Attracting long-term investors with strong governance and ESG

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There have been considerable advancements in recent years in improving the corporate governance environment throughout the MENA region. Much more work remains, however, to appeal to institutional investors, especially in the face of a particularly challenging investment climate. Fortunately, a number of very constructive measures were recently enacted that are improving matters, and forward-thinking leadership will likely continue this positive trajectory.

Background and current regional challenges

Corporate governance is still, relatively speaking, very much in the early stages of development in the MENA region. Although policies are quite advanced in certain states, particularly those in the GCC, substantial inconsistency remains throughout the region, and even the most advanced regimes do not have the same depth and breadth of regulation and interpretation as their European and North American counterparts.

Strong governance is more critical in developing than mature markets, since robust policies and procedures that protect investors can partially compensate for a less developed regulatory regime. Despite the progress that has been made to date in improving corporate governance frameworks, several challenges exist that arise both from legacy issues as well as from more novel problems.

One of the main differentiators in the MENA region is that a majority of major business continue to be either family dominated or government backed. While some of these businesses have in fact adopted state-of-the-art governance regimes, these are the minority, and many continue to suffer from deficiencies when it comes to some of the most fundamental issues of good corporate governance, such as problems with transparency and disclosure, independence and expertise, and sufficient minority protections.

Most sophisticated investors will be more ready to invest in developing markets when global markets are stable and returns in developing markets are particularly high. And while some more aggressive investors may be willing to overlook inadequate corporate governance controls in exchange for higher returns, this is not the case with institutional investors, who will consider strong corporate governance to be as important as solid financial performance. Institutional investors understand that strong corporate governance often leads to higher profits and performance anyway, but more importantly, they are under an obligation, often by applicable regulation, to disclose to their stakeholders the details of their portfolio companies, including their governance profiles. A high return is not worth the reputational damage that can be done by a corporate scandal due to weak policies and controls, and consequently a lack of clear and comprehensive corporate governance policies in target portfolio companies will scare off most major institutional investors.

To further complicate matters, investors flee to the safety of established markets during periods of crisis, putting increased pressure on firms in developing markets to attract capital. The MENA region has suffered from a number of setbacks in recent years, which will only increase the challenge in attracting investors. Even before the onset of Covid-19, oil prices were already low, and the pandemic has pushed them down much further. This has hurt GCC economies, since despite recent progress in diversification of business (particularly in the UAE and Bahrain, with Saudi Arabia recently making advances), reliance on oil and gas remains strong.

In addition, regional conflicts, from the wars in Syria and Yemen and the related conflict with Iran, as well as the blockade with Qatar, are only adding to a difficult investment climate. There have also been the well-publicized troubles of some of the region's biggest success stories, such as the downfall of Abraaj and now of NMC Healthcare, which shows that even companies that have had the most success in attracting foreign investment can suffer scandals that could likely have been avoided through more effective corporate governance.

Strengthening corporate governance with a focus on ESG

The challenges facing the region are considerable, and the outlook will unlikely improve in the short term. As a result, regulators throughout the region will need to take substantial measures to give comfort to institutional investors that are considering opportunities in the region. This will include making sure that corporate governance fundamentals are strong, as well as encouraging more companies in the region to pay attention to ESG considerations.

This must start with reinforcing the corporate governance "basics" including strong protection for minority shareholders, robust policies on reporting and transparency, a clear separation of the executive and oversight roles, a majority of independent, non-executive directors, separate audit, nomination and remuneration committees, comprehensive policies on compliance and ethics, etc.

What is of perhaps more importance, however, particularly in light of the Abraaj and NMC scandals, is to clearly demonstrate that these policies are being effectively implemented, and not just being given lip service. Companies should expect that investors will undertake thorough due diligence to make sure that strong governance is firmly embedded in a company's day-to-day operations and is part of its ethos, rather than being simply a nicely drafted policy that is filed away and forgotten. This diligence will be part of an ongoing relationship, as the investor will undertake recurring investigations and expect regular reporting.

One new consideration in the current environment is that investors will be putting much more emphasis on business continuity plans. Although this is something that every company should already have been paying attention to, many have not, and this will need to become an area of particular focus.

In addition to solidifying traditional corporate governance, institutional investors have been increasingly insisting that their portfolio companies take into consideration ESG goals, have policies that further those goals, and make regular reports on the progress made towards those goals.

ESG goals can relate to a variety of issues, and companies should consider including several ESG goals as part of their mission, such as human rights and sustainable supply chains, reduction of poverty and philanthropy, climate change and the environment, social responsibility, ethics, diversity, integrity and transparency, etc. Institutional investors have been the main drivers behind the growth of ESG goals, and even if a company is not seeking investment directly from an institutional investor, including ESG goals can be important as there can be indirect pressure to adhere to them. For example, private equity houses will often impose similar ESG requirements, as they themselves frequently have institutional investors as limited partners, who will insist that the fund's portfolio companies comply with ESG goals.

The adoption of ESG goals is not purely an altruistic exercise, as studies have shown that companies that are dedicated to ESG are often more profitable when compared to those that place less emphasis on ESG. Reporting on ESG performance demonstrates transparency and effective management and enhances a company's ability to attract long-term capital and institutional investors. Moreover, credit rating agencies have begun to look at the non-financial performance of companies to evaluate credit risks, and the incorporation of ESG considerations can have credit implications.

Although cynics may believe that institutional investors are touting ESG goals for marketing purposes, while really focusing only on the highest return, a recent Wall Street Journal article noted that ESG investing is not a fad, and that investment into ESG funds more than doubled in the first quarter of this year compared to last (despite the challenging economic climate). This is for very good reason, as a WSJ study showed that about three quarters of ESG funds outpaced[1] the average return of a fund's broader category.

As with more traditional corporate governance considerations, however, it is very important to avoid "greenwashing" and agreeing to implement ESG policies, but then failing to take the necessary actions to make change happen. Institutional investors will investigate implementation thoroughly, and a claim to pursue ESG goals without follow up can backfire and be worse than having no ESG plan at all.

Progress made and the way forward

Fortunately, there have been some very promising signs of progress recently, both in terms of strengthening corporate governance generally, and of furthering ESG goals specifically. Both have occurred in the UAE, which continues to be the leader in the region in establishing a business and investor friendly environment.

Earlier this year the UAE Securities and Commodities Authority adopted a new Corporate Governance Guide for Public Joint-Stock Companies (the New Guide), which introduces new rules for listed companies. While many of the requirements in the New Guide

[1] "ESG Investing Shines in Market Turmoil, With Help From Big Tech", Wall Street Journal, May 12, 2020.

reflect current international best practice, some measures go beyond that, including in particular a requirement for companies to establish gender diversity policies, and have a minimum of 20% representation of women on boards. Not only is this incredibly forward thinking, but something that is sorely needed in a region that falls far behind its counterparts in Europe and North America.

In addition, from an ESG perspective Dubai Financial Market (DFM), in cooperation with S&P Dow Jones Indices and Hawkamah, has introduced an ESG Reporting Guide (the ESG Guide) as well as an ESG Index, which was launched in April of this year. The ESG Guide aims to have companies incorporate ESG information into their reporting processes through a set of 32 ESG metrics. The ESG Index includes the top 50 Pan Arab companies based on their performance on nearly 200 ESG metrics and uses an ESG score-weighting scheme to identify the top performing companies in terms of ESG performance. It is too early to assess the performance of the ESG Index, however, it is derived from the MENA-wide S&P/Hawkamah ESG MENA index, which was launched in 2011, and which has outperformed the benchmark.

Although the New Guide and the ESG Guide are aimed at listed companies, privately held companies that are looking to attract institutional investment would also do well to enact policies that comply with both Guides. Moreover, while listed companies are encouraged to confirm their ESG data using external third-party verifiers, privately held companies may want to consider doing the same, as external verification can provide investors with a higher level of confidence in the quality of a company's ESG claims.

As is often the case, other regulators in the region will likely follow the example of the UAE and Dubai and incorporate similar policies, and encourage similar practices in their respective jurisdictions. Given the current extremely challenging environment, there has never been a better time to adopt such measures.