A Corporate Governance Checklist for Public Companies in MENA – What Needs To Be Done?

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In this article, David Haglund, portfolio manager covering the Middle East and North Africa region and wider global Frontier markets, provides his views on the corporate governance considerations institutional investors should take into account when making investment decisions.

Corporate governance standards across the Middle East and North Africa (MENA), like most of emerging markets, typically trail those in developed markets. The implications for companies which have lower levels of corporate governance are far reaching and often include an elevated risk profile, poorer performance and less potential for growth.

Even for those companies which do have higher levels of governance, and in turn increased access to financing, lower capital costs, stronger share and operational performance and higher valuations, the definition of 'corporate governance global best practice' is constantly evolving, which can make it challenging to keep up. We consequently still consider investing in companies with weaker governance if there is an improving trend. Many of the region's blue-chip companies today for example had poor levels of governance over the past decade or two. Since then, they have made significant improvements in investor relations, transparency, risk management, shareholder engagement and board composition.

Although this positive trajectory is encouraging for the region, more needs to be done. As investors look for stability and clarity in today's historic economic downturn, we think there is no better time than now for public companies to ramp up their levels of corporate governance and bring them in line with global best practice.
Below are some key corporate governance considerations institutional investors in and outside the MENA region take into account when making investment decisions.

Shareholder Engagement

Ongoing engagement is essential to building and retaining trust between a company and its shareholders, as it deepens mutual understanding and fosters accountability. It is important that management has a robust internal reporting system in place to communicate clearly across different platforms and at regular intervals. Clear, effective communication should also ultimately be based on a deep understanding of the shareholders, which needs to be routinely updated and monitored.

For communicating with investors, companies should supplement their results releases with investor presentations and host public, quarterly conference calls. Though more companies in the region are starting to host such calls, there are still many that do not. A company's executive management should also attend regional and international investor conferences and consider hosting annual 'investor days' at their premises.
Working closely with sell-side research analysts to initiate and maintain research coverage is also essential, as the larger the investor community that the company interacts with, the deeper the breadth of analysis the company will be able to benefit from. Discussing and challenging the company's financials and strategy by numerous financial intermediaries leads to constructive and valuable feedback for the management and the board. Management would be short sighted not to take advantage of this feedback and use it to enhance governance and long-term value.

The board should also be open to including material shareholders' proposals on proxy forms to be discussed and voted on at annual general meetings. Shareholders should preferably be asked to vote on all material decisions of the company, such as large acquisitions and capex programs.

It is worth highlighting the role of the investor relations officer ("IRO"), who act as a bridge between the management, the board and the shareholders. The IRO is a great tool but shouldn't be a substitute for direct interaction with shareholders as executive management remains the preferred means of communication on material matters, such as business strategy and daily operations.

Globally, companies are increasing their levels of shareholder engagement. Those that have invested in this tend to benefit from shareholder support in market sell offs, such as the one we are living through now. Those that do not, typically suffer.

Transparency and Accountability

Many companies in the MENA region are still not aligned with global best practice when it comes to their levels of disclosure, and there are several factors we look at in a company's reporting process. Financial statements should be supported by investor presentations with detail on historical operational data and industry specific KPIs, and sensitivity analyses are a welcome addition. Most of this information should also be accessible on company websites, something we do not always observe. Lastly, the management and board can only be held accountable if their actions are disclosed and monitored.

Generally speaking, the more data available typically promotes trust, reduces the company's risk profile and helps all stakeholders make better decisions. An abundance of data tends to indicate internal control systems are solid and enables better risk monitoring. More transparency also promotes accountability and, in turn, should foster a greater sense of management responsibility and increase operational performance.

It is also a widely accepted economic principle that reliable, real time and available information is key to the efficiency of the financial markets.

Independent and Qualified Board

Having a majority of independent board members increases oversight, reduces risk for minority shareholders and generally decreases the risk of corporate governance failure. Studies also show there is a positive correlation between board independence and firm performance. The biggest challenge to widespread adoption of independent board members in the MENA region today is amongst family owned businesses and state owned, controlled companies.

Aside from having more independent board members, directors need to have the appropriate expertise and background. Strong integrity is also key, and directors should be capable of challenging and providing guidance to the executive team. We would also like to see more women on regional boards.

Preferably, directors should not hold more than five board positions simultaneously. Board tenures tend to be relative long for some directors in the region and we would rather see a higher rotation of board members by encouraging lower average terms and implementing reasonable limits.

Aside from the board, monitoring committees (i.e audit, compensation and nomination committees) should also have a majority of independent directors. Several international and regional accounting scandals were the result of a weak audit committee for example, so having a majority of independent directors, if not all, is critical.

Finally, we are generally opposed to the same person being chairman of the board and CEO as it increases the risk for conflicts of interest, decreases effectiveness and tends to lead to negative operational performance. A clear line should consequently be set between the accountability of the board and that of executive management.

Executive Compensation

It is important that there is alignment between total remuneration and long-term value creation by the executive management, and that this is clear and transparent. Having a balanced, long-term and share-based program tends to keep management engaged and there should be a reward mechanism that holds them accountable for their decisions. A substantial part of remuneration should be share-based and ideally locked in for a period longer than three years. The total remuneration package should be published and approved at the company's Annual General Meeting. It is important that the total size of remuneration is not excessive, and is in line with regional peers and the company's profitability.

ESG (Environment, Social and Governance)

We like to see regional companies increase their focus on Environmental and Social factors as they are closely interlinked with Governance and the longevity of the business. The Covid-19 pandemic has exposed ESG risk with regards to issues like supply-chain disruptions and disaster preparedness, but there are other long-term factors such as climate change to still consider. Companies should strive to decrease negative environmental and social outcomes from their operations, and a failure to do so could result in reputational damage or harm their long-term viability.

ESG is still relatively in its infancy in the MENA region, however we are seeing improvements every year and companies are improving their

levels of sustainability risk and disclosures. There is more to be done however and we would like to see further disclosure on climate change risk analysis, carbon emissions, renewable energy, water consumption trends, social programs, health and safety policies, gender breakdown, equal opportunity policies and human right policies. These disclosures are aligned with global best practice and would likely uncover a few areas for improvement.

Related Party Transactions

Related party transactions tend to raise red flags amongst investors and can at times be used in an abusive manner. These transactions often lead to conflicts of interest and increase corporate governance risk. We would like to see companies remove or at least significantly reduce the number of related party transactions over time. In the meantime, all related party transactions should be at arm's length and for fair market value and have true corporate benefit. Shareholders and directors should also disclose potential conflicts of interest and recuse themselves from voting on their approval.

Foreign Ownership Restrictions

Whilst removing investment hurdles is generally the responsibility of the domestic regulator, companies often weigh in on these decisions. For example, increasing the foreign ownership limit is to some extent the decision of UAE companies, and we would like to see them increase to the maximum permitted. In addition to benefiting from the expertise of international investors, more foreign ownership may trigger benchmark inclusions and increase the volume of total active and passive investors in the MENA region.

Rotation of Auditors

Companies should change auditor every five years. This allows for a new auditor to take a fresh look at internal control systems and reporting procedures, generate recommendations not heard before and uncover previously unknown areas of risk.

Capital Allocation

Capital allocation is the combination of corporate governance and corporate finance. Investors prefer companies with a prudent capital allocation framework aimed at reducing financial risk and enhancing long-term value. We like to see manageable debt levels, a consistent dividend policy and adequate cash management, all of which are clearly beneficial in challenging times such as today.

In Summary

Whilst an exhaustive corporate governance checklist is outside the scope of this article, the foregoing considerations constitute some of the essential factors regional boards and management should be turning their attention towards.

As part of the regional financial community, we have a responsibility to assist companies and markets in rebuilding investor confidence after some of the most recent governance failures. But confidence and trust can only be rebuilt on the basis of robust corporate governance. We cannot expect governments and regulators to drive the change towards strengthening these standards alone– it must also be driven by shareholders, including institutional investors and financial intermediaries like analysts, brokers and rating agencies. Institutional investors in particular have a leading role to play in championing strong governance standards and being stewards of this change.

We would like to see more regional public companies take the aforementioned steps to improve their corporate governance practices, not only to comply with domestic regulations and accounting standards, but also so that they come in line with global best practice. This will be essential to restoring market confidence and attracting both domestic and foreign capital in today’s highly competitive financial world.

Looking forward, the long-term growth potential of the region remains strong, despite the ongoing Covid-19 pandemic and lower oil price environment, and we will continue to push for promising change in the corporate governance space.