

1. INTRODUCTION

The increased emphasis on environmental, social and governance (ESG) considerations in investment analysis has led to investors focusing on how companies manage their resources and risk exposures that relate to such factors.

Mismanagement of resources allocated to managing ESG factors has led to events which have negatively affected security prices in the past.

2. OWNERSHIP STRUCTURE AND THEIR EFFECTS ON CORPORATE GOVERNANCE

Ownership structures reflect unique political, social, economic, legal, and other forces in each country/region.

1. Dispersed vs. Concentrated Ownership

Ownership structures are classified as either dispersed, concentrated or a hybrid of the two.

Dispersed ownership	Concentrated ownership
Comprises of numerous shareholders none of which have corporate control	Individual shareholder or group (controlling shareholders) with the ability to exercise corporate control
Less common than concentrated ownership	More common than dispersed ownership

Refer to: Exhibit 1, Reading 17 for a jurisdiction classification of corporate ownership structure.

Degree of share ownership may not reflect actual corporate control due to the following reasons:

- Controlling shareholders include majority shareholders (own more than 50% of a corporation's shares) and minority shareholders (own less than 50% of a corporation's shares).
- Horizontal &/or vertical ownership arrangements:
 - **Horizontal ownership:** Companies with mutual business interests have cross-holding share arrangements with each other
 - **Vertical or pyramid ownership:** a company or group has a controlling interest in two or more holding companies, which in turn have controlling interests in other companies.
- **Dual-class shares:** one share class is granted superior or full voting rights while the other class has inferior or no voting rights.

2. Conflicts within Different Ownership Structures

The type of corporate ownership structure will affect corporate governance policies and practices due to potentially different conflicts existing between shareholders and managers and among shareholders themselves.

Types of ownership structures:

A. Dispersed ownership and dispersed voting power – Principal-agent problem

Weaker shareholders lack the power to exercise control over stronger managers. This gives rise to *principal-agent problem*: manager's interests are in conflict with those of shareholders to whom they report to.

This problem may be mitigated with the presence of controlling shareholders who can control the board of directors and have the incentive to monitor management.

B. Concentrated ownership and concentrated voting power- Principal-principal problem

Controlling (strong) shareholders maintain a position of power over both (weak) managers and minority shareholders.

Strength: Controlling owners may effectively monitor management and control their appointment because they have control over board of directors

Limitation: May give rise to the principal-principal problem – controlling shareholders may allocate company resources to their benefit at the expense of minority shareholders

C. Dispersed ownership and concentrated voting power - Principal-principal problem

Controlling shareholders with less than majority ownership can exercise control over other minority

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owners through mechanisms such as dual-class share structures and pyramid structures.

Strength: Shareholders can monitor management due to their outsized voting power.

D. Concentrated ownership and dispersed voting power:

Arises due to voting caps – legal restrictions on the voting rights of large share positions – to prevent foreign investors from acquiring controlling positions in strategically important local companies.

Practice: Example 1, Volume 3, Reading 17.



3. Types of Influential Shareholders

1) Banks

In Asia and Europe, banks have control over corporations with which they have a lending relationship in addition to equity interest. This dual relationship can give rise to conflicts of interest where banks pressurize such organizations to take out large loans to the detriment of other shareholders.

2) Families

A common ownership structure in Latin America is family ownership.

Interlocking directorates: Same family or same member of a corporate group controls several corporations.

Strength: Lower risks associated with principal-agent problems as families have concentrated ownership and management responsibility.

Limitations:

- Poor transparency
- Lack of management accountability
- Less consideration of minority shareholder rights
- Difficulty in acquiring quality talent for management positions.

3) State-Owned Enterprises (SOEs)

Listed SOEs are partially owned by the government and have publicly traded shares (mixed-ownership model). This model is subject to lower market scrutiny of management compared to corporate ownership models (implicit or explicit state guarantees to prevent corporate bankruptcy)

4) Institutional Investors

Representing a significant proportion of equity market ownership in many countries, these investors have the resources and expertise to make informed judgment in exercising their shareholder rights.

When ownership is widely dispersed, institutional investors may not qualify as a controlling shareholder but can promote good corporate governance by holding a company's board or management accountable.

5) Group Companies

Cross-holding share arrangements and long-term relationships between group companies with horizontal and vertical ownership structures may restrict transfer of share ownership as well as create an obstacle for outsiders to purchase a significant stake in the organization.

There is a greater risk that companies with group structures may engage in third-party transactions at the expense of minority shareholders.

6) Private Equity Firms

Involvement of private equity firms such as venture capital and leveraged buyout (LBO) firms in the management of corporations may bring important changes to a companies' corporate governance.

7) Foreign Investors

When foreign investors invest a significant amount in emerging markets, there can be a considerable impact on corporate governance practices for the local company:

- Investors from countries with greater levels of transparency and accountability may demand the same in the investee country
- Local companies cross-listing in countries with greater transparency and stringent investor protection laws may benefit local minority shareholders

8) Managers and Board of Directors

Insiders (managers and shareholders with ownership positions) will have economic interests which are more aligned with external shareholders, i.e. they will seek to maximize the long-term value of a company.

A drawback is that insiders with large ownership positions may seek to protect their own interests at the expense of shareholders.

4. **Effects of Ownership Structure on Corporate Governance**

1) **Director Independence**

Percentage of independent directors is higher in countries with dispersed ownership structures compared to concentrated ownership structures. Independent directors:

- serve a narrow role in concentrated ownership structure as compared to dispersed ownership structures.
- play an increasingly important role with a rise in corporate scandals;
- have no material relationship with the company with regard to employment, ownership or remuneration
- wholly comprise the remuneration and nomination committees in dispersed ownership jurisdictions where such committees are mandatory
 - Note: In concentrated ownership jurisdictions, these committees are not necessary and where they exist, jurisdictions recommend that they wholly or majorly comprise independent directors. Thus principal-agent conflicts are less of a concern in these jurisdictions.

All OECD countries have issued a requirement or recommendation for the level of independent directors serving on board – a requirement or recommendation for the minimum number or ratio of independent directors.

2) **Board Structures**

A company's board of directors can either be structured as one tier or two tier.

One-tier board: Consists of a single board of directors, composed of executive (internal) and non-executive (external) directors. This is the most common board structure.

Two-tier board: Consists of a supervisory board that oversees a management board.

Supervisory boards can act as a control function by reviewing the annual report, overseeing the work of external auditors, analyzing information provided by the management board, inspecting corporation's books and records, and setting or influencing management compensation.

3) **Special Voting Arrangements**

Several countries have special arrangements in place to ensure the engagement of minority shareholders in board nomination and election process.

4) **Corporate Governance Laws, Codes, and Listing Requirements**

Many jurisdictions have implemented a national "comply or explain" approach for companies – disclose adoption of recommended corporate governance practices or explain why they haven't done so.

Other jurisdictions which do not have national corporate governance codes rely on company law or regulation or stock exchange listing requirements to achieve similar objectives.

5) **Stewardship Codes**

Voluntary stewardship codes encourage investors to exercise their legal rights and increase their level of engagement in corporate governance.

The UK Stewardship Codes, for example, are not entirely voluntary.

3. **EVALUATING CORPORATE GOVERNANCE POLICIES AND PROCEDURES**

Benefits of effective corporate governance include:

- Higher profitability;
- Growth in return on equity;
- Better access to credit;
- Higher and sustainable dividends;
- Favorable long-term share performance and
- Lower cost of capital

Regular dialogue and engagement efforts with companies can help investors understand the benefits of corporate governance policies and procedures.

Shareholder activism refers to strategies used by shareholders to compel a company to act in a desired manner.

Evaluation of a company's board of directors is often a starting point for investors when evaluating the quality of corporate governance.

1. Board Policies and Practices

Each capital market is subject to different corporate governance issues, depending on its predominant ownership structure, history, legal environment, culture, and industry diversity.

1) Board of Directors Structure

When evaluating board structure, investors consider whether the organization and structure of the board provide sufficient oversight, representation and accountability to shareholders.

CEO duality – when CEO serves as chairperson of the board – may raise concerns that the monitoring and oversight of the board is compromised and may lead to an independent director being hired to protect investor interests.

2) Board Independence

The absence or presence of a minority of independent directors is a negative aspect of corporate governance and may create the potential for managers to act in a self-striving manner. The lack of independent directors may increase the investors' perception of the corporation's risk.

3) Board Committees

Investors assess whether there are sufficiently independent committees that focus on key governance concerns such as audit, compensation, and the selection of directors.

Presence of non-independent committee members or executive directors may lead investors to suspect potential conflicts of interest or biases in matters relating to compensation decisions (remuneration committee), management recruitment (nomination committee), and integrity of financial reporting (audit committee).

4) Board Skills and Experience

A board with concentrated skills and experience lack the expertise to govern as may a board with diverse skills and expertise unrelated to a company's core operations.

Companies facing large ESG risks or dealing with natural resources have board members with expertise in climate, environmental or social issues.

Board director's tenure

Many corporate governance codes consider a tenure exceeding 10 years as long.

The flip side of a long tenure is that the director has a comprehensive understanding of how the company operates as well as how effective management has been during the tenure.

The negative side of a long tenure is directors may be too closely aligned with management or directors may be resistant to changes in the corporation.

5) Board Composition

Board composition reflects number and diversity of directors include their:

- Professional,
- Cultural,
- Geographic background,
- Age,
- Gender, and
- Tenure.

Boards with too many members or those which lack diversity are less effective compared to boards that are smaller and more diverse.

6) Other Considerations in Board Evaluation

Board evaluation is necessary to maintain a company's competitive position and to meet the expectations of investors.

A board evaluation can be performed:

- by the board itself (self-evaluation);
- by an outsider on behalf of the board (external review);
- on an "as needed" basis; or
- using a periodic external review.

A board evaluation covers:

- how the board performs its duties;
- the board's leadership;
- the board's structure; and
- interaction between members and management (including culture)

**Practice: Example 2, Volume 3,
Reading 17.**



2. Executive Remuneration

Executive remuneration involves such issues as:

- transparency of compensation,
- performance criteria for incentive plans,
- the linkage of remuneration with the company strategy, and
- pay differential between CEO and average worker

Say-on-pay provision: Allows shareholders to vote and/or provide feedback on remuneration issues

Claw-back policy: Allows a company to recover previously paid remuneration if a specific event is uncovered.

Investors will need to use tools and/or rely on metrics which indicate that executive incentive plans provide appropriate incentives for management to drive the value of the corporation.

3. Shareholder Voting Rights

Straight voting structures: Shareholders are entitled to one vote for each share owned.

Dual-class share structures: company founders and/or management have more voting power than the class of shares available to the general public.

Dual class share structures can create conflicts of interest because they can benefit one group of shareholders over another – company founders and/or management over minority shareholders.

4. IDENTIFYING ESG-RELATED RISKS AND OPPORTUNITIES

ESG-related information is generally available in publicly available corporate filings, documents, and communications.

Challenges faced by analysts with respect to ESG-related information:

- Inconsistent reporting of information and related metrics by companies
- Voluntary disclosure of information varies between companies

1. Materiality and Investment Horizon

Materiality:

In an ESG-context, materiality cover ESG-related issues expected to affect a company's operations, its financial performance and the valuation of its securities.

Company definition of materiality may differ in usefulness: Defining positive ESG information as material is not useful as it may have little impact on a company's operations and financial performance. Alternatively, a company may not report negative ESG information which investors consider material.

Investment horizon:

ESG issues differ in their impact depending on the length of the time horizon and how perceive these issues – Investors with short-time horizons may find that longer-

term ESG issues have little impact on security's valuation in the near term.

2. Relevant ESG-Related Factors

Unlike corporate governance factors, ESG risks and opportunities differ among companies. Analyst must consider the ESG factors affecting a company's industry.

Approaches to identify a company's (or industry's) ESG factors include:

1. Proprietary methods:

Analysts use their own judgment and the firm's proprietary tools to identify ESG information by researching companies, news reports, and other relevant sources. Company disclosures can be found on their websites and/or in corporate citizenship or sustainability reports.

2. ESG data providers:

Analysts use information provided by ESG data providers which is reflected in individual ESG analyses, scores, and/or rankings, for each company in the vendor's universe.

Vendors may rank or score companies within their industries and provide detailed ESG-related industry analyses.

3. Not-for-profit industry organizations and initiatives:

Analysts consider not-for-profit initiatives which provide data and insights on ESG issues. These organizations include:

- International Integrated Reporting Council (IIRC)
- Global Reporting Initiative (GRI)
- Sustainable Accounting Standards Board (SASB)

IIRC provide a standardized framework of ESG disclosures in corporate reporting.

GRI works with various stakeholder groups to develop sustainability reporting standards. These standards include a list of business activity groups or industries with relevant sustainability topics corresponding to each group (Refer to Exhibit 3 for an illustration of these topics).

Equity vs. Fixed-Income Security Analysis

ESG integration: the implementation of qualitative and quantitative ESG factors in traditional security and industry analysis.

- ESG integration differs for equity and fixed-income (debt) analysis. In equity security analysis, ESG integration is used to identify potential opportunities and mitigate downside risk. In fixed-income analysis, ESG integration is used to mitigate downside risk.
- The process of identifying and evaluating different ESG-related factors is similar for equity and corporate credit analysis.
- ESG integration differs considerably for fixed income and equity securities valuation

- In equity securities valuation: analysts deal with ESG-related factors by:
 - Analyzing them in the context of forecasting financial ratios and metrics
 - Adjusting them in valuation model variables
 - Using sensitivity and/or scenario analysis
- In fixed-income valuation: ESG-related factors may be integrated using:
 - internal credit enhancements
 - forecasting financial ratios and
 - relative ranking of companies (or governments)
- For valuation of credit sources, analysts may rely on relative value, spread, duration, and sensitivity/scenario analysis

Example: ESG Integration in Equity Security Analysis

An analyst might lower the discount rate for a snack food company that is expected to gain a competitive advantage by transitioning into using a sustainable source of a key ingredient for its product.

Example: ESG Integration in Credit Analysis

An analyst may include the effect of lawsuits on the credit ratios, cash flow, or liquidity of a toy company.

5. EVALUATING ESG-RELATED RISKS AND OPPORTUNITIES

The process of incorporating ESG considerations in the investment process helps investors to take a broader perspective of industry and company analysis. The integration of ESG factors in financial statement analysis and valuation can help drive investment decisions.

1. ESG Integration

ESG integration process:

Step 1: Identify material and quantitative ESG factors that pertain to a company or its industry.

Step 2: Evaluate factors on a historical or forecast basis and relative to peers

Step 3: Make appropriate adjustments to a company's financial statements or valuation

ESG-related adjustments to the income statement & cash flow statement include:

- Projected revenues
- Operating/non-operating costs
- Operating margins
- Earnings

- Capital expenditures, and etc.

ESG-related adjustments to a company's balance sheet include:

- Analyst's estimate of impaired assets

Valuation adjustment for equities include adjusting a company's cost of capital using the discount rate or a multiple of price or terminal value

Valuation adjustments for bonds include adjusting the issuer's credit spread or CDS to reflect CDS considerations.

[Refer to: Exhibit 5, The ESG Integration Framework](#)

2. Examples of ESG Integration

Refer to Examples 3-5 for illustration of ESG integration for three companies in different industries.

[Practice: End of Chapter Questions + FinQuiz Questions & Item-sets](#)

