At its most basic level corporate governance matters to investors because there is a strong correlation between good governance and high financial returns. Numerous studies have shown that good corporate governance helps firms improve their operational efficiencies, raises profitability, boosts shareholder confidence and leads to premium valuations.

All things being equal, and over any meaningful period, a well governed company with a robust operating environment that includes appropriate checks and controls, high levels of transparency and disclosure, and a strong relationship with its shareholders is likely to perform better than a poorly governed one.

Not only is the level of profitability likely to be higher but the quality of earnings and the certainty of future earnings is likely to be better. This allows equity investors to lower the discount rate by which to evaluate the company and lenders to demand lower returns for their loans.

Indeed a study by ABN Amro Asset Management published in July 2005 showed that the Returns on Equity at Brazilian firms with above average corporate governance were 45% higher and net margins were 76% better than those at companies displaying below average practices.
Brazil provides an interesting model for the Middle East and North Africa (MENA) region given its slightly more advanced stock market development and greater exposure to international investors since the beginning of the century.

The Brazilian Novo Mercado (New Market) is a listing segment of the stock exchange for the trading of shares issued by companies that voluntarily commit themselves to adopt corporate governance practices in addition to those required by law.

Since inception in January 2007 and through to the end of 2014, the Novo Mercado’s 125 member ‘Special Corporate Governance Stock Index' gained 77% while the benchmark Bovespa index increased by just 14%. Governance was not the only factor but it was an important one.

In the MENA region, Hawkamah institute for corporate governance has combined with Standard and Poor’s Indices to develop an Environmental, Social and Governance (ESG) index. This measures the performance of the 50 best rated stocks in the MENA region calculated by reviewing and scoring close to 200 environmental, social and governance factors.

Governance typically gets highlighted in times of crisis or after transgressions are exposed so it is not surprising that well governed companies tend to perform particularly well during such periods and perhaps not as much during upcycles that are often characterized by increased business risk and high leverage.

Nonetheless the S&P Hawkamah ESG Pan Arab Index has outperformed its underlying benchmark since inception in October 2011 even as the markets have rallied and despite a lack of general awareness of corporate governance among many investors, and particularly retail investors that are so prominent in the regional markets.

The methodology and scoring of the S&P/Hawkamah index is comprehensive but its construction is frankly a bit rigid and relatively unsophisticated. And yet a fairly simple proxy for well-governed companies has comfortably beaten many active portfolio managers in a bull market.

The conclusion is that a governance screen is likely to help investors perform better not only in the good times but probably into any prolonged market downturn. The peace of mind alone is worth the effort.

The variations in performance among companies are most pronounced in emerging markets that tend to be relative inefficient due to poor research coverage or that suffer from a sluggish price discounting mechanism, but apply to more advanced markets too.

A paper published in the Quarterly Journal of Economics in 2003 by academics at Harvard University and Wharton Business School observed performance differential of up to 8.5% per year in the United States, supposedly the world’s most efficient and sophisticated market, among the best and worst governed companies. It is hardly surprising that corporate governance funds are flourishing even in the so called developed markets.

While the efforts of regulators over the past few years have elevated overall standards across MENA, the road to global best practices is long and adherence among local companies continues to vary considerably.

Last year Fitch cautioned that the ratings of companies in the Gulf are being constrained by relatively weak corporate governance compared to those in the developed markets. It cited the absence of effective
independent boards, weak transparency and limited disclosure practices at privately-owned companies, while conceding that governance is steadily improving for publicly-listed companies.

For all the talk about improved governance there continues to be a steady stream of deeply disappointing incidents, even among the region’s largest companies, underscoring the fact that many firms have yet to apply international best practices irrespective of what MSCI market classifications imply.

Apologists argue that the MENA region needs to take a gradualist approach to best practices due to ‘cultural issues’ or be given ‘room to manoeuvre’ but there is really no excuse for slow adoption. Consumers in the region don’t ask to use dial-up internet because it’s too soon to migrate to broadband and contractors don’t seek to build the world’s 15th tallest tower or 10th biggest mall because it’s too ambitious to aim higher. A region that aspires to be the biggest and the greatest in commerce and industry should not settle for anything other than the best governance practices.

Regulators have an important role to play, as do shareholders, directors and auditors, but the wider community including financial analysts and even the media must also help monitor companies and call out those that fail to meet the highest standards.

Having robust checks helps with marketing to foreigners providing comfort around the level of corporate governance, particularly in new markets and to new investors. Deregulation and opening of markets in the region is positive but it is equally important that foreigners are not lured under false pretences only to be disappointed.

As managers responsible for other people’s money Asset Managers have a fiduciary duty to invest judiciously and with due care. The relative security afforded by well governed companies allows us to sleep better at night.

Sustainability, certainty, quality and transparency of earnings allow investors to assign premium valuations and pay higher prices for well governed companies. At the end of 2014, the Novo Mercado in Brazil traded on a Price to Earnings Ratio of nearly 21x compared to 16x for Bovespa for a 30% premium. This is on the high side of studies that show premiums of between 20%-30% in many markets but confirms that they are real and demonstrable.

Improved operational efficiency, higher earnings and premium valuations are positively evaluated by investors, feed into stock price performance and are precisely what asset managers, and shareholders more broadly, desire.

While the preference is usually to invest into well governed companies there is strong evidence to suggest that the best financial returns are derived from investing into poorly governed companies that are committed to improving their practices. Management are occasionally the catalyst for change but more often it is the shareholders that lead the way in demanding better practices and higher returns.

While activist shareholders are neither encouraged nor necessarily desired in the region there is a growing group of ‘consultative shareholders’ that seek to engage in dialogue and offer to work with management to advance the company’s systems, organisation and controls to their mutual benefit. Traditional asset managers are not involved in these activities but observe carefully and support where appropriate as vested shareholders.
The effects of governance today are being felt beyond investors and shareholders. Governance has an impact on multiple stakeholders including customers, employees and society more broadly. Customers want their vendors to do good with their money and employees are seeking fulfillment as well as a decent pay day. The power of social media to make, or break, products and services is also an important consideration for many businesses. In fairness, many companies within the MENA region have embraced their Corporate and Social Responsibilities.

There is no doubt that the advances to corporate governance across MENA, and specifically within the GCC, have been substantial over the past decade. But corporate governance is not a static target and overall adherence to the spirit as the legal requirements is still lacking. There is no time to sit on any laurels and plenty of work to be done.

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