PERSPECTIVE

Corporate Governance in Emerging Markets: Harnessing Winds of Change

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Emerging markets provide many potential investment opportunities, but corporate governance shortfalls can present challenges. Over the years, some countries have moved faster than others to plug their governance gaps. In the first of this two-part series, Franklin Templeton Emerging Markets Equity's Chetan Sehgal and Andrew Ness outline what corporate governance is and how emerging markets are making improvements in this area.

Corporate governance is a term that is easier to grasp than define. It is a sprawling subject, and its definition can vary from one investor to another. That said, academic and industry research tends to view corporate governance at the country and company levels.[1]

- **Country:** Laws, regulations and policies that shape the investment environment typically take center stage. Investors look to the quality of a market's public institutions, reflected in the strength of its property rights, disclosure standards and other features, to determine how much they can trust the market with their capital. These features also form the institutional framework in which companies operate.
- **Company:** Here, checks and balances between a company's board, management and shareholders are key. We believe internal systems that help the board to effectively monitor management, incentivize managers to act in the best interests of all shareholders, or enable shareholders to hold the board to account should contribute to sound governance.

We think, at its core, corporate governance determines how well companies are able to operate in the longer-term interests of all shareholders. One study offers this definition: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[2]

The Search for Alpha

What makes good corporate governance vital? To start, it is integral to a company's sustainability. A healthy system of controls, incentives and values, reflected in features such as a majority-independent board, well-designed executive remuneration scheme and sensible capital allocation framework, should enforce discipline on management to steer the business for the long haul.

Also striking is the impact governance often has on stock valuations. The market has typically discounted companies with poor conduct or policies deemed to shortchange investors. Governance improvements give these companies a chance to achieve re-rating.

As a whole, studies have largely found a correlation between better governance and increased access to financing, lower cost of capital, stronger operational performance and higher valuations for companies.[3]

But to be clear, corporate governance is just one factor out of many that can affect a company's prospects and share price. We think investors should assess a firm's governance alongside traditional financial measures to form a comprehensive view of the potential investment returns and risks.

Governance in the Emerging Market (EM) Context

Corporate governance in EMs has come under the spotlight given their growing heft on the global financial stage. In the past 20 years or so, EMs' share of global stock market capitalization has more than doubled,[4] standing at 30.0% in June 2019.[5] However, their governance standards generally trail those in developed markets, deterring some investors.

In a study by the World Federation of Exchanges (WFE), investors identified governance concerns as a particular challenge in EM investing.[6] Some said they would avoid investing in a company if they believed it had poor governance. A unique challenge lies in the concentration of company ownership in EMs. Extensive research has flagged the dominance of family and state-controlled companies in these economies—and the potential for minority shareholders' interests to be compromised.[7]

Without adequate safeguards, controlling shareholders would find it easier to direct corporate resources to serve their own purposes, and at minorities' expense.

Over the years, some EMs have moved faster than others to plug their governance gaps. We see two main drivers at work. First are the wake-up calls that followed economic storms and corporate scandals sparked by governance failures.

The 1997 Asian financial crisis (AFC) was a major turning point for economies and companies that had borrowed excessively, stoked in part by lax governance. The 2008–2009 global financial crisis (GFC) reinforced the dangers of debt excesses and ineffective oversight.

Second is the desire to gain entry to major market indexes and attract more capital. For economies eyeing index inclusion, governance yardsticks feature among the range of criteria they have to meet. The accessibility, efficiency and transparency of their financial markets, plus the strength of their regulatory systems, are just some factors that index providers assess. Consider FTSE Russell's decision in 2018 to add Saudi Arabia to its emerging market index. The country's market reforms, as well as its efforts to enhance corporate governance, helped it secure the nod.[8]

Lessons from Turmoil: Asian Financial Crisis (AFC)

Large capital inflows can signal trouble for countries that are ill-equipped to handle them. Markets in East Asia learned this the hard way in the late 1990s, when their over-reliance on short-term US-dollar borrowings sowed the seeds of the AFC. Weak corporate governance was among the multiple inter-related causes of the crisis.

Banks accumulated exposures to over-heated industries and highly leveraged companies amid inadequate market supervision, loose internal controls and a culture of relationship-based lending. For as long as capital flowed, markets looked fine on the surface. But a sudden pullback of liquidity spawned bankruptcies and saddled banks with a heavy burden of non-performing loans.

The AFC was a powerful catalyst for governance reforms in the hardest-hit economies. South Korea, for example, witnessed the fall of several large family-controlled conglomerates, or chaebols. Complex ownership structures, intra-group loans and guarantees, and other poor practices enabled some chaebols to borrow and invest imprudently. In the wake of the AFC, struggling chaebols were forced to restructure. South Korea shored up its financial regulatory and supervisory framework and introduced measures to bolster governance within companies.

Lessons from Turmoil: Global Financial Crisis (GFC)

Some 10 years after the AFC, banking systems again came under pressure. This time, however, the impact was far wider. What started as a crash of the US subprime mortgage market in 2007 soon led to the collapse of major US and European financial institutions that had over-leveraged to invest in mortgage-backed securities. Panic spread throughout the cross-border financial system, triggering a liquidity crunch in developed and emerging economies. Behind the crisis were multiple governance lapses, including poor risk management in banks and ineffective regulatory oversight.

The GFC prompted sweeping policy responses on national and global scales. For instance, the Basel Committee on Banking Supervision, the world's standard-setter for bank regulations, unveiled a Basel III framework aimed at bolstering the industry's resilience. Basel III raised both the quantity and quality of banks' regulatory capital base and contained requirements for sound risk management and adequate disclosures.

Though the crisis did not start in EMs, it created momentum for policymakers in these economies to fix governance deficiencies that remain.

In the next post in this series, Sehgal and Ness will explore the progress being made in select countries, and why they believe improving governance has become a structural theme driving EM equities.

What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size and lesser liquidity.

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1. Sources: International Monetary Fund, "Corporate Governance, Investor Protection, and Financial Stability in Emerging Markets," Global Financial Stability Report: Fostering Stability in a Low-Growth, Low-Rate Era, October 2016; Claessens, S. and Yurtoglu, B., Corporate Governance in Emerging Markets: A Survey, January 15, 2012.

2. Source: Shleifer, A. and Vishny, R. W., "A Survey of Corporate Governance," Journal of Finance 52 (2): 737-783, 1997.

3. Source: Claessens, S. and Yurtoglu, B., Corporate Governance in Emerging Markets: A Survey, January 15, 2012.

4. Source: International Monetary Fund, "The Growing Importance of Financial Spillovers from Emerging Market Economies," Global Financial Stability Report: Potent Policies for a Successful Normalization, April 2016.

5. Source: Bloomberg. As of June 2019.

6. Source: Cleary, S., Alderighi, S. and Boukai, B., Investing in Emerging and Frontier Markets—An Investor Viewpoint, World Federation of Exchanges, January 2019.

7. Source: Aguilera, R.V. and Haxhi, I., "Comparative Corporate Governance in Emerging Markets," forthcoming in Oxford Handbook on Management in Emerging Markets, (Eds.) R. Grosse & K. Meyer, May 14, 2018.

8. Source: Torchia, A. and French, D., "Saudi to join FTSE emerging index from next March, attract billions," Reuters, March 29, 2018. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

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