IMPACT BOARDS
EMERGING MARKETS

Reflections on EM corporate governance and the controlling group's conundrum

Back from my long travels in Mexico, where I hosted two events on Corporate Governance with Delphos and BIVA (Bolsa Institucional de Valores) on the 11th and 12th of October - for companies, regulators, governance specialists and investors, - my mind kept ruminating about the corporate governance conundrum.
The penny has started to drop on many questions that weigh on stakeholders' minds. Even though these questions were raised in Mexico, it is reasonable to assume that this conundrum exists across emerging markets jurisdictions, with nuances, where controlling groups dominate the Boards.
Controlling groups in EM companies would like to avoid this conundrum by having their cake and also eat it. This conundrum largely translates into keeping full control of company decisions at management and board levels, provide the minimum possible disclosure and reporting, while keeping unfettered market access.

The controlling group's conundrum largely looks like this:
A very entrepreneurial founder started a business decades ago and he/she is still running the business. Supporting the founder, we may find a second and even a third generation family members involved in the business. It is reasonable to believe that succession to control this group should fall to one or more family members now in supporting roles.
The company has grown into a well defended market position in the country, providing a sense of security. That said, the controlling group is disappointed that the estimated multiple for the business appears to be low compared to other listed competitors' valuations. Advisors and bankers have suggested that corporate governance may be a factor dampening down valuations.

The company has modernized and has onboarded professional managers with expertise to assure a more efficient performance at many levels.

As the world has become more complex, and other "stakeholders" have emerged to define corporate obligations towards them, there is a sense of resistance growing in the company.

Boards, which the controlling ownership set up as a council of "wise men" to provide unbounded advice to a typical CEO/controlling shareholder/Chairman of the Board, may not be complying with its theoretical mission to monitor risk or set up strategic guidelines for success. Board members were "invited to join" the Board by the controlling shareholder, and along the way, have lost to some degree their agency duty to serve all stakeholders. Their conflicted rapport makes them beholden to servitude.

This arrangement is not conducive to proper accountability towards all stakeholders, as the functions of the Board are neutralized by the agenda of the controlling group. All benefits that would normally accrue to make better companies -i.e., in economic, market, social or financial terms- are potentially lost or downgraded.

The challenges to the Board - from looking after minorities, to nominating and arranging remuneration for professional Board members and executives, to monitoring risk, defending against fraud, and setting up robust cybersecurity, maintaining proper disclosure and reporting etc. - in the eyes of many stakeholders, need to be handled by independent Directors, and not Directors that become an appendix to the controlling group.

As the world enters a new financial paradigm, where money is no longer free, capital becomes more selective and has the power to vote against the lack of proper accountability with its feet.

Companies can always go to their "friendly" bankers if markets are not as condescending as they were in the 2010's. But banks are also under pressure to become more accountable. Banks, especially global ones, must answer their own stakeholders when it comes to engaging in "responsible" lending. That means that banking relationships at the highest levels have limitations and come with strings attached. The need for transparency, and for sustainable business practices is gradually forcing banks to become more demanding in their corporate governance, due diligence, and sustainability planning.

Hence, bargaining power is now moving away from controlling shareholders to other stakeholders.

Sticking with the outdated Board practices is becoming wishful thinking as capital will be harder to secure without proper change. This change is not rocket science and it makes a lot of sense to make better companies. Controlling groups need to start with a change of culture that shift boards from "yes" people to professional and independent Board members with a full understanding of their agency role.

To the question as to *'Why do companies list abroad instead of listing at the local exchanges'*, there are many plausible answers. One that resonates with me on a practical level, and that is a big incentive for candidates, is secondary market liquidity. Anecdotally, it appears that most overseas exchanges selected by EM entities had more rigorous corporate governance requirements, and disclosure and reporting rules. Corporate governance data in emerging markets has a lot of gaps, with studies to this effect still limited, and restricted to specific countries. The correlation, if not the causality, appears to be between the quality of corporate governance and liquidity. I sincerely hope that future research will be more precise and establish causality.

On the question of access to markets, the answer is different subject to who you ask. To the many intensive industries (not only oil and gas) that are born and bred in emerging markets, sticking to the old customs carries many risks. The new breed of ESG sensitive young investors is not keen on investing in these sectors, and they also can vote with their feet, even if they recognize that the modern world does not work without these industries. Hence, companies in these sectors wishing to avoid a refinancing cliff, or stranded assets (take your pick, or both...) need to improve their governance and transparency to win these investors and remain investable.

So, what is it going to be? Better companies? Better access to capital? Better risk management? Better corporate reputation? Better valuations? Or...hanging on to whatever worked in the past for the sake of full control and no accountability.

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