FOUNDERS, FAMILIES, AND STATES

Governance in Emerging Markets

By Alan Brett

Investors may be seeing the economic promise of emerging markets: An evolving middle class, a ramp-up in infrastructure spending, and rapid digitization are driving growth in the developing world. By 2050, six of the seven largest economies in the world are projected to be emerging economies, according to PwC estimates.[1]

The tradeoff, of course, is risk. It isn't just a lack of liquidity, or the potential for political unrest or currency shocks. These all tend to make headlines, but the biggest threats are often ongoing and obscure; for example, governance issues that stifle shareholder rights, cause value leakage via related-party transactions, and lead to suboptimal strategic decisions and succession plans.

Poor governance isn't limited to tiny companies or frontier markets. On the contrary, some of the largest emerging-market companies continue to rank low on governance according to MSCI ESG Ratings.[2] Take Alibaba Group. The Chinese e-commerce, retail, and technology giant went public on the New York Stock Exchange in the largest global initial public offering ever. With a recent market capitalization of $450 billion, Alibaba is one of the top constituents on the MSCI AWCI ex US Index. Yet, on the MSCI ESG Ratings scale of 0 to 10 for governance, it scores near the bottom, in part because its ownership structure severely limits the rights of minority shareholders.

This isn't to say investors should or should not avoid investing in emerging markets altogether, or that they should steer clear of the Alibabas of the world. To be sure, governance risk is just one of many factors investors may consider when weighing upside and downside potential of a security.

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Investors may want to consider, however, integrating governance into their decision-making frameworks, paying particular attention to the extremes. Approaches taken by investors vary. Some may decide to exclude companies from their portfolios when governance risks are too high, and others may decide to adjust their valuations. The risk-reward balance applies to governance risk factors just as it would to any other business risk.

GAUGING GOVERNANCE RISK

To help investors systematically evaluate companies on environmental, social, and governance (ESG) factors, MSCI ESG Research analyzes various ESG metrics of publicly traded companies across all major markets. Within governance, MSCI looks at 96 key metrics that range from shareholder rights to voting practices, across sectors and markets. Each company starts with a "perfect 10" score, with points deducted for key metrics that fall short of global standards. A score of 0 indicates our determination that the company has significant governance risks, and a score of 10 signifies qualities that are associated with low governance risk. These scores are regularly updated. MSCI ESG Research reviews companies in depth annually.

Whereas investors often look at environmental and social risks in the context of a particular industry, governance risk is typically driven by a combination of where the company is listed and its ownership structure. Local norms set the tone for key governance issues, and country-specific laws can limit or exaggerate problems. For this reason, MSCI ESG Research publishes in-depth country-specific reports to help investors navigate an increasingly complex landscape.

How do companies in key emerging markets stack up to their developed counterparts? To answer this, MSCI ESG Research looked at governance risk in three major emerging markets—China, India, and Malaysia—to find common causes for concern within each country.

CONCENTRATED OWNERSHIP IS THE RULE

The shareholder base of companies in developed markets is often widely distributed, but emerging markets are characterized by large owners controlling significant blocks. Just 37 percent of emerging-market companies tracked by MSCI are widely held, meaning that no single shareholder or group controls more than 10 percent of voting rights. In China, a mere 3.4 percent of MSCI China Index companies are widely held, and in India that number gets sliced to 1.3 percent.

Concentrated ownership—a shareholder or shareholder group that controls 30 percent or more of a company's voting rights—is by and large the rule, not the exception in China, India, and Malaysia. More than 80 percent of constituents of the MSCI China, MSCI India, and MSCI Malaysia indexes exhibited concentrated ownership as of November 2017 (see figure 1).

Too much power in the hands of too few shareholders, or managers as the case may often be, may open doors for potential abuse. Rights that investors in developed markets might take for granted may be skirted easily by companies that are family conglomerates, variable interest entities, or state-owned enterprises.

To be sure, identifying, analyzing, and rating governance risk is an exercise in nuance, particularly in emerging markets. Governance risks vary widely, depending on the nature of the company's ownership, the separation of ownership and management, and the design of the capital structure and its impact on the voting rights.

So, although investors in U.S. or European companies often start their due diligence with the composition of the board or executive compensation, emerging-market investors may choose to start their due diligence by looking at ownership structures. Against this backdrop, one may be able to better understand the risks or relative opportunities.

FAMILY CONGLOMERATES

There's something to be said for a thriving multigenerational business, but there comes a point when the story goes from quaint to worrisome. Namely, a single family with a large controlling stake in a firm raises a laundry list of issues, from family feuds (see table 1) and nepotism to ill-advised strategies and succession plans.

Such ownership is extremely common in India, where approximately half of the India constituents of the MSCI ACWI Index as of February 2018 were family firms—companies where family members hold 10 percent or more of the voting rights and maintain at least one board seat. Among companies included in the MSCI ACWI Index, by comparison, 20 percent met our definition of a family firm.

Taking that further, approximately 25 Indian companies are included in the index that are part of family conglomerates, which MSCI ESG Research defines as corporate groups with two or more listed entities.

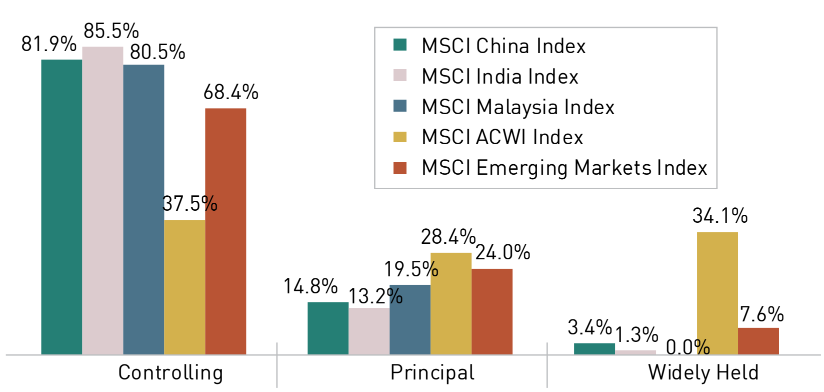
As family businesses expand and require more capital, family firms historically have spun off subsidiaries or created new companies that helped retain family control—or in some cases, acquired companies to bring them under family control. Through this process, the number of firms that are included in family conglomerate structures has increased over time. Now in its fifth generation of family leadership, India's largest conglomerate, the $100-billion Tata Group, has grown to some 16 listed companies with approximately 700,000 employees.[3]

Every company is different, of course, but such structures do pose additional risks and possible value leaks via related party transactions or ongoing payments to parent companies, often at the expense of shareholder dividends. At the same time, the risk of board entrenchment and infrequent board meetings may leave minority investors exposed to risks of being shut out of decision-making, and a lack of independent leadership may deter growth.

Perhaps most worrisome is the common practice of appointing the same "independent" board director to multiple boards within the same family conglomerate, often for an extended period of time. Bajaj Autos, for example, recently had one "independent" director appointed to three boards within the conglomerate. (Bajaj recently scored 1.2 out of 10 for governance, putting it near

Figure 1

PERCENTAGE OF LARGEST OWNERSHIP CLASSIFICATION AT MSCI INDEX CONSTITUENTS



Source: MSCI ESG Research as of November 28, 2017
Definitions:
Controlling – Largest shareholder or shareholder group holds 30 percent or more of the voting rights.
Principal – Largest shareholder or shareholder group holds between 10 percent and 30 percent of the voting rights.
Widely Held – No shareholder or shareholder group holds more than 10 percent of the voting rights.

the bottom of all Indian companies tracked by MSCI.)

This raises questions about an individual's ability to adequately represent the interests of minority shareholders when apparently entrenched in the family structure.

In Malaysia, family-controlled firms represented 34 percent of the MSCI Malaysia Index as of September 2017. Because the stock exchange Bursa Malaysia requires "one share one vote,"[4] families historically have spun out entities and used complex share structures, such as pyramids and crossover shares, to take cash out of the companies while maintaining control. In seven of nine family conglomerates identified in Malaysia, MSCI ESG Research identified that a sizable subset of each board comprised a combination of family members, former executives, or long-serving independent directors.

As a result, there is a significant risk of an abundance of potentially convoluted family conglomerate structures that may preclude thorough investor analysis. At the same time, a high incidence of related party transactions[5] as of September 2017, especially compared to the rest of the MSCI ACWI Index companies, suggests a higher risk of potential loss of value for minority shareholders.

The risks of related party transactions are considerable. They represent potential conflicts of interest and loss of value for minority shareholders; financial transactions may favor company insiders over minority investors. In Malaysia, the average ratio of recurring revenue transacted through related parties such as major shareholders, family members, and associated companies is nearly 4 percent, a significant percentage of a company's total revenues for a given period. Common transactions in this market include the purchase and sales of goods, and the rendering of professional services.

Table 1

FAMILY FEUDS

Family	Year	Outcome
Ambani	2004–2005	After the death of Dhirubhai Ambani (founder of Reliance Group) in 2002, a feud between his two sons Mukesh and Anil became public. In 2005, Reliance split into two groups (Reliance Industries and Reliance Group) led by the two brothers.
Bajaj	2004–2008	The Bajaj family conglomerate split into two separate groups after a public feud between two brothers, Rahul and Shishir.
Tata	2016–2017	Dispute within the Tata family holding company, with Chairman Cyrus Mistry ousted.

STATE-OWNED ENTERPRISES

Family ownership isn't as prevalent in China, where just 16 percent of MSCI China Index constituents as of September 2017 were family controlled. In China, state-owned enterprises (SOEs) are a driving force. Nearly 60 percent of MSCI China Index companies are SOEs, which MSCI ESG Research defines as those where the national government directly or indirectly controls at least 10 percent of voting rights. Among SOEs, the state typically holds a controlling stake, which local regulations and MSCI ESG Research both define as 30 percent or more of the voting rights. In the case of PetroChina Company Limited (PetroChina), the controlling parent China National Petroleum Corporation held more than 86 percent of voting rights as of September 2017.[6]

Although Chinese SOE boards include government representatives and sector expertise, most boards do not have a majority of independent directors; 75 percent of chairman roles are executive positions according to MSCI ESG Research as of September 2017.

For some 20 years, China has been implementing SEO reforms aimed at giving boards more autonomy, improving dividends, and improving accounting transparency, among other changes. As China's markets become more accessible to global investors, new governance practices are likely to surface.[7]

Indeed, reform measures are in the works, but issues remain. Shareholder returns at Chinese SOEs underperformed relative to both other MSCI ACWI Index SOEs and other MSCI China Index constituents based on five-year total return data as of August 2017.

SOEs are also relatively common in Malaysia, with 34.1 percent of MSCI Malaysia Index companies associated with the state as of September 2017. In India, 17 percent of companies are state owned. Contrast this to the broader benchmark: Just 8.3 percent of constituents of the MSCI ACWI Index are SOEs.

The biggest risk for investors in SOEs is, again, a misalignment of interests. This can materialize in any number of ways, including related party transactions in which the listed subsidiary routinely makes payments to the controlling parent, at the expense of minority shareholders.

FOUNDERS WHO WON'T LET GO

Within the past couple of decades, a new corporate structure has emerged. The variable interest entity (VIE) is now a popular model for Chinese companies looking to raise capital via U.S. markets. Prominent VIEs include Alibaba, Baidu, JD.com, and Tencent, among others. Investor interest is high due to the high level of shareholder return at many of these firms (see figure 2).

Because Chinese law prohibits foreign ownership of companies in regulated industries, VIEs offer a back door to investors via a complex legal structure that was first used by SINA Corporation in 2000. First, company founders establish an entity in a country outside of China; most are set up in the Cayman Islands or Hong Kong. Then, the founders transfer intellectual property to the VIE and set up contracts that entitle the VIE to a portion of the company's profits.

In other words, investors who buy stock in a VIE don't own the company itself, and their voting rights are often limited.

VIEs are fewer in number than SOEs, but they represent a growing share of market cap in China. Meanwhile, more than 70 percent of VIEs in China as of July 2017 are founder firms, with the founder remaining as chairman or chief executive officer of the company. This opens doors for potential abuse, namely by company founders who seek to maintain tight control of their organizations as they reduce their overall ownership. In fact, four of the bottom five governance assessments for constituents of the MSCI China Index utilize a VIE structure.

There is a connection between governance risk and the location where a VIE is established. Cayman Islands entities carry risk for the most potential abuse. Founders can use a dual-class share structure to retain control even while issuing shares. Moreover, Cayman Islands companies are not required to hold annual general meetings; such meetings typically are enshrined in company law in most markets. Without an annual meeting, shareholders are left without a regular forum in which to hold the board accountable. Baidu, for example, hasn't had an annual governance meeting since 2008, and JD.com hasn't had one since its 2014 initial public offering.

Many VIEs also have implemented prohibitively high thresholds by which shareholders can request extraordinary general meetings. In other global markets voting-right thresholds to request such meetings are generally set at 5 percent to 10 percent. At Alibaba the threshold is 33.3 percent. Because minority ownership is just 45 percent, some 75 percent of minority shareholders would need to collaborate to request a special shareholder meeting—a near impossible task.

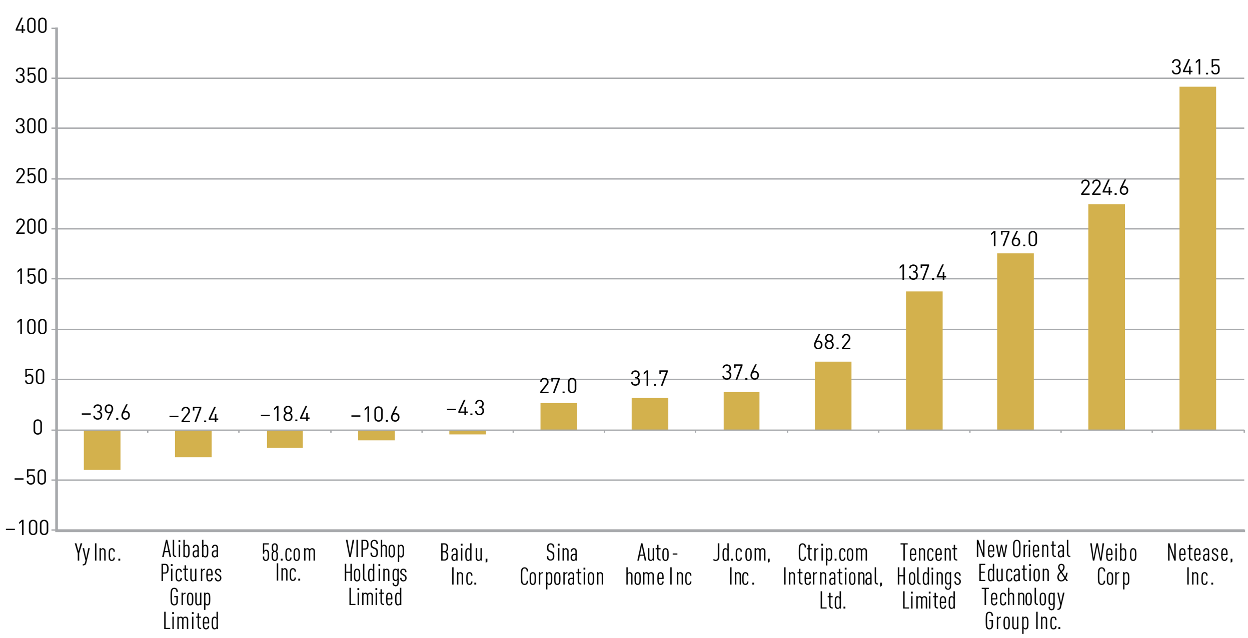
VIEs listed in Hong Kong, however, may pose lower governance risks. Among the VIEs in the MSCI China Index, Tencent Holdings has an above-average governance score. Although it is also a Cayman Islands exempt company, it is listed in Hong Kong where arguably the shareholder protection rights are stronger. Tencent also does not have a dual-class structure with different voting rights.

Another potential issue is board composition, which may allow founders another outlet for shutting out minority shareholders. A common feature of founder-firm VIEs is founding entrepreneurs who monopolize a board by appointing "trusted associates" as executive directors and minimizing the number of independent directors.

For example, JD.com's articles and bylaws specify that the company's board cannot muster a quorum in the absence of Richard Liu, founder, chief executive officer, and chairman. As such, he can veto anything by simply staying home. Combined with his controlling shareholding due to a multiple share class structure with unequal voting rights, Liu

Figure 2

MSCI CHINA INDEX VIES THREE-YEAR TOTAL RETURN



Source: MSCI ESG Research as of July 27, 2017. Ownership Structure/TSR Data - MSCI ESG Research and/or Thomson Reuters Data as at July 27, 2017 (five-year TSR data not included given only eight VIEs have a five-year trading history).

FOUR QUESTIONS TO ASK

Investors interested in getting a read on a company's governance risk may consider starting with the following questions:

Is there concentrated ownership? Whereas the shareholder base of companies in developed markets is often widely distributed, emerging markets are often characterized by large owners controlling significant blocks. In China, India, and Malaysia, more than 80 percent of constituents include a shareholder or shareholder group that controls 30 percent or more of the voting rights as of November 2017.

Who are the controlling owners? The implications of concentrated ownership vary by key owner type. Whether it's family, founders, or the state, each category raises key issues, including a lack of independent boards and related-party transactions.

Is there complex ownership? Certain structures can make concentrated ownership more egregious because they help owners, namely families, raise capital through public markets as they preserve control through cross shareholdings and pyramids.

What about control-enhancing structures? Still other structures can limit the rights of different voting groups, including foreign investors. Many emerging-market companies impose ceilings on voting rights, give governments veto rights, or make it virtually impossible for minority shareholders to organize.

can defeat any resolution from which he is not legally required to abstain.

As of July 2017, 96.7 percent of U.S. company boards are majority independent and across the MSCI ACWI Index 66.2 percent are majority independent. Among MSCI China Index constituents, 75 percent of boards are minority independent of management. However, many directors are in fact still linked to major owners or to the Chinese state.

MAKING GOVERNANCE PART OF THE EQUATION

Companies with governance issues still may achieve above-market returns for their shareholders. Yet, as is the case with most ESG risks, governance risks often come to light when challenges arise, succession plans are needed, or scandals surface.

In many emerging-market countries, there has been an interest in raising governance standards across the board. For Malaysia and India, for example, this includes the adoption of stewardship codes as well as conferences designed to educate local markets on how best to create and impose a sophisticated governance framework.[8]

Likewise, an increasing focus on ESG further ups the ante. As more investors, both institutional and retail, screen for governance, markets may be more likely to reward companies that outrank their peers. With more tools at their disposal, investors no longer need to operate in the dark when it comes to sizing up how companies are governed and whether company leaders act in the interest of shareholders and stakeholders.

Bottom line: Long-term investors may want to consider gaining a deeper understanding of what they own, and that may mean delving into governance issues to understand the potential for risk.

Moreover, investors may consider paying attention to the outliers, for better and for worse, taking note of how governance is progressing or regressing.

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ENDNOTES

1. See PwC Global, "The World in 2050," https://www.pwc.com/gx/en/issues/economy/the-world-in-2050.html.
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ADDITIONAL SOURCES

Analysis cited in this article is sourced from the MSCI ESG Research Corporate Governance Country Report series, including:

- Malaysia Governance Country Report, October 2017
- China Governance Country Report, October 2017; Summary Report available at https://www.msci.com/www/research-paper/corporate-governance-in-china/0747013985
- India Governance Country Report, March 2017

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