Navigating Emerging and Frontier Markets with Corporate Governance

Louise Hedberg
Head of Corporate Governance, East Capital
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Executive summary

Company failures, regardless of market, almost always stem from corporate governance violations. Violations do occur, and will continue to occur in all markets, not only in emerging and frontier markets. Specialist investors with an active stockpicking approach can leverage their knowledge, experience, local resources and network to make more informed investment decisions and avoid unnecessary risks.

Financial markets that have a clear and level playing field, for both controlling and minority shareholders, are better positioned to attract capital than markets where governance risks are more difficult to mitigate – especially in times of financial turbulence or increased perceived risk.

We see four major forces contributing to the development and enforcement of higher corporate governance standards in general: 1) active investors, 2) free and independent media, 3) peer pressure and 4) positive influence from corporate governance associations, sector initiatives, research groups and international institutions.

Although country specific research on corporate governance delivers mixed results, our experience shows that ownership structure and board composition are the key governance considerations in emerging and frontier markets, determining the probability for all other governance related risks and opportunities.

Our research of a sample of large Russian listed companies shows that independent directors and younger board members have a positive effect on both return on equity and weighted average cost of capital.

The fact that emerging and frontier markets fall short on the governance development curve of more developed markets is natural and doesn’t really say much. Significant improvements have been made, and emerging and frontier markets have every opportunity to catch up and overtake more developed markets through:

- Reviewing and strengthening minority rights in company law and other local legislation;
- Raising the level of corporate governance in general by means of a clear code of corporate governance to complement legislation and other regulations;
- Making state owned enterprises take the lead by:
  - Developing an ownership policy and code of corporate governance for state owned companies, based on international best practice; and
  - Recruiting professional management teams and boards in state-owned enterprises.
- Establishing competent and efficient supervising authorities for monitoring and sanctioning to drive implementation and ensuring enforcement.

» Our experience shows that ownership structure and board composition are key to determining the probability for all other governance related risks and opportunities.

East Capital collaborates with other shareholders, investor initiatives or associations:

- Investor Protection Association (IPA), Moscow Since 2002
- Asian Corporate Governance Association Since 2009
- United Nations PRI Principles Since 2012
- Carbon Disclosure Project Since 2014
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Every board game has them: rules. The box comes with a small folded piece of paper that lays out, in tightly written text, just how the players should behave: who tosses the dice first; what happens if two players simultaneously land on the same square; and, of course, what you need to do to win. In addition to the printed rules, players are naturally expected to behave well, stick to sportsman-like behaviour, and most of all not to cheat.

The same is true in financial markets. A combination of company law, stock exchange rules, listing requirements and some sort of national code of corporate governance and sometimes EU directives form the ground rules of the market. History certainly plays a role too and whether societies define themselves as rules- or principles-based, further shapes the local context of how the “game” is played. Add to this the expectations inherent in more relative qualitative concepts such as “best practice corporate governance” or being “shareholder friendly” as well as regulations stretching outside their jurisdictions (UK Bribery Act and FCPA). Ratings, rankings and other indices provided by NGOs such as Transparency International or standards and expectations set by supranationals including the World Bank and the OECD help to fence in the boundaries of the playing field within which issuers are expected to play and investors should be able to rely on when making and managing their investments.

The system of corporate governance and its rule set is meant to reduce problems arising from classic “agency theory”, where managers may pursue their own interests over shareholders’ if they are not sufficiently monitored.

For active, knowledgeable, experienced investors with good risk controls and strong relationships with their custodians and brokers – understanding the corporate governance landscape offers a clear opportunity.

Louise Hedberg
Head of Corporate Governance, East Capital

Rule set on a typical financial market

Financial Market

- Company law, corporate charter and internal policies
- National code of corporate governance, stock exchange rules and listing requirements
- Interterritorial regulation: EU directives, UK Bribery Act, FCPA (US)
- Market infrastructure: Custody, Brokers, etc.
- Ratings, rankings, indices: TI, GMI, World Bank’s Doing Business, RESPECT Index
- Relative concepts: “Best practice” “Shareholder friendly”
- Supranationals: EBRD, IFC, OECD
- History and culture: Defines if the society is principles-based or rules-based
- Corporate governance landscape offers a clear opportunity.
The upshot is that corporate governance has been promoted from a specialist topic, studied by lawyers and the governance team, into the mainstream and something that concerns all investors – big and small.

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has witnessed governance failures with far-reaching systemic implications, including Worldcom/Enron/Tyco and the more recent financial crisis. Investors on less developed markets more often experience issues like dilution, weak minority investor protection and opaque related-party transactions. The upshot is that corporate governance has been promoted from a specialist topic, studied by lawyers and the governance team, into the mainstream and something that concerns all investors – big and small.

The typical analytical approach of assessing an issuer’s operations and long-term return prospects starts with financial reports and scoping out management in face-to-face meetings or on-site company visits. But these traditional assessment techniques are clearly improved by a review of the company’s corporate governance structure and practice. Ultimately, it boils down to determining if a company and its board are reliable guardians of the business and your capital. Is there a controlling shareholder? What is the ulterior motive of the major shareholders and how does it align with the interests of minority shareholders? Is the reporting dependable, and are there any red flags in terms of a history of mistreating minority shareholders or other poor behaviour? For active, knowledgeable, experienced investors with good risk controls and strong relationships with their custodians and brokers, this offers a clear opportunity.

A 2009 study by the Economist Intelligence Unit for IFC further underlines the business case for incorporating environmental, social and corporate governance (ESG) factors into investment decisions in emerging markets:

“The investment case in emerging markets rests most heavily on the concept of inefficient markets, where not all the available information is incorporated in the current stock price. There is a lack of comprehensive research coverage in emerging markets in general and a dearth of ESG related analysis in particular. Given the higher levels of both risk and return in emerging markets, investors who make an effort to understand the impact of ESG have a better chance of reducing risk and boosting returns. Because information is scarcer in emerging markets, fund managers see sustainability criteria as a way to make superior investment decisions.”

East Capital’s 17 years of experience in dealing with emerging and frontier markets confirms this. We typically find that companies that appreciate the purpose of good corporate governance are more often well-managed in every sense, hereby better positioned to deliver attractive long-term returns to their shareholders. In emerging and frontier markets with less developed rules, best practice or legal system, we regularly see gaps in the rules or their enforcement. As an active investor we believe that we can leverage our detailed knowledge and experience of both market and issuer specific issues – ownership structure, board composition and the ability for minority investors to partake in its nomination process, country of incorporation and voting thresholds for different resolutions, etc – to support our investment process. A robust bottom-up strategy translates into a clear advantage over a passive index approach, which cannot actively factor in, or navigate around, corporate governance issues.

A robust bottom-up strategy translates into a clear advantage over a passive index approach, which cannot actively factor in, or navigate around, corporate governance issues.

Emre Akçakmak, Portfolio Manager, meeting with Sinpaş Real Estate Investment Trust in Istanbul, Turkey.
Why should countries prioritise corporate governance reform?

The widely used OECD definition provides a fair illustration of corporate governance defined as:

“A set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”

Like the OECD, East Capital agrees that the presence of an effective corporate governance system, within an individual company and across an economy as a whole, will contribute to the degree of confidence necessary for a properly functioning market economy. Higher trust and confidence lowers the cost of capital, which supports continued growth – the ultimate goal for most countries and perhaps even more so in a time of generally decelerating growth. This is particularly evident in more volatile times where the higher risk sentiment quickly drives investors to markets and individual companies with lower perceived risk in general of which corporate governance is one component.

It is often claimed that higher corporate governance risks in emerging and frontier markets account for part of the valuation discount to more developed markets. Looking at price-to-earnings ratios (P/Es) over time (illustrated on page 7), the valuation gap is clear, and even expanding in Russia’s case. On an absolute level, particularly when it comes to enforcement, there is still room for governance improvements in our investment region.

Exchange Centre, home of the WSE since 2000.
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But falling short of developed markets in this perspective is natural and doesn’t say all that much. Looking at the significant development of governance standards in many emerging and frontier markets during the past ten years, we see that developed markets are merely a few years ahead of emerging and frontier markets on the governance development curve. We instead expect many emerging and frontier markets to listen and learn from the big governance failures in developed markets, and (hopefully) take the opportunity to catch up and in some respects even overtake more developed markets just by not making the same mistakes.

Indeed, we see examples of emerging and frontier markets that instead see an opportunity in being bold and taking the lead. One example is the Sustainable Stock Exchange initiative, a voluntary commitment to promote improved ESG practices among the companies listed on exchanges. Initially launched in 2009, with the support of the UNCTAD, the UN Global Compact, and the PRI and UNEP-FI, the initiative promotes collaboration with investors, regulators and companies. Named by Forbes magazine as one of the “World’s Best Sustainability Ideas”, the initiative currently unites nine stock exchanges out of which six are included in MSCI’s definition of Emerging Markets (Bombay, Istanbul, Brazilian BM&FBOVESPA, Johannesburg, the Egyptian Exchange, and the Warsaw Stock Exchange) and one is classified as a Frontier Market (the Nigerian Stock Exchange), with the other two members being NYSE Euronext and NASDAQ OMX (which also comprise the Baltic markets, of which Lithuania and Estonia are also members of the Frontier Markets Index). This voluntary commitment is both commendable and encouraging.

As the natural “go-to-place”, stock exchanges can play a major role in developing governance standards by using its listing requirements and rules to raise the bar where policy and regulation may not be enough in the eyes of the international investors. This is particularly important given the large number of passively managed investment products available today. With the goal of having as little tracking error as possible to index, index products are obliged to invest into whatever issuers make up the index, effectively preventing them from actively steering clear of issuers with lower governance standards or greater sustainability risks in general. This means that as long as index products exist, even issuers with subpar standards will receive certain guaranteed investor attention. In an ideal world, stock exchanges should take on a greater responsibility to ensure that all the companies admitted and traded on their main lists fulfil a minimum threshold of certain ESG criteria. This would automatically reallocate passive investments to better behaved issuers, rewarding them for their efforts to be well managed.

In this regard, investors’ expectations for investor protection on the more developed exchanges are sometimes perhaps too high. This can lead to major disappointments when a pedigree listing in a developed market proves to be far from risk-free, from a governance perspective. Interestingly, two of the most egregious corporate governance

![Valuation gap: Russia vs BRICs, Turkey, EU average and US](source: Bloomberg)
cases in Russia, in the last twelve months, involve companies listed on the official lists in London and Stockholm, respectively. In both these situations, the corporate entity was incorporated in a third country like Bermuda or the Cayman Islands where company law is less rigorous from the minority investors’ perspective. Where minority investors were relying on the UK Takeover Code or the European take-over directive and the rules of an established stock exchange to protect them, the companies are easily taken private using the more generous Cayman merger plan or Bermudan amalgamation process. To the detriment of minority shareholders, these jurisdictions offer little protection as special resolutions require no more than two-thirds or at most three-quarters majority at the shareholders’ meeting as compared to 90% in most developed markets. Furthermore, the conflicted shareholders are allowed to exercise their voting rights, putting the already low voting thresholds within very easy reach and, leaving minority shareholders to fight for their rights through litigation in far-away jurisdictions. As if this wasn’t bad enough, the majority shareholders are allowed to use the company’s own cash in the process, so the company is effectively buying itself out, a type of financial assistance which is prohibited or restricted in most developed markets following corporate scandals in the past, such as Trustor in Sweden in the late 1990’s.

The recent corporate governance cases unfortunately do not help to improve Russian companies’ image or reputation as far as the international investment community or the media are concerned. However, they also dent the reputation of the exchanges. In the interest of remaining an attractive listing and investment destination, exchanges should expand and formalise the listing rules to include minority interest rules to ensure that all issuers – regardless of country of incorporation – are obliged to abide by certain rules and standards. It was therefore good to see the Swedish Corporate Governance Board immediately initiating a review of the takeover rules to strengthen minority rights in mergers and merger-like processes this year. At the start of May it was proposed that the Swedish takeover rules should be amended with effect from 1 July this year. The amendment will mean that this type of decision requires no less than two-thirds majority at the shareholders’ meeting and that the conflicted shareholders’ votes will not be counted.6

## Enforcing better standards of corporate governance

Emerging markets have been increasingly adopting codes of corporate governance over the last decade to drive reform and sustain or restore investor confidence7. We welcome this development since codes help to better define the relative behavioural standards and practices investors can expect on the market.

Although we certainly expect listed companies that fall under their code to live up to these standards, it is important to remember that codes are voluntary and not legally binding in most countries. This means that the codes and higher corporate governance standards are only as credible and effective as their enforcement. At East Capital we see four major forces contributing to the development of higher corporate governance standards in general:

### 1 Active investors

Institutional investors play a key role in implementing and enforcing corporate governance codes through their monitoring capacity and constructive engagement with the company – or in the worst case, through litigation or exit. Although a still highly manual, complex and costly process, investors can and should exercise their voting rights at annual and extraordinary shareholders’ meetings (AGMs/EGMs) where this makes sense for their investment. Shareholder participation in AGMs and EGMs serves as a monitoring effect on the company’s management and board and instils respect for the highest decision making organ in the company, and ultimately the governance structure of the company. We see voting as a key component of active ownership and one important way for us to communicate our views to the companies and their managements.

As compared to five years ago, when we basically only voted where we were sure that our votes would influence the outcome of the resolutions at the meeting, we last year voted in companies corresponding to almost 40% of our assets under management, a number increased to almost 50% 2014.

### 2 Free and independent media

Media can keep investors and the wider public informed on governance developments in general and specific issues in particular. In Sweden, for example, the risk of reputational damage from the media is seen as the major driving force of self-regulation as managers and large shareholders want to avoid negative media and a tarnished reputation. In markets where public figures are less concerned with their image in the local media, we see that international financial media can play a more significant role. Initiatives such as the Baltic Institute of Corporate Governance education for business journalists in the Baltics can encourage more unbiased reporting on governance related issues, potentially increasing the effect of reputational sanctions in the media in the future.
In markets where companies, their owners and managers are unaffected by peer pressure, the enforcement will obviously be slower but can be helped by the activities of corporate governance associations, sector initiatives, research groups and international institutions.

3 Peer pressure

Not wanting to be worst in class, companies in a sector will benchmark themselves against relevant peers to keep pace. Large companies can lead the way and inspire others by publicly embracing codes and setting new and higher standards, even before regulation comes into place. In more developed markets, this is currently seen in sustainability related issues where environmental regulation is not clear or strong enough to guide companies around global environmental challenges. Companies nevertheless see an advantage in taking a voluntary lead and encourage regulation to catch up. From an issuer perspective, we sometimes hear that codes and other rules are unreasonably burdensome in terms of time spent and cost attached, especially if the company is small. We agree that internal resources should be wisely spent, but argue that issuers should see corporate governance improvements as an investment in better and cheaper access to long-term capital, especially if competition for investments is high. Russia’s idea to launch a premium-listing segment, the Novy Rynok, similar to Brazil’s Novo Mercado, could perhaps boost peer pressure in the long run. Companies ready to comply with the higher governance criteria of the premium segment can actively distance themselves from issuers with higher governance risks, decrease the “Russia related discount”, and hopefully attract new and more significant investor attention, which may spur or even force peers to follow suit over time. In the case of Brazil’s Novo Mercado, this premium segment not only attracts the bulk of new listings in the Brazilian market but also significantly outperforms the broader market index on most measures.

This is also the reason why East Capital in 2013 decided to add “Best Corporate Governance” as an additional category to our annual Awards ceremony – to recognise a company that demonstrates a clear aim to create value for all shareholders through good corporate governance. The winner of the first award was Russian M.Video, based on the motivation that the company’s corporate governance practices are nearing international standards which include a recognised respect for the rights of minority shareholders, a stable dividend policy and a transparent and open approach to communication with external stakeholders.

Furthermore, M.Video’s board of directors comprises nine independent directors out of a total of ten directors, which is high by any standards.

4 Corporate governance associations, sector initiatives, research groups and international institutions

In markets where companies, their owners and managers are unaffected by peer pressure, the enforcement will obviously be slower but can be helped by the activities of corporate governance associations, sector initiatives, research groups and international institutions. The Investor Protection Association in Moscow (IPA), the Asian Corporate Governance Association (ACGA) and the Baltic Institute of Corporate Governance (BICG) have improved standards and initiated dialogue around new legislation in their respective markets. Common success factors for these associations is a deep understanding of the local financial market, significant knowledge of international best practice, legal competence, a wide network of stakeholders, comprising not only investors, wanting to contribute to educational efforts and not least a constructive and collaborative approach. The BICG Executive Education Program today educates almost 100 Baltic executives per year to become better board members, and has educated in total more than 400 executives from state owned, listed and private companies, since its start five years ago. The institute has also organised specific research on and tailored educations for the governments and state owned enterprises in the Baltics which clearly raises the awareness and understanding of good corporate governance.

We see how international institutions such as the IMF, EU and OECD can condition financial aid or membership, respectively, with reforms and improvements. The OECD Russia Corporate Governance Roundtable launched in 2011 to support Russia in its bid to become an OECD member, has recently supported the first revision of the Russian Code of Corporate Governance since its launch in 2002. This roundtable has involved all relevant stakeholders, sourcing the views of issuers, regulators, local and international investors such as East Capital, researchers, international institutions, and other experts. The revised Russian code was approved and published in April 2014. The investor community is now awaiting firmer guidance on how to expect the code to be enforced and what practical improvements investors can expect.

From an issuer perspective, we sometimes hear that codes and other rules are unreasonably burdensome in terms of time spent and cost attached, especially if the company is small. We argue that issuers should see corporate governance improvements as an investment in better and cheaper access to long-term capital, especially if competition for investments is high.

Peter Elam Håkansson, Chairman and Chief Investment Officer, during a visit at portfolio company Bank Saint Petersburg in St. Petersburg.
Warsaw Stock Exchange:

Committed to more sustainable business practices

In 2008, the Warsaw Stock Exchange (WSE) started to train companies and raise awareness of good governance practices and compliance with the Code of Best Practice for WSE listed companies. Soon thereafter, in 2009, an ambitious project to launch a sustainability index – the first of its kind in Eastern Europe – was initiated.

The index is based on voluntary evaluation of Polish companies listed on the WSE Main List. Criteria include compliance with best corporate governance, information governance and investor relations standards and also adherence to environmental, social and personnel criteria.

The index currently comprises 23 companies and is revised annually. Not only has the RESPECT index performed notably better than the WSE 20 main index since its launch in November 2009, see illustration below, companies that are included in the index are proud of this accolade and communicate this to their stakeholders.

In December 2013, WSE reaffirmed its commitment to sustainable business practices by becoming the ninth stock exchange, and the first in Central and Eastern Europe, to join the UN backed Sustainable Stock Exchange Initiative.

» Since its launch in 2009, the RESPECT index has performed notably better than the WIG 20 main index.

Representatives from the companies included in the seventh edition of the RESPECT Index Project, announced on 17 December 2013.
Company case study:  
**Fondul Proprietatea, pursuing higher standards**

With a full-year GDP growth rate of 3.5 per cent in 2013 – which exceeded all expectations, and was among the fastest in Europe – and an expected growth of 2.5 per cent during 2014 according to the IMF, Romania became a clear favorite among frontier market investors last year. The Romanian stock market delivered a total return of 31 per cent during 2013. But the market remains small in relation to the size of the country (around 10 per cent of GDP) and liquidity is low. One way to expand the market is continuing on the privatisation track through more IPOs. The other is launching and implementing significant reforms to the regulatory framework of the financial market to attract long-term investors and thereby improve valuations.

As one of the largest foreign investors on the Romanian Stock Exchange, East Capital has experienced a number of deficiencies in the Romanian financial market throughout the years. Lagging other EU countries in transposing important directives (such as the take-over directive) and in establishing credible and sufficiently equipped regulatory institutions has clearly affected minority investors’ ability to enforce rights and remedies, which would be available in any ordinary, established capital (or EU) market. East Capital’s wish list for Romania includes:

(i) ensuring correct implementation of EU Directives related to the harmonisation of the capital markets and
(ii) significantly improving corporate governance in Romanian companies in general and in state owned companies in particular.

The Romanian government has the power to affect both, with a portfolio of attractive assets waiting to be privatised, and the regulatory power to fundamentally improve corporate governance standards and management quality in State Owned Enterprises.

Romanian Fondul Proprietatea (FP) is one stakeholder that will clearly benefit when the government decides to realise this upside potential. FP is a restitution fund established by the Romanian government in 2005 to provide compensation in the form of fund units to citizens whose real estate assets were confiscated by the previous communist governments.

According to the company, Romania is the only country in Eastern Europe, which has attempted to find a fair solution for restitution – at its actual value – of confiscated property. FP is today a closed-end investment company, with its shares freely traded on the Bucharest Stock Exchange (BVB) since January 2011. The portfolio includes holdings in 62 companies (55 per cent listed and 43 per cent unlisted) mainly in the power, oil and gas sectors (approximately 90 per cent of NAV)², most of which the state granted the fund at inception.

FP’s portfolio is actively managed by Franklin Templeton Investment Management since September 2010. Their only priority is to create shareholder value by unlocking the long-term value of the underlying portfolio holdings. FP clearly communicates that a primary focus will be to ensure that strong corporate governance principles are followed by portfolio companies, something which is expected to benefit both the holdings and other stakeholders. Actions in the portfolio companies have included:³

- Implementing improved corporate governance practices and streamlining decision-making processes
- Representation of FP on the board
- Measures to increase efficiency, profitability and transparency
- Bringing foreign expertise and additional financing
- Supporting management on planned IPOs and SPOs

FP and its investment manager have clearly demonstrated that they are unafraid to challenge the state as counterparty by setting, and clearly communicating, very high expectations for their holdings. Striving to implement the highest corporate governance standards, FP and its manager have shown both professionalism, consistency and, most notably, courage in fighting for necessary improvements in the holdings – not uncommonly taking disputes to court. This has clearly contributed to the positive NAV development during Franklin Templeton’s time as official investment manager.

Romgaz is one good example where standards have improved significantly in recent years, contributing to FP’s NAV performance. The privatisation of Romgaz through a listing on the Bucharest exchange was critical as it showed the real commitment from the government to develop the capital markets, finally putting Romania on the map as a destination for portfolio investors.

Although there is clearly more to be done in Romania, especially on regulatory reform, we see that FP and its manager continues to relentlessly plough on and continue to act as a catalyst for improvements. As a listed company, FP is highly liquid, exceptionally transparent, has a clear and consistent dividend policy and best-in-class investor relations, which altogether have contributed to a 54.8 per cent increase in the share price (27.8 per cent excluding dividends), compared to 23.6 per cent of the Bucharest Stock Exchange (9.5 per cent excluding dividends)²² and a record low discount to NAV of 29.7 per cent on 31 March 2014. Going forward, FP’s efforts will contribute to higher valuations in Romania’s continued privatisations, which will benefit the company’s NAV, as well as the Romanian citizens whose national assets are boosted in value.
Country case study:

**Turkey firmly positioned in the governance forefront**

Equity markets that comprise many companies with a concentrated ownership structure are often associated with a disinterest in, or absence of, higher corporate governance standards. Russia is often mentioned as one example due to the dominance of large state owned companies. We would argue that there are clear exceptions. In Turkey, controlling shareholders (such as the Koc and Sabanci families) do play a dominant role in the management of their companies, but not necessarily at the expense of minority investors. On the contrary, the Istanbul Stock Exchange, or Borsa İstanbul (BIST) as it is called since 2013, is since several years taking a clear lead on further developing corporate governance standards.

After decades of macroeconomic instability and the banking crisis of 2000, Turkey engaged in ambitious reforms to develop its financial markets to attract international investors. In this context, the Capital Markets Board of Turkey (CMB) has played a major role to improve corporate governance of listed companies. The CMB first issued a Code, the “CMB Principles of Corporate Governance” for the Turkish market in 2003, with the OECD Principles of Corporate Governance as a benchmark and extensive public consultations as a supporting tool. One key driver behind the successful implementation of the Code, is the presence of a strong and dependable regulator, the Turkish Capital Market’s Board (CMBT), established as early as 1982. Other important contributing factors are adopting IFRS in all listed companies (2005) and creating a central Automated Disclosure Platform at the stock exchange where all issuers’ reports and press releases are published and made freely available to all external stakeholders simultaneously (2009).

In 2011, the CMB took a bold step and abandoned the comply-or-explain nature of the code, making most of the CMB Principles mandatory, which requires more significant regulatory capacity. However, the CMB appears to be equipped to be able to monitor and enforce the principles, and unlike regulators in many other emerging market jurisdictions, the CMB appears to have both the financial resources and ability to attract and retain top talent. In fact, the CMB is regarded as one of the most attractive employers in Turkey.

Turkey continues to take the lead on new types of initiatives. In 2012, Turkey notably became the first country in the world to require all listed firms (almost 400) to organise their general shareholders meetings electronically. This allows shareholders to follow the proceedings, communicate with other shareholders and not least vote in real time through e-GEM, a single electronic platform overseen by the Central Shares Depository (MKK). This is uniquely shareholder friendly, and will hopefully enable more international investors to follow the discussions at the general meeting and more cost-effectively engage and exercise their voting rights. Furthermore, far reaching plans of launching a sustainability index during 2014 is hoped to serve as yet another instrument to actively increase both local and international investment inflow to Turkey in the midterm. The Turkish Government’s strategy since 2009 – to make Istanbul an international financial centre – will hopefully support continued development of the market, if the recent political turmoil does not unsettle this goal.

In 2012 Turkey became the first country in the world to require all listed companies to allow shareholders to participate in shareholders’ meetings using e-GEM, an internet-based voting and meeting tool. In its first full year of use, 13,462 investors from 41 countries participated in general meetings via e-GEM, increasing the total shareholder attendance by over 120%. Attendance via e-GEM has continued to increase during 2014, with up to 798 e-GEM participants in one meeting. The system not only increases the transparency of the Turkish market, but also makes it easier and less costly for international investors who want to be active owners.

### Number of attending shareholders

<table>
<thead>
<tr>
<th>Year</th>
<th>Physical</th>
<th>e-GEM Conduct &amp; Investor Screen</th>
<th>e-GEM Full-year</th>
<th>Total</th>
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<td>2011</td>
<td>9093</td>
<td>8394</td>
<td>6339</td>
<td>15627</td>
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<td>2012</td>
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<td>8394</td>
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</tr>
<tr>
<td>2013</td>
<td>13462</td>
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</tr>
<tr>
<td>2014*</td>
<td>4934</td>
<td></td>
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</tr>
</tbody>
</table>

* Equity market as of 1 September 2014

Source and photo: Merkezi Kayıt Kuruluşu (MKK), the Turkish Central Securities Depository.
The impact of active ownership

Active investors – both asset owners and asset managers – play an important role in encouraging and contributing to improved governance standards at both market and issuer level. East Capital is often asked if we can quantify the value of active ownership activities in portfolio companies.

A review of existing academic research on the topic reveals that corporate governance is a complex subject that is difficult to quantify in a single rating. There are many plausible proxies for corporate governance, but there is no agreement upon “best” measure17.

We can of course find examples where our governance concerns have helped us avoid investments in companies that later failed, or where we have preserved value by blocking detrimental resolutions at shareholder meetings. We can also list situations where we have created value by working with companies to develop a clear and consistent dividend policy, professionalise board work and processes, improve reporting and investor relations, ensure equal tag-along rights for minorities and reach a more fair value in buy-outs. We are always aiming to influence through constructive dialogue, but equally ready to take the legal route if deemed to be part of our fiduciary duty.

Apart from on-the-ground presence, local focus and knowledge, numerous company visits, and an on-going dialogue with both national and international institutions; trying to influence the composition of the board is one of the practical tools we can, and do, use. We welcome reforms aimed at increasing the number of non-executive and independent directors in corporate boards. For example, the OECD principles of corporate governance (2004) maintain that the board should have a sufficient number of non-executive directors to ensure its independence from the executives; the UK corporate governance code (2010) requires that at least half of the board should comprise non-executive directors, the Sarbanes-Oxley Act requires the audit committees to consist solely of independent directors; the recently revised Russian code obliges listed companies to have a majority of independent directors19. The major issues we see is that the definition of independent directors is not congruent from market to market and the criteria are not always challenging enough, which leaves room for interpretation as to the actual degree of independence. Sadly, we still come across directors who are unable to demonstrate the integrity expected from an independent director, straying from their fiduciary duty to represent the best interest of all shareholders, typically through opaque arrangements with the controlling shareholder.

Over the past years, East Capital has participated in the nomination and election of 20-30 independent directors per year in Russia, either on our own or in collaboration with other minority investors through our membership in the Russian Investor Protection Association (IPA). Altogether the IPA has contributed to nominating and electing over 450 independent directors to Russian boards20. The Russian nomination system, in combination with the cumulative voting system, is actually one of the most democratic we have seen. With only 2 per cent of the local shares a shareholder or group of shareholders, have the right to nominate one or even several candidates to the board. At the AGM, each shareholder is given votes corresponding to their number of shares times the number of board seats. The shareholder is then free to place his or her votes on one or more candidates of their own choice. The candidates with the most votes are elected to the board until the next AGM. By pooling votes on one or two candidates, also minority shareholders have a real opportunity to elect their candidate without any filters. Whereas the Russian nomination system formally remains a way for minority investors to ensure representation on the board, the actual act of nomination is today preceded by an increasingly collaborative process. This includes discussions with the company and its current board members, meetings between the proposed candidate and the controlling shareholder and a more open dialogue between shareholders and company about which additional qualities and skills would benefit the board. We appreciate and welcome this development as professionalisation on both the investor and issuer side which will translate into better boards.

» We are always aiming to influence through constructive dialogue, but equally ready to take the legal route if deemed to be part of our fiduciary duty.

Aivaras Abromavicius, Partner and Senior Advisor, at the IPA conference. Aivaras is the vice Chairman of IPA since 2010.
Positive results support persistent focus on corporate governance

We have seen independent directors bring practical achievements and valuable contributions to Russian boards, such as blocking unfavourable transactions, increasing transparency and governance standards, improving dividend policies, and professionalising board practice.

In an attempt to determine the value impact of the composition of boards in Russian companies, East Capital has collaborated with Christofer Sköld, a masters’ student at the Stockholm University, Department of Economics, to conduct some bespoke research. Drawing on a sample of 62 of the largest companies listed on the Moscow Stock exchange, all of which are part of Bloomberg’s current ESG universe, based on inclusion in a specific index and voluntary reporting, we wanted to see if any of the board characteristics – size20, percentage of independent directors21, transparency22 and age23 – could have a proven effect on the companies in the sample. Since the board has the authority to make and ratify all important decisions in a company, board characteristics are relevant when determining the overall governance in a company. Utilising Hansen’s generalised method of moments (GMM), we were able to control the dynamic nature of the relation between corporate governance and firm performance. Dynamic in the sense that past negative performance might affect a company’s decision to actively improve its corporate governance standards, while corporate governance improvements at the same time aims to boost current and future performance24.

Although unable to receive robust statistically significant coefficients, except for board size, the consistency of the results are encouraging to our continued focus on trying to influence the board composition in our holdings, indicating that:

» We have seen independent directors bring practical achievements and valuable contributions to Russian boards, such as blocking unfavourable transactions, increasing transparency and governance standards, improving dividend policies, and professionalising board practice.

Bigger boards are not better boards

Results show that larger boards have a negative effect on performance, measured as return on assets (ROA). ROA is a relevant measure since it gives an idea as to how efficient management is at using its assets to generate earnings for its shareholders. This supports the academic research on agency theory and that bigger boards deteriorate the value of a firm because poor coordination and communication in a board (due to agency costs) leads to passive monitoring by the board members. A larger board has been found to be more vulnerable to conflicts as there is less “cohesiveness” among the members of a larger board25.

Independence is good

A higher percentage of independent directors of the total board has positive effects on both return on equity (ROE) and Tobins Q26. In most companies the board serves as the connection between shareholders and managers. Consistent with agency theory, a board comprised to a major extent of independent directors, is likely to be better equipped to ensure sufficient monitoring of the management’s work. This is especially important in markets where the public governance framework is less developed.

Investing in transparency pays off

Perhaps not surprisingly, a higher level of disclosure decreases the companies weighted average cost of capital (WACC), which is positive. Higher transparency was also noted to have a positive effect on return on equity. As investors, we value transparent and consistent reporting of all that is material and relevant to the company. We welcome that disclosure practices are developing in our investment region, where simultaneous information to all stakeholders in both local language and English is key to building interest and trust in the international investor community.

Age matters

Looking at the average age of the board members, higher average of age was found to have a negative effect on return on assets as well as a WACC, meaning that relatively “older” boards lower ROA while increasing the cost of capital. This would hold true to our own empirical experience where we see a generation of younger, better educated and internationally experienced board members contribute to more independent thinking and professional board standards which typically equates to better managed companies.

East Capital’s investment team spends a great deal of time on the ground, visiting companies and meeting management. Face-to-face involvement through company visits provides a good opportunity to see and discuss how relevant and material ESG issues impact the companies.
Navigating Emerging and Frontier Markets with Corporate Governance

What’s next?

Corporate governance in emerging and frontier markets has improved significantly over the last ten years. It has been supported by the implementation of international accounting standards, more generous dividend policies, constructive collaboration between issuers and investors (as opposed to seeing each other as antagonists), ambitions to become an international financial center (Russia and Turkey) and more professional communication published also in English and in a non-discriminatory manner, being some examples.

We believe that these interventions would raise corporate governance levels and further increase the attractiveness of our investment universe:

• Raise the level of corporate governance in general by means of a clear code of corporate governance - that is aligned with stock exchange listing criteria - to complement legislation and other regulations.

• Ensure enforcement by both the stock exchange as well as a proper supervising authority that can monitor and enforce implementation of the spirit and purpose of the code.

• Establish a set of sanctions, including fines, that are effective enough to deter violations. Conversely consider a set of incentives, such as lower listing fees for companies that apply best in class standards.

• Find ways to incentivise asset owners to have greater expectations on issuers, thereby pushing standards higher. Local pension fund regulations can be amended to incentivise investments in companies with certain governance standards.

• The perceived high level of bribery and corruption will continue to deter international investors. Major gains will be made from decreasing corruption, both for individual companies as well as society as a whole.

• Continue to migrate from what can be perceived as a more hostile to a more collaborative approach. The learning curve is steep, but dialogue and encouragement can help avoid unnecessary conflicts.

• Improve and strengthen operating procedures at the supervising authorities for monitoring, analysing, issuing and implementing opinions related to issuers’ actions.

• Benchmark mandatory public offer rules, methodology and sanctions against international best practice, including how to establish the identity and relationships of major shareholders, to ensure fair treatment of minority shareholders.

• Clarify and communicate what financial investors can expect from the state as an owner in state owned companies and the manager of the common property of the taxpayers. This includes developing an ownership policy for state owned companies and implementing a Code of Corporate Governance for state owned companies based on international best practice such as the “OECD guidelines on corporate governance of state owned enterprises (SOEs)”.

• Ensure that state-controlled companies are run by independent management teams and boards that have the competence, integrity and independence to act in the company’s, and all shareholders’ best interests. Management teams should be selected based on true management capabilities and sector knowledge rather than on political merits. State controlled companies should, like any professionally managed company, adhere to a clear transparent business structure, pricing structure and operations. They also need to clearly communicate dividend policies and payment dates, to accommodate the predictability required by the financial market to build reasonable assumptions of the value of a company.

» We believe that these interventions would raise corporate governance levels and further increase the attractiveness of our investment universe.
A comment from the author

The traditional investment assessment techniques are clearly improved by a review of the company’s corporate governance structure and practice. Ultimately, it boils down to determining if a company and its board are reliable guardians of the business and your capital.

Please feel free to contact me with comments and questions at louise.hedberg@eastcapital.com or on +46 707 10 43 21. I look forward to hearing your thoughts and feedback.

Best regards,
Louise Hedberg

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Navigating Emerging and Frontier Markets with Corporate Governance

End notes

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13 Kossov, 2013
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17 Bhagat et al, 2008 in Sköld 2014
18 OECD 2004; UK code, 2010; Muryev, 2014 in Sköld 2014
19 www.ipa-moscow.com
20 Board size: Number of Directors on the company's board, as reported by the company. Full time Directors only. Deputy members of the Board will not be counted. Europe: Where the company has a Supervisory Board and a Management Board, this is the number of Directors on the Supervisory Board. Source: Bloomberg
21 % Independent directors: Number of Independent Directors on the company's board, as reported by the company. Independence is defined according to the company's own criteria. Europe: Where the company has a Supervisory Board and a Management Board, this is the number of Independent Directors on the Supervisory Board. Source: Bloomberg
22 Transparency: Proprietary Bloomberg score based on the extent of a company's governance disclosure as part of Environmental, Social and Governance (ESG) data. Companies that are not covered by ESG group will have no score and will show N/A. Companies that do not disclose anything will also show N/A. The score ranges from 0.1 for companies that discloses minimum amount of governance data to 100 for those that disclose every data point collected by Bloomberg. Each data point is weighted in terms of importance, with board of directors data carrying greater weight than other disclosures. The score is also tailored to different industry sectors. In this way, each company is only evaluated in terms of the data that is relevant to its industry sector
23 Average age: Average age of the members of the board
24 Sköld, 2014
26 Tobin's Q is an as frequently employed performance measure in corporate governance studies as ROA. Tobin's Q is used as a proxy for a company's growth opportunities
27 www.oecd.org/daf/corporateaffairs/soe/guidelines
Sources


5. Kossov, Anastasia, CAN CORPORATE GOVERNANCE CODES BE EFFECTIVE IN EMERGING MARKETS? – INSIGHTS FROM TURKEY, INDIA AND COLOMBIA, a report to the OECD Russia Corporate Governance Roundtable organised for 22 - 23 October 2013 in Moscow, Russian Federation.


Investing in transparency pays off: Perhaps not surprisingly, a higher level of disclosure decreases the companies weighted average cost of capital (WACC), which is positive. Higher transparency was also noted to have a positive effect on return on equity. As investors, we value transparent and consistent reporting of all that is material and relevant to the company.
East Capital is a specialist in emerging and frontier markets. The company, founded in 1997, bases its investment strategy on thorough knowledge of the markets, fundamental analysis and frequent company visits by its investment teams. Our staff represents 23 nationalities and provides an unprecedented knowledge base of the regions we invest in. East Capital actively manages EUR 3.2 billion in public equity, private equity and real estate. We have clients, ranging from direct retail investors to leading third party distributors and first tier institutions, from all over the world. East Capital is headquartered in Stockholm, with offices in Hong Kong, Kyiv, Luxembourg, Moscow, Oslo, Paris and Tallinn.

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