Asia Insight

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Kicking the Tires

Asia has certainly had its fair share of crises and scandals over the years, from economic bubbles to corporate and governmental malfeasance. It's no wonder then that, whilst investors may no doubt be drawn to the attractive economic growth offered by many of the region's economies, we frequently encounter concerns over corporate reporting leading people to invest in multinationals listed outside of Asia. Many investors feel a sense of familiarity and comfort when they invest in Asia via multinational companies with emerging market businesses. A chief concern, as always, for investors and ourselves is the quality of corporate financial reporting and the commitment to corporate governance. Ultimately, we need to ask: can we trust management? These worries aren't limited to nervous investors making their first foray into international markets. Recently, the U.S. Securities and Exchange Commission (SEC) has made headlines in their similar inquiries into China's corporate landscape. The U.S. regulator has requested that the Chinese units of major accounting firms provide documents as backup for corporate auditing purposes. The U.S. claims the backup is needed for U.S.-listed Chinese firms in order to ensure their authenticity, however, China has maintained that its laws prevent the removal of such records from the country.

The issue of corporate governance and the protection of minority shareholders, such as ourselves, is an important consideration for any investor. This is particularly the case when it comes to investing in emerging markets. Good governance requires such qualitative (and quite frankly sometimes tedious!), broad-ranging analysis that many market participants, and even listed companies, sometimes pay only lip service to the process.

So What is Good Governance and Why is it Necessary?

There is no clearly defined prescription for good governance. Essentially, at Matthews Asia, we look for companies run in such a way as to minimize conflicts of interest across stakeholders and to ensure accountability for those who manage the business. Rules and regulations, the enforcement of those rules, and the culture of firms in adhering to policies all play a vital role in the foundation of a country's corporate governance standards. This means that not only do underlying companies have an important part to play, but so too do legislators, who are the rule setters, and regulators, who are the rule enforcers. With these structures in place, investor confidence can certainly improve and this is generally a major driver of the development of local capital markets, national competitiveness, economic stability and job creation if implemented properly over a reasonable length of time. According to a 2000 McKinsey & Company survey, over 75% of investors would pay more for a well-governed company, and a comparison of recent corporate governance rankings against valuations (see chart below) seems to attest that this sentiment still holds true. This confidence is, of course, particularly necessary for some emerging countries such as India that require foreign

PAYING UP FOR A WELL-GOVERNED COMPANY

Generally, the majority of investors would pay more for shares of a firm with good governance than for those of a poorly governed one with comparable financials. Whilst it is difficult to generalize about Asia's markets, extremes of "good" and "bad" governance are highlighted below.

	Corporate Governance Scores			P/E
	2007	2010	2012	2013 (est.)
Singapore	65	67	69	14.4
Hong Kong	67	65	66	15.8
Thailand	47	55	58	13.0
Malaysia	49	52	55	14.5
Japan	52	57	55	15.0
Taiwan	54	55	53	14.9
India	56	48	51	13.9
South Korea	49	45	49	8.9
China	45	49	45	10.0
Philippines	41	37	41	19.4
Indonesia	37	40	37	15.7

Sources: The McKinsey Quarterly 2000 Number 4: Asia Revalued; CLSA (September 10, 2012); Goldman Sachs (March 1, 2013), P/E is estimated for 2013 based on consensus median estimates, and is forward looking. There is no guarantee that P/E estimates will be achieved.

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capital on a regular basis due to a lack of local funding, as it continues to run current account and fiscal budget deficits.

So, how do we come to the conclusion of what "good" and "bad" companies look like from a governance perspective? There are many inputs, ranging from metrics such as ownership structures, interest alignment, historic capital allocation, transparency and independence—which all provide valuable insights into the way a business is managed.

Dubious Practices

Whilst all metrics are important, there are some that may factor more heavily in Asia. One of the largest areas of potential abuse of minority shareholders' interests in Asia revolves around the family ownership structures that still dominate the corporate sector.

ASIAN FAMILY BUSINESS MARKET CAPITALIZATION AS % OF TOTAL MARKET CAPITALIZATION

	Family Business Market Capitalization (USD Million)	% of Total Market Cap
Philippines	131,609	83%
Singapore	311,564	54%
South Korea	555,318	52%
Taiwan	453,552	49%
Indonesia	175,155	49%
Thailand	133,128	48%
India	762,279	47%
Malaysia	158,428	39%
Hong Kong	652,178	26%
China	416,524	11%
Total	**3,749,733**	**32%**

Sources: Bloomberg, Credit Suisse, Asian Family Businesses Report 2011

Many investors, quite rightly, are somewhat suspicious of large family-controlled entities after having witnessed historical cases of abuse. One of the standouts is the egregious actions of certain conglomerates known as *chaebol* in South Korea that have quite purposefully set up corporate structures in the past to facilitate opacity around their own ownership. This kind of complex and arcane financial fudgery is a prime example of interest "misalignment" as companies set out to gain a larger cashflow interest than their ostensible economic interest, make monitoring tougher and ensure that all companies within the group get a slice of the pie, even if they are not competitive suppliers or customers. Other reasons for wariness include the political connections that certain families have and exploit in order to benefit from the "crony capitalism" that some parts of Asia have previously seen. Further, these structures can lead to independent directors being actually less than independent as distant relatives and friends of friends become appointed to boards. This mismanagement is more easily perpetrated in the parts of Asia in which companies still vote by hand instead of by poll at their annual general meetings. There are actually a surprising number of such firms and they exist across the region, including in China, Singapore, India, Malaysia and the Philippines.

These family ties can also lead to another of Asia's largest corporate governance problems that still persists—related party transactions (RPTs). RPTs are essentially transactions between two entities that share the same major shareholder and can involve financial assistance, one-off asset transfers and continuous trading arrangements. Whilst these do not always necessarily destroy value for minority shareholders (on occasion, these transactions can have real strategic merit), there are multiple examples through decades of Asia's corporate history in which a listed company has been forced into buying assets from an affiliated, but unlisted, company at a rather dubious price. Again, this is a practice that should be frowned upon as minority shareholders' cash is siphoned off for the benefit of the family. Of course it should be noted that there are also some strengths to the structure of Asian family businesses. For example, there tends to be a long-term commitment by the owners and a track record of standing by their companies even during hard economic times such as the Asian Financial Crisis of the late 1990s and the global financial crisis of 2008.

Family businesses are not the only common ownership structure in Asia that can pose issues. Some parts of the region, such as China, in particular, have large state-owned enterprises that still dominate certain industries. Again, this structure does not need to be viewed as

“The culture in the majority of Asia is also slowly changing for the better, although it is clear that the road to these improvements will be long and somewhat bumpy as changes of this variety are never linear.”

definitively negative, but one should be cautious of certain problems that may arise. A clear example of this has been seen in the Chinese banking system where there have been major financial institutions willing to take foreign investors’ capital, and redirect this into the domestic economy to other state-owned enterprises at what are generally deemed to be interest rates that have failed to price risk appropriately.

As highlighted by the recent SEC concerns, one also needs to be wary of transparency and disclosure. The last few years have seen multiple allegations of fraud from Chinese companies listed in both the U.S. and in Singapore in addition to well-documented individual company cases in India and Japan. Not only have individual entities been called into question, some of the weak practices across certain countries need to be scrutinized. In India, for example, most companies still don’t supply balance sheets and cash-flow statements on a quarterly basis. This provides insight into a structural impediment in Asia that needs to be addressed in the near term. That is, there exists a dearth of qualified and experienced accountants manning audit firms across much of the lesser developed parts of the continent.

Why Bother?

So with all of these governance-related concerns and pitfalls running through our heads, why are we constructive on Asian companies and economies as long-term investors? The answer to that lies primarily in the progress that we are seeing. Problems still exist with some legislators, regulators and company management teams, but “good” companies that care about minority shareholders also exist in number. There are a plethora of examples in which we do see management teams with independent boards, impressive disclosure, aligned incentivization structures and a strong track record in allocating capital appropriately. We have even begun to see some companies voluntarily separate the CEO function from the chairman function, which is particularly startling in a country such as Japan. Further, in some parts of the region, namely Australia, Singapore and Hong Kong, world class governance standards are already in place. Asia is almost unrecognizable today when one compares it to before the Asian Financial Crisis with better regulation, new institutions and a far more involved domestic and international shareholder base. The more erudite and forward-thinking regulators have spent the last decade aligning standards with global peers and rewriting company law in order to achieve this. This includes improvements in areas spanning from reporting in internationally recognized accounting standards (International Financial Reporting Standards began to be implemented in parts of Asia recently and this process will continue throughout the decade) to limiting terms for independent directors, to the introduction of electronic voting, or e-voting, in certain countries in order to ensure that all votes during annual general meetings are counted. As these additional rules come into place, we are also witnessing an improvement in enforcement as media becomes more free in the digital age and some regulatory bodies see a boost to their funding.

Corporate governance standards in Asia are far from the finished article, but that is also the case in more developed markets like the U.S. and Western Europe where poison pills, staggered boards and golden parachutes are all still prevalent. Pleasingly, the culture in the majority of Asia is also slowly changing for the better, although it is clear that the road to these improvements will be long and somewhat bumpy as changes of this variety are never linear. And we should also remember that with inefficiency comes the ability to add value in our analysis. As a firm, the Matthews investment team participates in over 2,000 meetings with regulators and management executives of Asian companies both in San Francisco and on the ground in Asia through our frequent travels. These provide us with valuable opportunities to “kick the tires” on existing and prospective holdings. They enable us to get a better understanding of attitudes toward minority shareholders and, arguably most importantly, gain perspective on how these are changing over time as we meet with the same companies and their peers time and time again. We have the opportunity to quiz senior management and ask questions such as: how are you incentivized? What is your capital allocation policy? Why did you enter into a certain transaction? We also spend a great deal of our time analyzing financial statements and comparing these against relevant peers across the globe in order to better understand companies and any obvious accounting fabrication.

After all, we want to make sure that our interests are best-aligned with the managers and companies that participate in some of the world’s best-placed economies.

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