011 (According to Revenues)

We will discuss which effects the engagement in the project of developing the hospital sector had on the financial performance of the companies. Several different measurements can be used to study the real standing of the companies, which can be divided into financial and non-financial parameters. The non-financial parameters include organizational, structural and natural factors. As a result of the design of our research, we shall accentuate the financial indicators and will analyze the generally accepted financial indicators: net income, return on assets (ROA), revenues from sales, assets, capital and leverage. After discussing financial parameters and ratios, the real economic (intrinsic) value of the industry will be calculated, in which all the above-mentioned indicators should be reflected. Economic (intrinsic) value will be estimated using the so-called Residual Income Valuation Model (Feltham/Ohlson, 1995).[26]

[26] The weighted average cost of capital (WACC) of Aldagi-BCI as the cost of capital of the companies, which was the only available figure that could be acquired among the insurance companies.

4.2 Results

The dynamics of the development of ***net income*** indicates that these parameters of the industry and four big players of the sector in the last three years were generally increasing in the last three years before the "event"[27]. After the "event", the net income of three out of four big players sharply decreased. As a result, we can see a situation, in which, the net profit of a sector, which was generally increasing[28], was "forced" to replace foreign investors due to a failed government privatization project, which in turn made one of the main financial indicators sharply decrease. This kind of economically irresponsible behavior can be explained with the CPR phenomenon. The fact the one of the big players, "Aldagi-BCI", in contrast to its competitors and the industry as a whole, managed to maintain a steady increase in net income indicated its strong political connections[29]. Specifically, we can assume that the company got involved only in the last stage of the project (November 2011) due to this political connections[30].



Source: Financial statements of "Aldagi-BCI", "Imedi-L", "Irao" and "GPI-Holding;

[27] The "event" is the de facto engagement of the insurance companies in the hospital sector development project. Judicially, the mentioned event started in 2010, but in the case of some companies its results appeared only in the financial reports of 2011.

[28] It should be noted that the growth of the sector was partially caused by the national insurance programs started in 2007 according to government budget allocations.

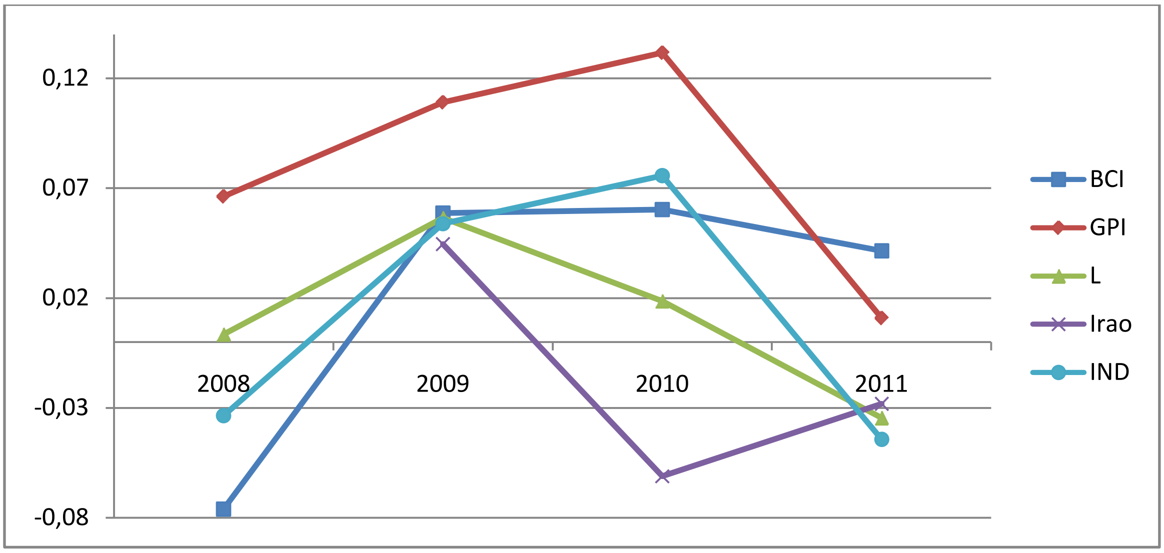
[29] The chairman of "Aldagi-BCI" Supervisory Board and the CEO of "Aldagi-BCI's" parent company "Bank of Georgia", Irakli Gilauri, is a close relative of the former Prime Minister of Georgia, Nikoloz Gilauri. It should also be mentioned that the former CEO of "Bank of Georgia" (2004-2007), Vladimir Gurgenidze, was the Prime Minister of Georgia in 2007-2008. These facts strongly indicate the existence of political connections in the company. In the case of "Imedi-L", we are dealing with a case of a local company lacking political connections; in the cases of "Irao" and "GPI-Holding", we are dealing with cases of affiliated companies of international parent firms lacking political connections.

[30] At the same time, "Aldagi-BCI" constructed-rehabilitated only those hospitals that were located in the closely populated regions (Imereti, Samegrelo), where in turn the greatest number of the population insured under the government program is concentrated (2011 financial statement of "Aldagi-BCI", p. 31).

http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market)

Graph 1. Net Income

We encounter a similar situation in case of ***ROA***. After the event, the ROA in the four main players in the market, as well as the whole industry, sharply decreased. This fact can be explained by both the fact that assets sharply increased and the net income sharply decreased. Another interesting factor is that the ROAs of the industry, "Imedi-L" and "Irao" become negative after the event and approach each other. It can again be seen that the least amount of decrease in ROA occurs in the politically well-connected "Aldagi-BCI", while the biggest fall is observed in "Imedi-L" and "GPI-Holding".



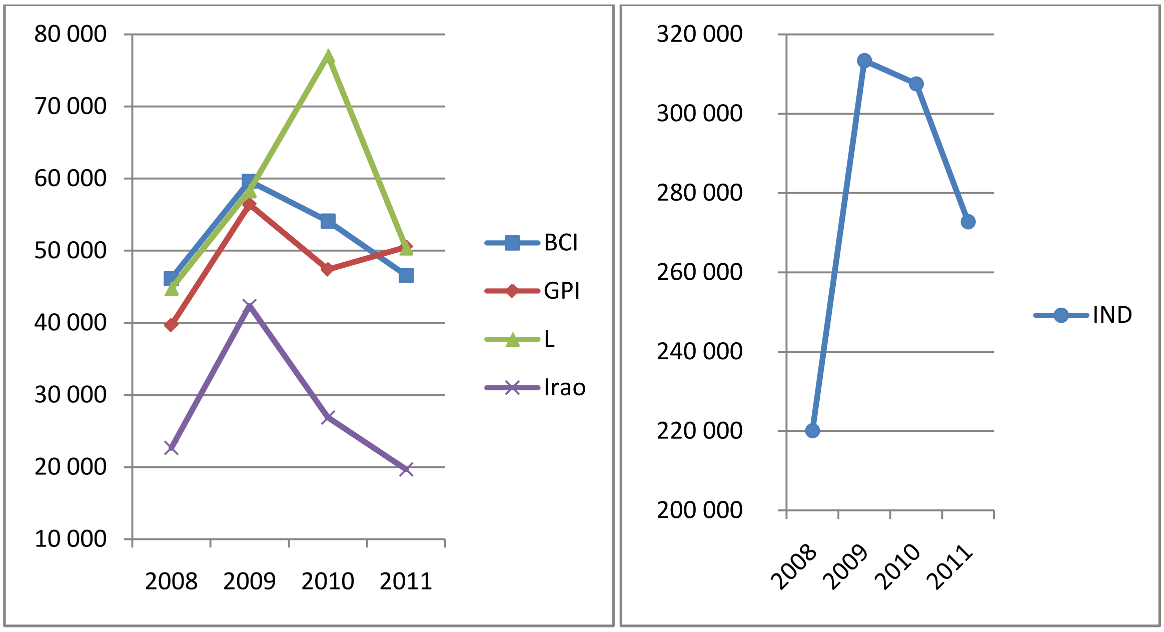
Source: Financial statements of "Aldagi-BCI", "Imedi-L", "Irao" and "GPI-Holding;

http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market)

Graph 2. ROA

As noted, one of the main stimuli for getting involved in the project of the development of hospital sector were the changes in the principle of the insurance program made by the government. The change dynamics in the ***total premiums (revenues)*** before the event and after the event indicate that, despite the beneficial national insurance system that was suggested to the companies, the 2011 profits of the companies and the entire industry, rather than increasing, did not even manage to approach the indicator of 2009.

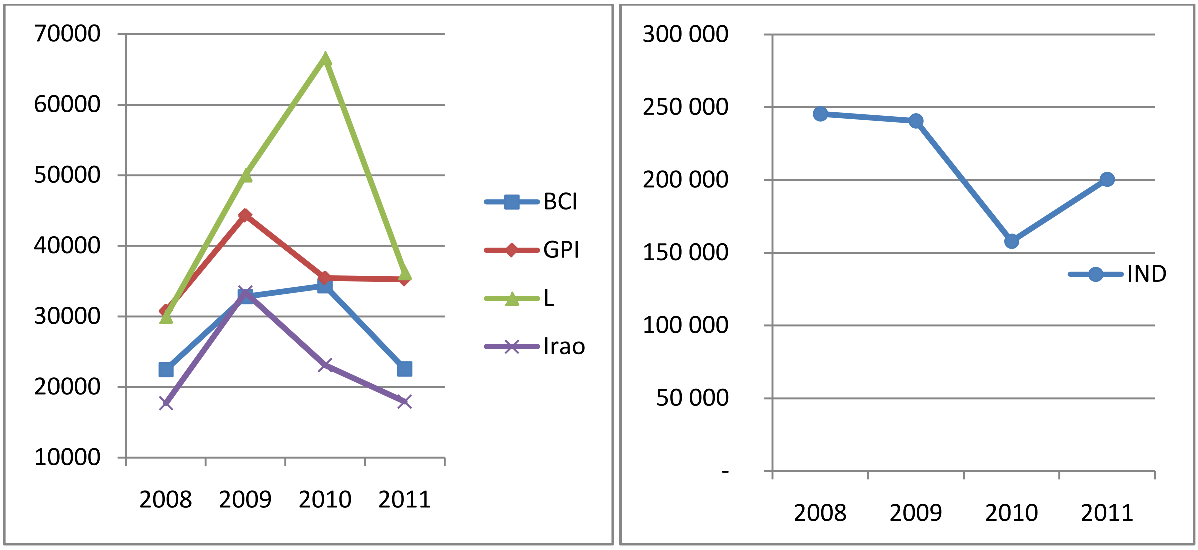
"Imedi-L" and "Irao" represent the two companies that were visibly the least able to use the stimulus/encouregement offered by the government. On the contrary, the revenues of these companies after the event decreased almost by 75% in the case of "Imedi-L" and 50% in the case of "Irao". Here, the fact that "Imedi-L" was the first company to join the hospital sector development project is taken into consideration, at the same time it was also the least politically connected. These circumstances likely caused the bankruptcy of “Imedi-L”, because the project did not generate additional revenue for the company, which resulted in it being bought by “Aldagi-BCI”[31]. The above-mentioned facts again strengthen the validity of our hypothesis that within the framework of CPR, the least politically connected company faces the greatest risk of being absorbed by its competitors.



Source: http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market); http://nbg.gov.ge/index.php?m=489 (Financial index of the insurance market);

Graph 3. Revenues of the companies and the whole sector (subtracted and corrected by re-insurance and non-generated premium reserves correspondingly):

[31] Additionally, in contrast with the other insurance companies, the government fined "Imedi-L" almost 2 million GEL, for insurance policies they issued to the beneficiaries below the poverty line (2010 financial statement of "Imedi-L", p. 54). The Vice-President of the National Bank’s 2011 decree should also be taken into consideration, which defined the rule of the marginal ratio between the net obligations taken from the insurer (for the insurance) and net capital (2011 financial statement of "Imedi-L", p. 63). By December 2011, the company had to face the fact that it was unable to follow the rule and before eliminating the above-mentioned circumstance it was threatened by a prohibition to take on new obligations. As a result of the above-mentioned facts, "Imedi-L" was absorbed by "Aldagi-BCI" in May of 2012, which was followed by an increase of 17 million GEL of the capital of "Imedi-L" and the company was saved from bankruptcy (2012 financial statement of "Imedi-L", p. 64)



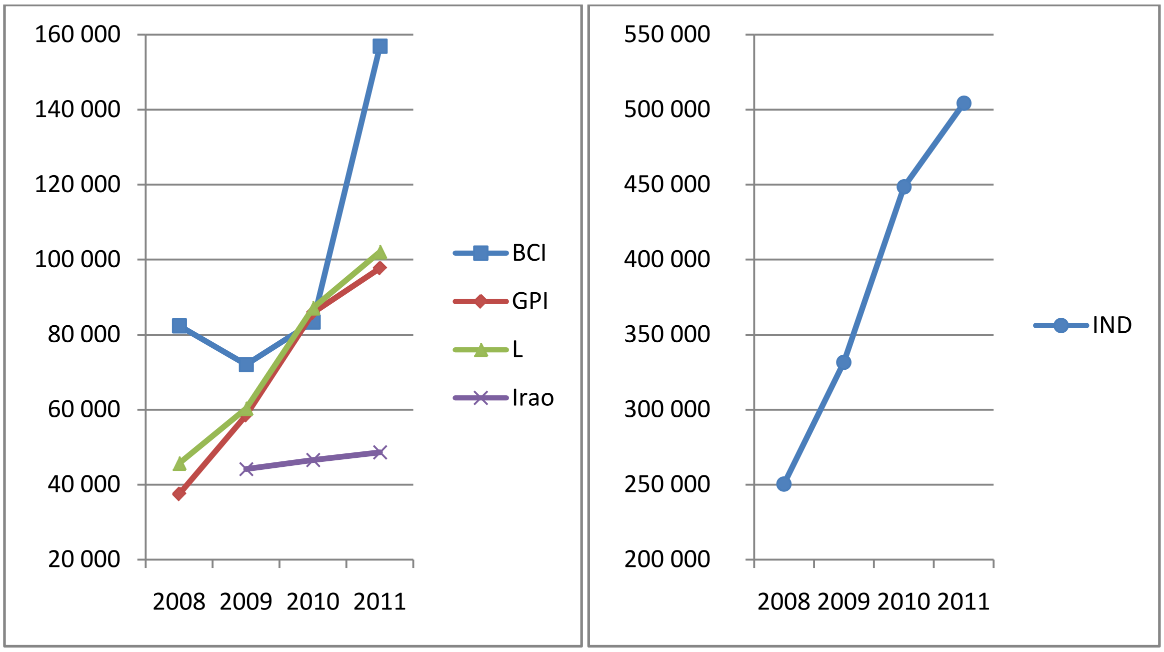
Source: http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market); http://nbg.gov.ge/index.php?m=489 (Statistical data of the insurance market);

Graph 4. Revenues of the companies and the whole sector from health insurance (subtracted and corrected by re-insurance and non-generated premium reserves correspondingly):

The change dynamics in the ***assets*** of the companies indicates that after engaging in the hospital sector development project, the growth rate of the assets of all four companies further increased. The growth of assets was generally a result of the growth of the main utilities. The following two graphs (Equity & Leverage) indicate that in the cases of two companies ("Aldagi-BCI" and "GPI-Holding"), the growth of assets was accompanied by the process of growth of capital, while the two remaining companies ("Imedi-L" and "Irao") were unable to increase capital, as well as maintain the existing leverage (Total Debt/Total Assets). The fact that "Imedi-L" and "Irao" were unable to increase their capital can be explained by the existence of a dysfunctional capital market in the country on the one hand and the character of the hospital development project on the other. The CPR conduct of the companies had a negative effect on their financial indicators and as a result caused a cautious attitude in the potential investors[32]. A similar doubt can be expressed about the involvement of the credit market in the insurance companies' project, which in turn must have caused a difficulty for the companies in attracting additional capital. In this case, aside from the fact that it is generally easier to attract capital for the politically connected companies, an important circumstance is the fact that "Aldagi-BCI" was and remains directly

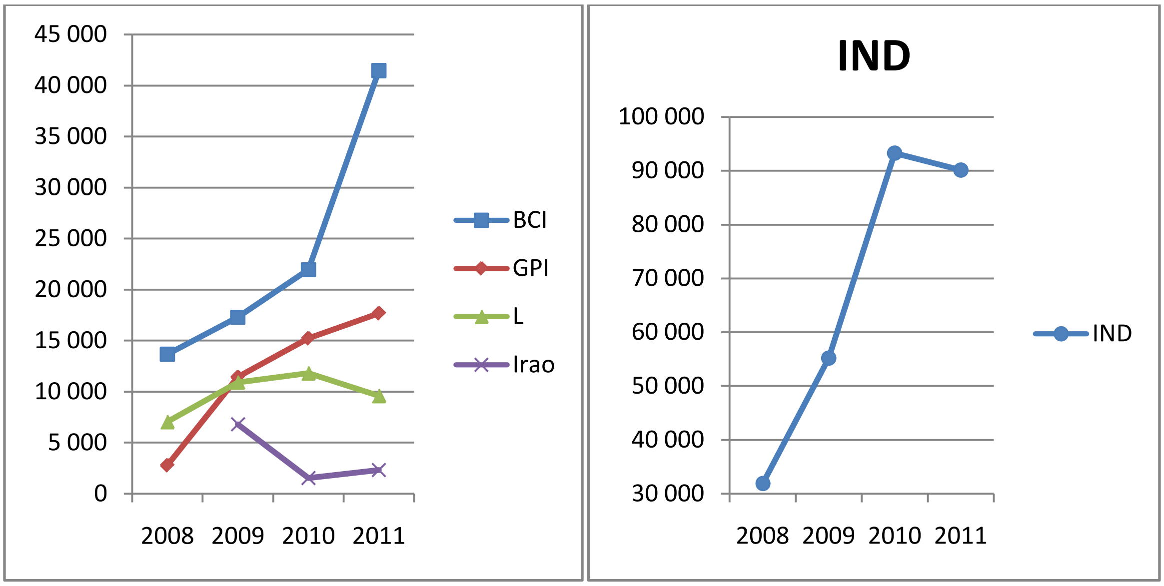
[32] In this case, the circumstance which saved "Irao" from bankruptcy was the fact that "Irao" is an affiliated company of a strong international insurance company, "Vienna Insurance Group". This gave the company the opportunity to overcome the short-term problems of liquidity with the help of its parent company. The same argument can be made for "GPI-Holding".

affiliated with the bank sector and according to this we can assume that the only actor which should have been confronted with the difficulties of financing the project was “Imedi-L”.



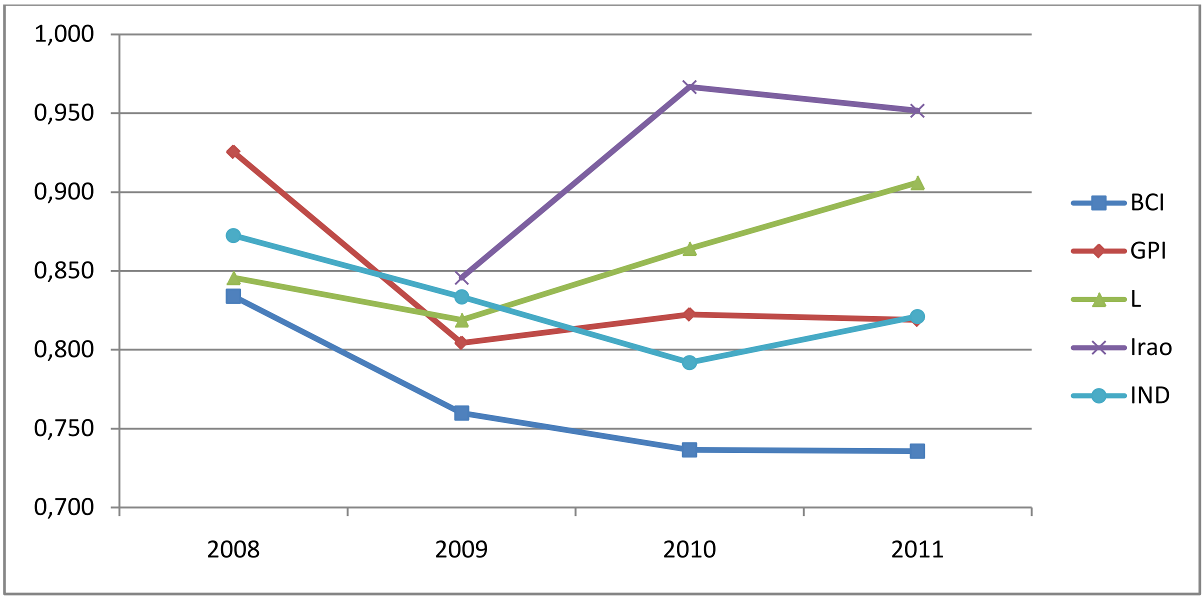
Source: Financial statements of “Aldagi-BCI”, “Imedi-L”, “Irao” and “GPI-Holding; http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market)

Graph 5. Total Assets of Companies and the Whole Sector



Source: Financial statements of “Aldagi-BCI”, “Imedi-L”, “Irao” and “GPI-Holding; http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market)

Graph 6. Equity of Companies and the Whole Sector

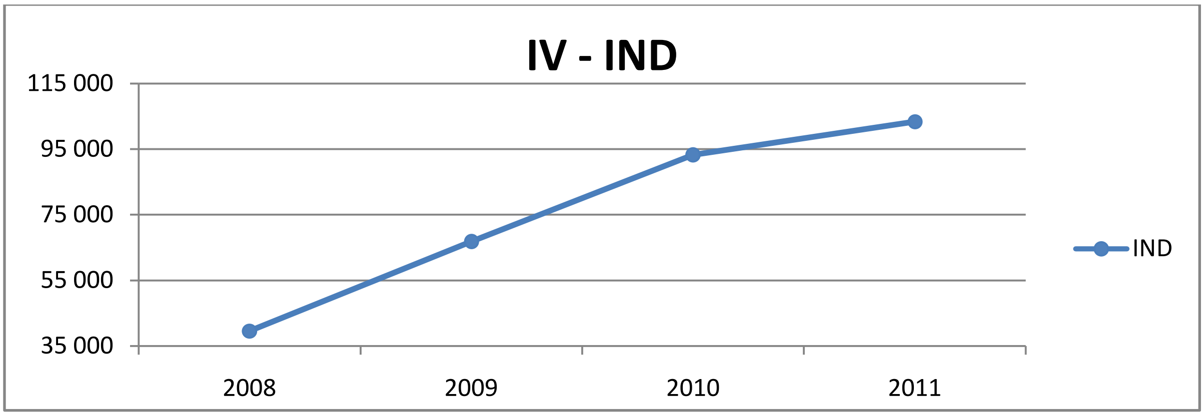


Source: Financial statements of "Aldagi-BCI", "Imedi-L", "Irao" and "GPI-Holding;

http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market)

Graph 7. Leverage[33] (Total Liabilities/ Total Assets)

Concerning the growth rate of the intrinsic value of the sector, it visibly declined after the event. It should also be taken into consideration that after 2010, the growth of the intrinsic value of the industry is mainly explained by the growth of the value of "Aldagi-BCI".

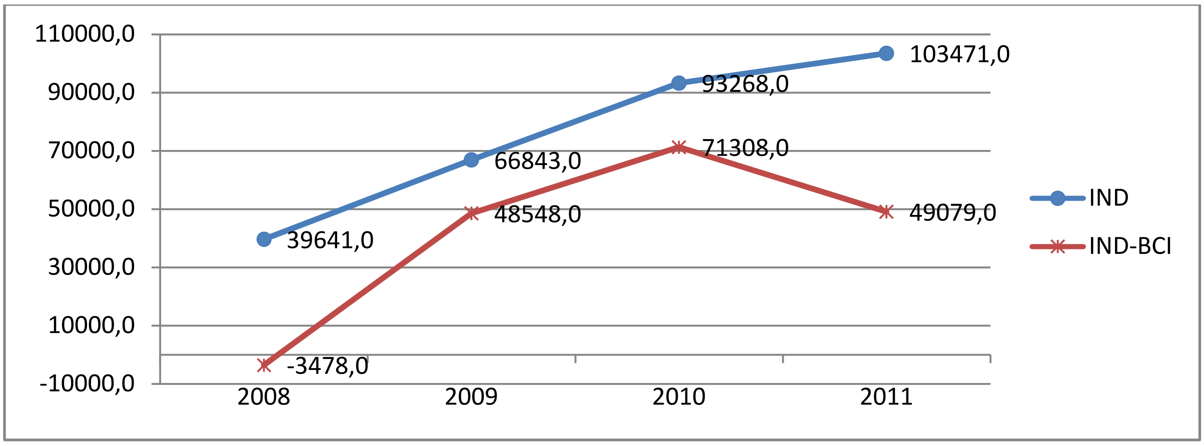


Source: Financial statements of "Aldagi-BCI", "Imedi-L", "Irao" and "GPI-Holding;

http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market)

Graph 7. Intrinsic Value - I

[33] In the case of calculating the leverage, it is interesting that out of four companies, two ("Aldagi-BCI" and "GPI-Holding") managed to increase their capital over last three years, which kept a stable value of leverage after engaging in the hospital sector development project in the conditions of a sharp increase in assets (mostly the main means). In contrast to these two companies, the other two, "Irao" and "Imedi-L", did not manage to increase their capital. On the contrary, after the event their capital decreased, which in turn caused a sharp decrease in their leverage value.



Source: Financial statements of "Aldagi-BCI", "Imedi-L", "Irao" and "GPI-Holding; http://nbg.gov.ge/index.php?m=488 (Financial index of the insurance market)

Graph 8. Intrinsic Value – II

5. Conclusion

The results of the research are consistent with the first formulated hypothesis in that after the CPR-project, the growth rate of the intrinsic value of the industry decreased by 25%. In addition, the important financial indicators (ROA, Net Income & Leverage) of the discussed companies visibly worsened. Findings consent to the second hypothesis of the authors as well. The least politically connected firm (in our case "Imedi-L", which, according to the 2010 data, had the greatest earned premium and the highest assets before engaging in the project) changed its shareholders almost completely after engaging in the CPR-project; the company was purchased from its previous shareholders, by its direct competitor ("Aldagi-BCI").

The positive effect that the CPR-project can have on the market participant which is the most politically connected also becomes clear. „Aldagi-BCI", after engaging in the project, became the dominant player in the market as of 2012 (before engaging in the project it was on the third or fourth position in the market according to the main indicators).

At this stage, after discussing the results of the research, we can once again return to the Modernization Hypothesis favored by the Georgian government. As mentioned above, within the framework of this model of development, the Georgian government was planning on the growth of foreign direct investments, privatization of the property owned by the government, liberalization of the economy through maximally decreasing the regulation and increasing the competition between the actors of the economy. To recapitulate, the results of our research are as follows: after individually selected foreign investors failed to meet their obligations and one of the most important privatization projects collapsed, the government "obliged" the players of the private sector to engage in CPR-project and participate in a harmful business-project through using the mechanisms of regulations. Within the framework of the project, the two extremities of government regulation had a profound effect on the health insurance market. On the one hand, strict government regulation almost completely eliminated an already weak competition in the market for three years, but on the other hand weak government regulation (especially the weak enforcement of the existing regulations in the healthcare sector) allowed insurance market players to compensate for the obligations taken on at the expense the insured citizens' rights, which caused a decline in the quality of the healthcare service. Concerning the insurance market, the best-connected firm ("Aldagi-BCI") became its most influential player, which was achieved through absorbing the most independent and successful company of the market ("Imedi-L").

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