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PERSPECTIVE

Corporate Governance in Emerging Markets: Progress and Opportunity

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There have been improvements in corporate governance in a number of emerging markets, but it remains a work in progress. In the second of this two-part series, Franklin Templeton Emerging Markets Equity's Chetan Sehgal and Andrew Ness explore the steps some regulators and companies in emerging economies have taken to improve corporate governance. They also share where they see opportunities for investors to potentially benefit from the positive trajectory of change.

Governance improvements across emerging markets (EMs) have been uneven. Nonetheless, the overall progress we have observed in several areas is encouraging. Accounting standards are a case in point. Local standards have increasingly converged with internationally recognized ones, providing a boost for information quality and transparency. Brazil, for example, is among EMs that have fully adopted the International Accounting Standards Board's International Financial Reporting Standards.

Regulators have also taken steps to empower minority shareholders by giving them greater say on related-party transactions, for example. In its annual study on the ease of doing business around the world, the World Bank noted that low-income economies have been catching up with their high-income peers when it comes to the transparency of related-party transactions over the last 10 years.[1]

In India, the securities regulator recently tightened rules around royalty payments made by listed companies to related parties—payments above a certain level would require approval from shareholders (with related parties excluded from voting).

Moreover, we have seen EM companies pay greater attention to enhancing shareholder value, whether through dividend increases or share buybacks. And, they are generally in a good position to do so, thanks to surging free cash flows. Investors' hunt for yield in an environment of low interest rates has turned up the heat on companies to distribute more cash to shareholders.

Critics note that corporate governance reforms in EMs have not gone far enough, and they have a point. While some economies have strengthened their public institutions, others seem to have done too little. In the latest Worldwide Governance Indicators study, low-income economies as a group continued to lag high-income markets considerably in terms of regulatory quality.[2]

Previous financial crises have underscored the perils of regulatory slack, especially when it comes to debt monitoring. With EMs collectively piling on increasing amounts of foreign-currency debt in recent years, their abilities to service or refinance their borrowings bear close watching.[3]

Meanwhile, minority shareholder protection remains a hot-button issue. We believe that regulators and companies can do more to promote the equitable treatment of minorities in EMs, by enhancing disclosures of related-party transactions or requiring shareholder approval for such deals, for example.

Pursuing Greater Shareholder Value: Two Country Case Studies

South Korea: South Korea's stock market valuation has historically lagged those on average in Asia or the rest of the world. Governance concerns linked to a chaebol-dominated market often shoulder the blame for this "Korea discount." But the situation could be looking up. South Korea's state pension fund and leading institutional investor, National Pension Service (NPS), raised hopes that it would inject governance rigor when it adopted a Stewardship Code in 2018. NPS has since said it would exercise its voting rights to increase shareholder value. Earlier this year, it voted against—and succeeded in blocking—the re-election of Korean Air's chairman to the board. NPS also named companies that it thought were underpaying dividends.

NPS's actions to promote shareholder value could prompt other institutional investors to take up a similar cause, and we expect South Korean companies to share more wealth with investors. They would be building on a positive trend. The dividend payout ratio in South Korea rose from 11.1% at end-2013 to 20.6% at end-2018.[4] And there could be scope for further growth, with the ratio remaining below the EM universe's 36.8%.[5]

We see many undervalued companies in South Korea, and healthier governance could help shrink the "Korea discount." Companies that have shown progress in recent years include smartphone and semiconductor maker Samsung Electronics. It decided in 2015 to introduce a rolling three-year shareholder return policy that has resulted in higher dividends and share buybacks. It also started quarterly dividend payments in 2017 to provide shareholders with more evenly distributed payouts.

Russia: Most investors are unlikely to associate Russia with governance excellence. What often comes to mind is its patchy track record in privatization, which began in the 1990s before its institutions were ready for a market-based economy.[6] The government has also retained a sizable presence in corporate Russia.[7]

Yet, many Russian companies have taken the initiative to set higher bars for their conduct and promote shareholder value. Some recognized the need to do so to appeal to foreign investors. Those that sought overseas listings adopted international standards.

Indicating the shift in corporate mindsets, the dividend payout ratio in Russia increased from 21.8% at end-2013 to 33.0% at end-2018.[8]

One company that has sharpened its focus on shareholder value is Lukoil, one of the largest integrated oil and gas groups in Russia. Lukoil stands out to us for its clearly articulated capital allocation framework, which aims to distribute a significant portion of its free cash flow as dividends to shareholders. The company also announced a new share buyback program, worth up to US$3 billion in 2019.

Tailwind for EM equities

We believe improving governance has become a structural theme driving EM equities. We also think active investors are in a favorable position to capture this tailwind. Differences in languages and disclosure rules can hinder information collection. Above all, screens tend to be backward-looking, which means they are likely to filter out poorly rated companies that are nonetheless ready for change.

We see few substitutes for first-hand, bottom-up research when it comes to assessing corporate conduct. Through local company visits, face-to-face interactions with management and other forms of fieldwork, active investors are more likely to gain a richer understanding of companies' attitudes to governance and their appetites for reform.

Relationship-Driven Engagement

We think direct engagement with companies creates opportunities for investors to effect governance improvements. We strive to be responsible stewards of our clients' capital, and we consider it our responsibility to promote stronger governance and pursue better outcomes for all stakeholders.

How do we advocate change? We see value in building trusting relationships with companies, forged through frequent and constructive conversations that reflect our understanding of their governance considerations, as well as our interest in their long-term success. We believe longstanding and credible relationships give us a competitive advantage in offering suggestions and seeding lasting governance improvements.

Our engagement activities can go further. This happens when governance concerns arise, and we believe working directly with companies to drive changes could enhance investment returns and serve the best interests of our clients. The circumstances of each case guide our responses, which can include the filing of shareholder resolutions and the nomination of directors.

Corporate governance has come a long way in EMs, even as unfinished business remains. Individual economies and companies have moved at different speeds in narrowing their governance gaps with their developed market peers, and laggards striving to catch up could give rise to compelling investment opportunities.

Read part one of this series, "Corporate Governance in Emerging Markets: Harnessing Winds of Change."

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. Source: World Bank, "Doing Business 2019: Training for Reform," October 31, 2018.

2. Source: Kaufmann, D., Kraay, A. and Mastruzzi, M., "The Worldwide Governance Indicators: Methodology and Analytical Issues," World Bank Policy Research Working Paper No. 5430, September 2010. Last available data covers 2017.

3. Sources: Stohecker, H., "Emerging market debt soars to record $69.1 trillion in Q1 on falling interest rates – IIF," Reuters, July 15, 2019; Bank for International Settlements, Statistical release: BIS global liquidity indicators at end-March 2019, July 31, 2019.

4. Sources: MSCI, Bloomberg. As of June 28, 2019. See www.franklintempletondatasources.com for additional data provider information.

5. Ibid.

6. Source: World Bank, 2013. Corporate Governance Country Assessment: Russian Federation. Washington, DC. @World Bank, https://openknowledge.worldbank.org/handle/10986/21422 License: CC BY 3.0 IGO

7. Ibid.

8. Sources: MSCI, Bloomberg. As of June 28, 2019. See franklintempletondatasources.com for additional data provider information.

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