**TRADITIONAL APPROACH**
Middle East markets are characterised by low institutional holdings

# Ethical & governance momentum by institutional investors

*The challenges and opportunities within Middle East markets*

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**Over the past decade, global markets have witnessed a noticeable reorientation in the views and concepts of corporate purpose. More companies are now integrating the interests of stakeholders into their decisions and operations and are shifting away from a mere focus on maximising shareholder value.**

Firms are indeed more actively considering and implementing ways to better serve their customers, to be mindful of employees' interests, and to weigh the impact of their actions and activities on various ethical, social and environmental fronts.

## The institutional force

While several parties, including regulators, employees and customers, are pushing in this direction, active institutional investors constitute a strong driving force. Their influence has been intensified by their growing ownership in publicly listed companies, especially in developed markets. For instance, a 2019 study by the Organisation for Economic Co-operation and Development (OECD) reveals that the holdings of institutional investors and other strategic investors reached 73 per cent, out of the total market capitalisation of firms on the global scale.[1]

In parallel to this surge in holdings, institutional investors are playing a growing role in upgrading the ethical and governance practices of their investee firms. One form of influence is exercised through stewardship and active engagement. Institutional investors are carrying out internal monitoring and scrutiny measures, pressuring companies and raising their voices on issues such as board directorship, transparency and disclosures, and remunerations.

Another form of influence is driven by socially responsible investing, wherein institutional investors reward the conforming firms by buying their shares and penalise the irresponsible ones by selling their shares. As a matter of fact, more investments are now being allocated to firms and funds that meet some environmental, social, and governance (ESG) criteria. The Global Sustainable Investment Alliance reports that the global assets managed under sustainable investment reached $30.7trillion in 2018, a 34 per cent increase from 2016.[2] Their proportion of total assets under management reached 26 per cent in the US and 51 per cent in Canada.

A recent study by professors at the American University of Beirut also documents an increase in institutional investors' holdings in US firms listed on Ethisphere's list of the world's most ethical companies during the quarter that firms are added to the list.[3] Ethisphere assesses and rates firms based on a spectrum of ethical and governance criteria, as well as corporate citizenship, social responsibility, and reputation factors. Firms that meet the criteria are included on the list. Since the index is certified by an independent outside party, it is believed to be a more credible assertion of the companies' commitment to ethical behaviour than the disclosures made by the companies' managers.

According to the study, institutional investors not only increase their strategic investments in these companies but also do so on a long-term basis rather than temporarily. The trend is noted more strongly among institutional investors that are considered long term or strategic. For example, pension funds increased their holdings of ethically responsible companies by as much as 13 per cent in the quarter of the listing on Ethisphere.

Focussing on emerging markets, a survey reveals that long-term, strategic institutional investors are willing to pay a premium of up to 24.5 per cent for well-governed companies, particularly those in markets where the legal frameworks for investor protections are weak.[4]

Thus, a two-way relationship is evident: institutional investors are getting more instrumental in improving the ethical, social, and governance practices of their investee firms, but they are also attracted to companies that adopt socially responsible behaviour and shy away from those that are likely to suffer from poor governance or managerial opportunism.

This provides a strong indication of the long-term value of ethical and governance practices as well as the superior protection they offer investors against managerial malpractice or unethical behaviours. In fact, there is wide evidence that these institutional investments, known as 'smart money', do pay off financially, operationally, and morally. For instance, it is documented that the adoption of ethical behaviour and commitment to social performance are associated with improvements in innovation, competitive advantage, value chain, employee empowerment and motivation, among others. Good governance is also associated with stronger operating and financial performance, lower risk and higher stock returns.

> *Providing institutional investors with the incentives to invest and exercise active engagement in regional companies is critical*

## Institutional investors in the Middle East and ethical and governance practices

The picture on the global front is promising. But do the Middle East markets have the potential to benefit from such trends in institutional investments?

To answer this question, it is important to assess how institutional investors are positioned in these markets and what role they play or are ready to play. The differences in governance expectations driven by the ownership structures of companies in the region are noteworthy here.

For that purpose, we examine the sample of listed companies in the four Middle East markets that are classified as emerging by MSCI: Egypt, Qatar, Saudi Arabia, and the United Arab Emirates (UAE). Given their MSCI listing, these markets are expected to have a greater degree of accessibility, openness to foreign ownership, ease of capital flows, and efficiency of institutional frameworks relative to the other regional markets. As such, they are expected to represent the most attractive frameworks for institutional investors, whether local or foreign.

Yet, the ownership data as of December 2019 implies otherwise. These markets are still characterised by low institutional holdings relative to international markets. The percentage of total outstanding shares held by all institutional investors is 40 per cent for Qatar and Saudi Arabia and 58 per cent for the UAE. The highest percentage, 68 per cent, is noted for Egyptian companies and is relatively close to the global average (see Figure 1, right).

The distribution of holdings across the different categories of institutional investors is also very informative (see Figure 2, right).

**Strategic institutional investors**
An equally important observation is that more than 80 per cent of the institutional ownership is held by government agencies, individual shareholders who are mainly family members, or large corporations, including passive banks, insurance companies, family offices, and other firms. All of these are classified as strategic entities that are quite passive in their stock trading.

In Egypt, a total of 23 per cent of shares are held by corporations, another 22 per cent by strategic individual investors, and 16 per cent by government agencies. The same order of holdings by magnitude is noted for the UAE sample. In Qatar, government agencies make up the largest percentage of shareholders, holding an average of 16 per cent of the shares (see Figure 2, above).

These strategic investors exercise the regular role of attending general assemblies and electing directors, and they are often involved in management, either directly or through representatives. But they still follow, to a large extent, the traditional approach of control. Their commitment to governance as well as to other ethical, environmental, and social objectives are mostly driven by regulatory requirements. Their decisions are also greatly influenced and constrained by political considerations in the sense that they would be reluctant to push for a major ESG change unless it is supported by a governmental policy.

**Investment managers with active trading strategies** The second broad category of institutional investors consists of the more active investment managers. These include hedge funds, investment advisors, sovereign wealth funds, among others. They are characterised by the capacity to direct their funds to attractive and lucrative investments. Yet, they hold

**FIGURE 1: TOTAL INSTITUTIONAL HOLDINGS OUT OF SHARES OUTSTANDING**

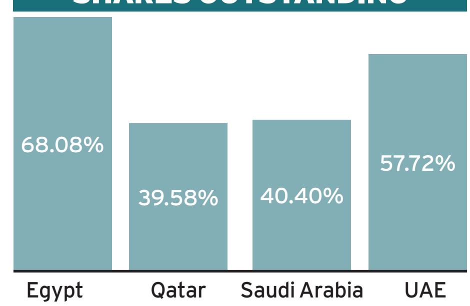
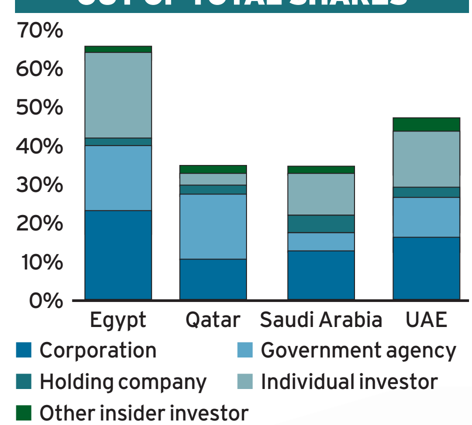



**FIGURE 2: HOLDINGS BY STRATEGIC ENTITIES OUT OF TOTAL SHARES**




a very small percentage of shares in the regional markets. Their holdings are limited to three per cent in Egypt and six per cent in Qatar as well as in Saudi Arabia. The highest percentage of 11 per cent is noted in the UAE, half of which is held by sovereign wealth funds (see Figure 3, over page).

Given their low ownership levels, these investors are still shying away from playing an active role in ESG issues. In contrast to the global markets, the engagement by these investors with the companies' board and management is almost non-existent and there is little-to-no dialogue on the various strategic or ESG matters. Their low level of holdings also limits any influence that they can exercise, whether through trading or voting, to improve the ESG behaviour of investee companies.

This situation may be, to some extent, explained by the lack of readiness or lack of incentives for the institutional investors to confront the controlling shareholders or their representatives on the board and management. But it could also be also attributed to some structural characteristics of the markets. For example, the low free float in most of the region's markets limits the number of investors who can trade the stock as well as their influence.

**Retail investors** The ownership structures, particularly the low percentage of shares held by institutional investors who follow active stock trading strategies, also point to the significant dominance of unsophisticated retail investors on trading activities. This category of investors tends to base investment decisions on speculation rather than on information. The engagement of retail investors in ethical and governance matters is certainly expected to be negligible.

**Foreign investors** A very important distinction to note is between regional and foreign investors. The latter category of investors is characterised by greater sophistication, higher expectations, and a relatively more active role in pushing their investee companies towards the adoption of ethical and governance responsibility. Yet, the ownership data suggests that their stewardship role is curtailed by their low exposure to the Middle East markets. Their holdings are limited to two per cent of total shares in Qatar, three per cent in the UAE, five per cent in Saudi Arabia, and six per cent in Egypt.

In addition to poor legal frameworks for investor protection and underdeveloped governance structures, foreign investors are discouraged by the general deficiencies in disclosures made by the regional companies as well as insufficient coverage by analysts. This intensifies their burden of tracking firms and gaining access to reliable information (See Figure 4, above).

Thus, the ownership structures observed in the region curtail an active investor engagement and impede a serious advancement into more ethically and socially responsible practices.

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## Incentives for a more constructive institutional role

The shift towards a corporate framework that treats ethical, social and governance responsibility as a way of operating the daily business, and not just as a regulatory requirement to be met on paper, is a long journey. Nonetheless, regional companies can benefit from the growing institutional

**FIG 3: HOLDINGS BY INVESTMENT MANAGERS OUT OF TOTAL SHARES**

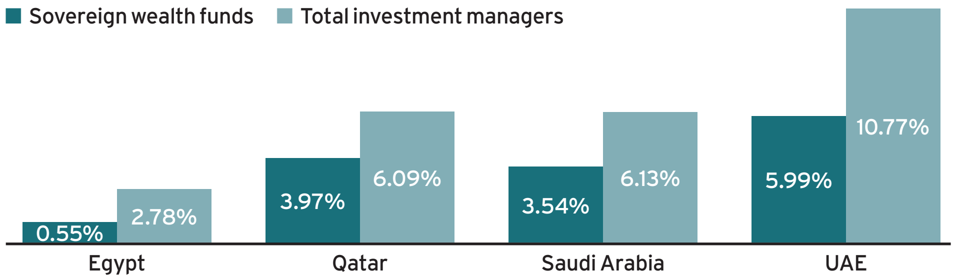
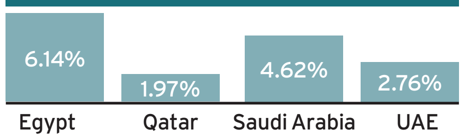



**FIG 4: HOLDINGS BY FOREIGN INVESTORS OUT OF TOTAL SHARES**




stewardship. Providing institutional investors with the incentives to invest and exercise active engagement in regional companies is critical – and there are multiple initiatives that can support progress in that direction.

The significant holdings by passive, buy-and-hold, strategic investors in Middle East companies can in fact be regarded as an opportunity. These entities have, by nature, a long-term view as well as strong incentives to maximise the financial and non-financial values of investee firms. This is supported by the US-based evidence that long-term investors increase their holdings the most in firms that are listed on the Ethisphere index.[5] As such, a cornerstone of the process starts with educating the strategic entities in the region on the benefits of adopting a fundamental and value-driven approach to ethics and governance, rather than a compliance approach. They also need to be given access to the tools and techniques to implement best practices. A parallel effort to widen integration of ESG at the policy level could also facilitate and expedite the progress.

Additionally, a greater degree of exposure to the active foreign institutional investors would certainly constitute a driving force towards stronger ESG responsibility. These investors would bring along some of the stewardship practices that are nearly non-existent in the region. Examples of such practices include open dialogue with investee firms, participation in general assemblies, the reporting of voting results, and the engagement in proxy fights. Abraaj, a UAE private equity firm that recently collapsed following allegations of funds mismanagement, is a case in point here. In fact, the foreign institutional investors were the first to raise concerns and question the use of funds by the firm's management and the first to request the appointment of an external auditor to investigate the issue.

But in order to attract foreign investments, several challenges need to be addressed. For example, it is imperative that companies adopt more transparent disclosures and provide reports in foreign languages. Also, the trend by institutional investors to put more weight on third-party verifications of the companies' commitment to ESG should be taken into consideration. As a matter of fact, 52 per cent of surveyed institutional investors stated that they base their research on third-party data such as governance scores or ratings.[6] As such, companies in the region should be incentivised to participate in awards such as those granted by *Ethical Boardroom* or to be put on such lists as the S&P/Hawkamah ESG Pan Arab Index.

Other important initiatives relate to the protection of minority shareholders' rights. At the regulatory level, improving the legal frameworks for investor protection is a central piece of the puzzle. At the corporate level, cumulative voting is an example of a structural instrument that would enhance the representation of minority shareholders on the board of directors, and thereby give them a stronger voice in decision-making. Furthermore, the establishment of investor relations functions would give these investors direct access to the company and would incentivise and institute a more active engagement.

Globally, institutional investors are acting as key enablers of ESG responsibility, whether through their internal influence on corporate decisions or through their investments that favour ethical and well-governed companies. While this role is still almost non-existent among Middle East companies, some regulatory, market and corporate initiatives may open the door for a promising long-term shift.

[1]https://www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.pdf [2]http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf [3]Ismail A., D. Jamali, S., A. Safieddine, G. Samara, "*Companies' Ethical Certification and their Attractiveness to Institutional Investors: An Intermediate Signaling Perspective,*" working paper [4]https://onlinelibrary.wiley.com/doi/full/10.1111/jacf.12253 [5]Ismail A., D. Jamali, S., A. Safieddine, G. Samara, "*Companies' Ethical Certification and their Attractiveness to Institutional Investors: An Intermediate Signaling Perspective,*" working paper [6]https://onlinelibrary.wiley.com/doi/full/10.1111/jacf.12253