Capturing the governance premium in less developed markets

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Why should investors care about corporate governance? Aren't stock prices of companies driven by their products, people and market opportunity – which in turn drive their revenue and profitability? While some of these factors have direct relationships to a company's share prices, each business needs to have the appropriate structure in place for making decisions. The rules, systems, process and policies put in place by the management of a company, under scrutiny of its Board, are nothing but corporate governance.

When performing research on a company, failure to thoroughly understand the efficacy of its corporate governance can be costly. Determining the calibre of management, it's Board and the robustness of its governance structure is likely to provide a significant contribution towards the true value of a business relative to its share price. Incentivisation and alignment to success of the management and the Board is a key driver as to whether capital and resources of the business are allocated effectively to maximise shareholder value.

There is a common perception that corporate governance violations are most frequently found in companies domiciled in emerging or frontier markets. (How often it is forgotten that developed markets have had their fair share of corporate governance failures – such as Worldcom, Enron and Tyco, as well as the more recent Lehmann Brothers and Bear Stearns failures which led to systemic concerns for share markets around the world.)

Yes, it is true that the corporate governance for companies domiciled in emerging markets more often falls short compared to companies in developed markets. But this should not be a surprise, as it is part of the reasons as to why these markets may be classified as emerging rather than developed. However, in their 2014 report "Navigating emerging and frontier markets with corporate governance", East Capital discusses the substantial improvements in corporate governance in emerging markets over the last 10 years which have seen companies from emerging economies close the gap relative to their developed market counterparts.

India is one such market where significant advancements have been made, especially since the Companies Act of 2013 was passed in legislation. Not surprisingly, the corporate governance framework in India is based primarily on the Anglo Saxon model of governance, which adopts the principles of the Cadbury Report, the OECD principles of corporate governance, and the Sarbanes Oxley Act (Pande & Kaushik, 2013). Some of the improvements cited include:

- Listed companies are required to have at least 50% of their board as independent directors. Furthermore, resolutions in company board meetings need to be ratified by at least one independent director.
- Total tenure of an independent director is not allowed to exceed two consecutive terms (five years per term). A special resolution from shareholders is required to allow a second term.
- To maintain their independence, independent directors are not allowed to receive stock options.
- India was one of first countries to legislate social responsibility for corporations. For example, companies that meet a certain size filter are required to spend at least 2% of their average net profits made during the three immediately preceding financial years on socially impactful factors.
- In the interests of diversity and thought, corporations must have at least one woman director.

A common feature of emerging market companies is a controlling shareholder, often referred to as the promoter or founder of the business. This is particularly prevalent in India where promoters own approximately 45% of the equity of publicly listed companies.

A deep understanding of the ownership structure, Board composition, and the promoter's incentives, track record and character is therefore crucial to determining the success of the business. Of course, this requires specialist knowledge. Being on the ground, from those who have operated within the market can leverage off their experience, resources, strong relationships and networks to understand issues such as whether there is a controlling shareholder, is there an ulterior motive, do actions align with the interests of minority shareholders, and are there any red flags in terms of a history of mistreating minority shareholders.

Another important factor to consider where a controlling shareholder exists, is the ability of minority shareholders to partake and influence significant decisions (e.g. the nomination process, voting thresholds for various resolutions, etc.). This can be a major concern for minority shareholders in capital markets where weak minority investor protection exits. In the most recent release of the World Bank's "Doing Business" report, India ranked eighth in the world for protecting minority shareholders – ahead of many developed countries including the United States, Australia, Japan and countries across Europe. According to the report, India scores highly in terms of shareholder rights and governance, corporate transparency and conflict of interest regulations.

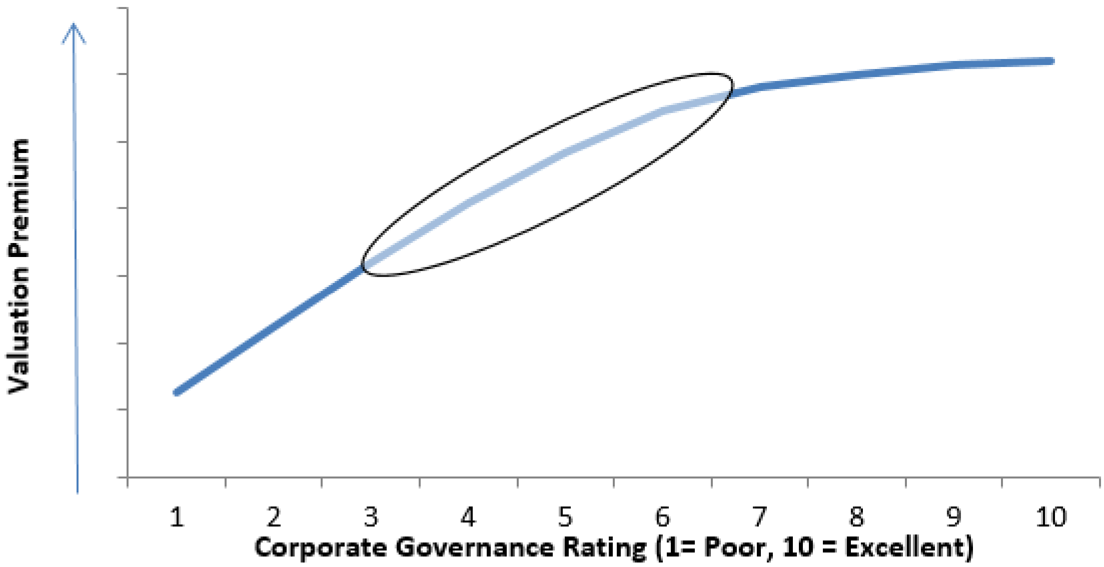
This goes to the point that perception is not always reality – especially for investors in developed markets who believe companies they know and understand are less likely to experience governance issues. Lack of familiarity does not necessarily equate to weak corporate governance.

While passive strategies are popular for their low cost and ease of implementation, they have important shortfalls when it comes to investing in markets where there is a larger dispersion of governance practices. The most obvious is that investors taking a passive investing approach are obliged to invest in all constituents of the index, preventing active avoidance of companies with lower governance standards.

The investment case for active management in emerging markets rests most heavily on the concept of market inefficiency as it provides a ripe environment for investors with local knowledge and experience to add value.

Given the higher levels of both risk and return potential, investors who can identify companies in emerging markets that are undergoing a significant rate of advancement in corporate governance standards can find themselves in a sweet spot, as these companies tend to re-rate quicker as the market acknowledges their advancement. Figure 1 below illustrates this "sweet spot". Assuming other influences are held constant, the rate of advancement of a company's corporate governance can have the most significant impact on its stock price.

Figure 1: The corporate governance



Source: India Avenue

Specialist, on the ground, stock pickers with an active approach can leverage their knowledge, experience, local resources, strong relationships and networks to identify companies undergoing this "sweet spot" transition phase. In turn, this can result in outperformance of local benchmarks by navigating around unwanted corporate governance risks.

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