EXCLUSIVE GUEST FEATURE

By **Greg Barker** - Director, Head of Research, Portfolio Manager
-Sustainable Capital Mauritius

Debunking the Biggest Myths of Corporate Governance in Listed African Equities.

"The great enemy of the truth is very often not the lie, deliberate, contrived and dishonest, but the myth, persistent, persuasive and unrealistic." . . . . John F. Kennedy

Introduction

Myths tend to thrive in environments of imperfect information. Africa and its financial markets certainly fall into this category. The most persistent of these 'African investment' myths have an element of truth that makes them intuitively appealing, yet they fail to pass muster under the close scrutiny of empirical evidence. We test the 'urban legends' of corporate governance in African equity investment against the hurdle of empirical research and objective analysis and conclude that these myths are 'busted' when weighed against factual data. In support of our case, we present evidence and case studies to debunk the following myths:

Myth #1: ***"There are not enough well-governed, high-quality African companies to invest in. Management quality and corporate governance is generally poor":*** *We lay this fairy tale to rest by outlining the investable universe of over 900 Africa ex-SA dominant companies and by drawing on our first-hand experience of high-quality companies in Africa ex-SA over the past 5 years. The low success rate of international companies who have entered Africa over the past decade on the assumption of inferior, poorly-governed domestic competitors provides credence to our case.*

Myth #2: ***"African investments in Africa are 'off the page' risky from a corporate governance perspective":*** *We distinguish between socio-political risk (including country governance risks), investment risk (on a stock-specific basis, including corporate governance risks) and portfolio risk. Unlike socio-political risk, investment risk includes the key component of price. The case study of post-revolution Egypt in 2011-2012 is a key example of short-term perceptions of country governance risk leading to great opportunities for contrarian investors.*

Myth #3: ***"You can't do sustainable investment in African listed equities":*** *We have often faced the question of how it is possible to do sustainable investment in Africa; the underlying assumption being that companies operating in Africa are not sophisticated enough to manage material environmental, social and corporate governance risks and opportunities that face their businesses. Nothing could be further from the truth! Our own experience suggests that the potential to generate 'sustainability alpha' is in fact far greater in Africa than it is in more mature markets, and that the difference between disclosure and reality can only be reliably uncovered through first-hand due diligence.*

Myth #4: ***"Foreign multinationals in Africa are better governed than local, family-owned businesses":*** *The listed equity market in Africa presents cases that often contradict traditional corporate governance wisdom. For example, family-owned, controlled and managed businesses with intergenerational time horizons and material, direct shareholdings may present far lower governance risks to long-term investors than listed companies controlled by a foreign multinationals where management have little incentive to grow the value of the local subsidiary.*

Myth #1: *"There are not enough well-governed, high-quality African companies to invest in. Management quality and corporate governance is generally poor".*

Myth: This fairy tale inevitably comes in the form of a question from foreign investors who have typically never set foot in Africa (except perhaps on a safari holiday) and have certainly not met the senior management teams of Africa-dominant companies, nor witnessed the corporate governance, asset quality and earnings growth prospects of these companies. The assumption that Africa-dominant companies and their management teams are somehow inferior to others around the world is so preposterous that a rational observer would find it hard to believe that sophisticated investment professionals and seasoned business people could hold this perception. Yet, African countries are littered with the bones of international companies who entered African markets on the assumption that poorly-governed domestic competitors would yield easily and offer up rapid market share gains at high margins (consider the low success rate of South African companies in the rest of Africa as a prime example).

Reality: Let's put the myth that 'there are not enough companies to invest in' to the test. Our investment universe includes all Africa-dominant companies (excluding South Africa). This definition includes any listed company with the majority of its economic footprint (by assets, revenues, operating profit) in Africa ex-SA, regardless of where it is listed. By our calculations, 901 companies meet this criterion. If we narrow this down to companies with a market capitalisation of greater than USD10m, the number comes down to 767 companies. Based on our minimum liquidity requirements, we reduce that universe to about 300 companies. Since we typically aim for high-conviction, concentrated portfolios of less than 25 stocks (with most of our portfolios concentrated in the top 10), we only need to be invested in less than 5-10% of the investment universe at any point in time. Our job is to find the top 5% of Africa's well-governed, high-quality companies that are trading at material discounts to their fair values and thereby warrant material overweight positions in our portfolios.

Case Study: Since we founded Sustainable Capital 5 years ago, our investment team has conducted over 650 detailed management interviews and due diligences on Africa-dominant companies in their home countries, including detailed corporate governance assessments and forensic investigations of potential conflicts of interests with shareholders. We see daily examples of world-class companies across all industries with top notch management teams, often operating 'below the radar screen'. By any objective measure, these companies are often way ahead of best international practice in terms of corporate governance, operating efficiency, innovation and asset allocation.

Myth #2: *"Investments in African listed equities are 'off the page' risky from a corporate governance perspective".*

Myth: A common premise is that African countries are riddled by socio-political risk, armed conflict and corruption (country governance risks) and that companies suffer from poor corporate governance, making it difficult to secure a fair return by investing in listed companies. Investments in African listed equities are often seen as 'off the page' risky by uninformed investors, who believe that the geography should play no role in the portfolio of a rational investor due to the risk of capital losses.

Reality: A key underlying assumption of this myth is that corporate governance and socio-political risk is equivalent to investment risk. This is clearly an incorrect premise, since investment risk is a function of both fundamentals (such as country or company risk, or growth prospects) as well as the crucial element of price. From a fund manager's perspective, we believe that investment risk in Africa comes from: a) Not knowing what you are doing (not knowing enough about the company that you are investing in); b) The price paid for an asset (a share of a company, in our case). The former risk source can be mitigated through detailed company research and due diligence, which should include detailed corporate governance research. The latter can only be overcome through a disciplined investment process.

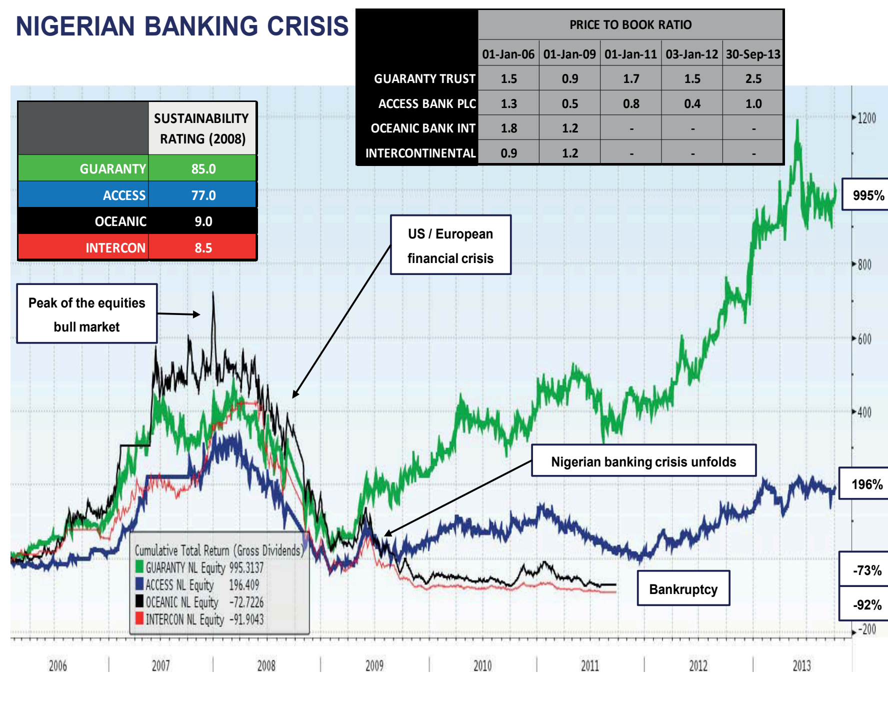
In terms of governance at a country level, Sustainable Capital measures country quality according to a 'country sustainability rating' using quantitative metrics, including factors such as rule of law, control of corruption, government effectiveness, political stability, infrastructure quality, human capital, voice and accountability, regulatory quality and environmental footprint. Analysis of our historical data over the period 1995-2012 reveals that African countries have made dramatic structural and long-term improvements in the operating environment for businesses over the past 10-15 years.

Case study: The Nigerian banking crisis that unfolded in 2009 represents a classic case of mispriced corporate governance risk. Investment returns in USD measured from 1 January 2009 to 30 September 2013 range from -92% for the worst-governed banks to +995% for the best-governed banks (see Nigeria Banking Crisis Chart below). The quality of the corporate governance of these banks translated directly into financial performance (through dramatic market share gains and losses) and ultimately into shareholder value. Yet, when we consider valuation levels in 2009 on a price to book basis, the corporate governance risk that was clearly inherent in the poorly managed banks was totally mispriced by the stock market, with the worst-governed banks trading at a premium to their better-quality peers.

Myth #3: *"You can't do sustainable investment in African listed equities".*

Myth: In 2008, Sustainable Capital set out to pioneer sustainable investment in listed African equities (outside of South Africa). We define 'sustainable investment' as the integration of material environmental, social and corporate governance factors into investment management practices with the conviction that they have a substantial effect on the long-term financial performance of companies and, ultimately, on shareholder value. Over the past 5 years, we have often faced the question of how it is possible to do sustainable investment in Africa. The assumption behind this question is that companies operating in Africa are not sophisticated enough to manage material environmental, social and corporate governance risks and opportunities that face their businesses over the next 10-20 years.

Reality: Nothing could be further from the truth! In fact, we would argue that the potential to generate 'sustainability alpha' (outperformance generated by

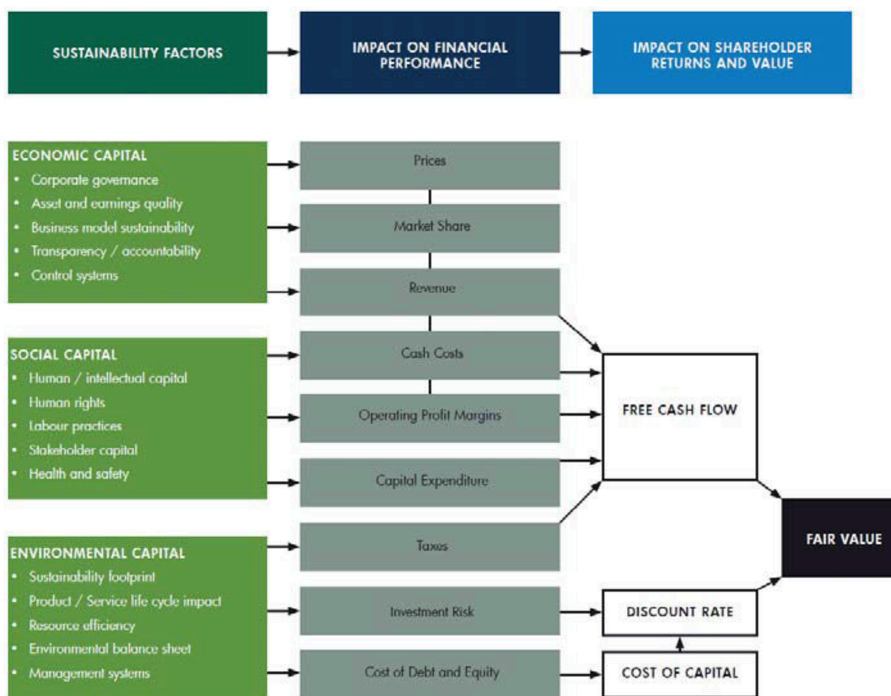


Case study: Having conducted over 650 sustainability audits on Africa-dominant companies over the past 5 years, we have encountered many examples of inefficiently priced sustainability factors: Commercial banks where differences in the quality of corporate governance have been chronically mispriced; real estate companies with contaminated groundwater liabilities equivalent over 50% of their market values; mining companies where the 30-year geological mine life has been rendered irrelevant by the lack of ethical backbone in the management team (with subsequent loss of the company's title); and, industrial manufacturers where poor labour practices and subsidised energy costs have later unwound in material cash cost escalations and margin compression.

exploiting mispriced sustainability risks and opportunities) is far greater in Africa ex-SA than it is in more mature markets, where disclosure is more freely available. It seems that few listed equity investors in Africa are conducting true long-term investment research. Apparently, Africa's listed equity markets have not yet reached the size where they justify the dedicated efforts of international, sustainability-focused researchers and asset managers.

However, our experience provides clear evidence that long-term, sustainability factors are materially mispriced in African equity markets, which is not particularly surprising in an environment of imperfect information. There is a wide gap between disclosure and reality in African companies. Equally, there is a major divergence in company quality. Some companies masquerade in their formal reports as exemplary corporate citizens, yet a due diligence of their operations often reveals a different picture. At the other extreme, there are incognito African companies that are 'flying below the radar screen' with limited reporting. Under close scrutiny, it becomes clear that they are world-class, cutting-edge companies ahead of best international practice on issues ranging from labour practices and corporate governance to environmental management.

The only reliable way to differentiate between 'spin doctor' pretenders and companies of authentic quality is first-hand due diligence conducted on the ground in African countries. The reality is that sustainability disclosure and third-party research is probably 10-20 years away from the point where high-conviction investment decisions can be supported purely by desktop research conducted from a stuffed chair in an air-conditioned office. Sustainable investment in Africa certainly makes sense from our perspective, as we view this long-term research as mutually inclusive with investment outperformance.



Integration approach to sustainable investment in Africa ex-SA | (source: Sustainable Capital)

Investors who can integrate these long-term factors into their estimates of fair value for each company, and thereby into their portfolio construction, are likely to be rewarded with investment outperformance.[24] In selected cases where significant value can be unlocked by addressing material sustainability risks and opportunities, African markets provide great scope to enter into collaborative, constructive engagement with companies and thereby unlock value for clients. Asset managers in Africa who take cognisance of these

[24] This 'integration approach' should not be confused with simple negative screening by sector or geography, which often detracts from long-term sustainability outcomes through unintended negative impacts on stakeholders (including investors).

long-term factors also have a unique opportunity to positively influence company behaviour through their capital allocation decisions.

Myth #4: *"Listed subsidiaries of foreign multinationals in Africa are better governed than domestic, family -owned businesses".*

Myth: The main objective of good corporate governance is to overcome the inherent conflicts of interest between shareholders and management associated with the 'agency dilemma'. A complex governance risk faces minority shareholders when they invest in the listed subsidiaries of multinational companies, where the parent company typically has majority ownership and control of its local subsidiary. Corporate governance practices can impact the entire chain of shareholder value creation/ destruction, from capital allocation (including dividend policy, financial leverage and corporate actions) through to operating profit margins and earnings growth (influenced by transfer pricing, management incentive systems and profit-sharing arrangements). There seems to be a commonly-held perception that listed subsidiaries of foreign multinationals in Africa are better governed than domestic, family-owned businesses. However, our research leads us to question this belief.

Reality: Most listed companies in Africa ex-SA (71% of the top 100 companies by market cap) have majority, controlling shareholders. Major conflicts of interests may arise when 'slicing the pie' (distributing value between majority and minority shareholders). In these cases, minority shareholders face the risk of material value destruction. This risk is exacerbated by perverse management incentives whereby the management teams of listed multinational subsidiaries are employed by the parent company and benefit from share-based incentives at the holding company level, providing no meaningful incentive for value creation at the local subsidiary level. We seriously question how alignment with minority shareholders is served by providing equity incentives for management at the parent company level, in which minority shareholders generally have no interest whatsoever.

The listed equity market in Africa presents cases that often contradict traditional corporate governance wisdom. For example, family-owned, controlled and managed businesses with intergenerational time horizons and material, direct shareholdings may present far lower governance risks to long-term investors than listed companies controlled by a foreign multinationals where management have little incentive to grow the value of the local subsidiary.

Different controlling shareholding structures demand a case-by-case, company-specific research approach that includes an analysis of sector dynamics, the historical and cultural context of corporate governance practices in specific companies and countries, and the economic value derived from the controlling shareholder's input. Sustainable Capital's long-term investment approach and our emphasis on downside risk protection makes the analysis of corporate governance a key component of our company analysis, valuation and investment decision-making process.

Case study: The subject of 'management fees' is a good example of poor corporate governance that is common practice amongst listed subsidiaries of foreign multinationals. Minority shareholders need to be aware that parent companies may unfairly tap the economic profits of their listed subsidiaries (for example, through revenue- sharing arrangements) before the stage at which minority shareholders participate, which is ultimately at the level of earnings and cash dividends. In most cases, we find it difficult to justify the level of fees charged by parent companies based on an arm's length assessment of the economic benefit of goods and services provided. The difference between the 'management / service / brand fees' paid to the parent company and the intrinsic value of these assets amounts to a tax on minority shareholders. Our own research indicates that these fees can amount to between 15 and 25% of the company's profit before tax, with questionable benefits from the group holding company. At Sustainable Capital, we believe it is important to integrate this corporate governance risk into company valuations through appropriate discounts.

Conclusion

We have tested some of the 'urban legends' of African equity investment against the hurdle of empirical research and objective analysis. Having put some entrenched assumptions to the sword, we leave it to investors to draw their own conclusions in light of the evidence and case studies presented. We find that, though generally based on some element of truth, these myths are 'busted' under close scrutiny when weighed against factual information. We present evidence and case studies to debunk the myths that "investments in African listed equities are 'off the page' risky from a corporate governance perspective", "there are not enough well-governed, high -quality African companies to invest in", "you can't do sustainable investment in African listed equities" and "listed subsidiaries of foreign multinationals in Africa are better governed than domestic, family -owned businesses".

Contributor Profile

Greg heads up Sustainable Capital's investment team, manages the Africa Alpha Fund and co-manages Sustainable Capital's Africa Sustainability Fund, Nigeria Fund and Africa Consumer Fund. Greg has led the development of Sustainable Capital's investment process, which relies on proprietary, in-house research with an emphasis on detailed industry- and company-specific analysis and valuation. Greg has extensive experience in sustainable investment research and has developed a strong track record of investment decision-making in listed African equities over the past 9 years. Since co-founding Sustainable Capital 5 years ago, Greg has been travelling into African countries to conduct detailed, bottom-up research on companies. Greg is a CFA Charter holder with over 14 years of industry experience. He is a graduate of the University of Cape Town, having completed a Masters Degree in Sustainability and subsequently an MBA from the Graduate School of Business.