Good Governance Turns Sustainability Words into Action

Ronald CHAN

Founder
&
CIO of Chartwell Capital

Kübra KOLDEMİR

Argüden Governance Academy
Sustainability Researcher
&
SustainFinance
Business Writer

Andrea WEBSTER

Chartwell Capital Limited
Managing Director

Shifting Mindsets: A Smarter Capital Allocation Policy

Business leaders face a collective challenge not only to address ESG (Environmental, Social and Governance) matters arising from the recent COP26 summit, but also to figure out what the most effective solution to address sustainability objectives for the 21st century is. Arguably, rather than fixing holes to fulfill ESG requirements, dealing with the elephant in the room is being able to introduce the right corporate governance culture from the top, or risk seeing implementations of form over substance.

It is not good enough for business leaders to push change onto their subordinates. They must lead by example to enable a culture integrated with ESG. To instill the best practice, many stock exchanges have asked listed companies to align their governance culture with purpose, values, and strategy. Leaders must therefore think holistically about what it means and takes for a company to do good and do well. To drive the culture conversation forward, aligning all stakeholders' interest with the right capital allocation policy is key.

The Enemies from Within

Sir Winston Churchill once quipped that "we shape our homes and then our homes shape us." Reshaping the culture of listed companies in Asia has been a challenge, especially for family-controlled companies. In Hong Kong and Singapore, they account for 60 percent and 70 percent, respectively, of total listed companies.

Asking family-controlled companies to change requires strong leaders who are ready, willing, and able. Unfortunately, not many are out there. There are good reasons for this. For example, it is usual for no one in the family except the patriarch or matriarch to make the ultimate decision. As members of the second and third generations join the family business, few are passionate about their job. They see it more as a family duty or responsibility.

Worst of all, many family members have become trust fund babies, so their priority is to collect as much dividend as possible. Even when a company is professionally managed, the mission for its management is to maximize dividend payout. For this reason, Asia tends to provide a relatively higher dividend yield, luring many income funds from around the world to invest in this region.

Income fund managers initially meant well and wanted to do good, but as the world has been in a low interest rate environment since the 2008 financial crisis, they inevitably push company management to do what it takes to squeeze out as much dividend as possible. This inadvertently creates a negative feedback loop, which is exacerbated further when dividend-hungry family members support such an endeavor. The result: company management cuts cost, leverages up the balance sheet for dividend recapitalization, and pays out all the company's free cash flow as dividends. Such acts breed short termism and form an unhealthy corporate culture that not only poisons the company but drags society backward.

By way of illustration, some Asian telecom companies are majority owned by a controlling shareholder and institutional investors. As management is directed to pay out 100 percent of free cash flow as dividend, these companies deploy little capital for investments in new technology, spend little effort on empowering its employees, and contribute no greater good for the community. Yet, they are endorsed as high quality and predictable cash cows.

On the flip side, doing the right thing is highly discouraged, if not severely penalized. For example, the controlling shareholder of a media company recently decided to halt dividend and re-deployed capital to transform the business. This led to harsh criticism, resulting in a staggering 50 percent drop in share price as investors rushed for the exit door.

Starting a Capital Allocation Conversation

Stakeholders must sit down and start a civilized conversation to understand each other's bottom line by asking the right questions. For example, would family members or investment funds be satisfied with a 90 percent free cash flow payout instead of 100 percent? Thereafter, would the company be able to deploy 5 percent of its free cash flow for innovation and 5 percent for employee benefits?

Many Asian families are now focused on succession planning. Perhaps by starting a capital allocation conversation, these families and their stakeholders can better gauge such transitions. While this may win approval from investors and attract new clients and employees, it may also help spur the next generation's interest in their family businesses. In the meantime, it will better reflect the business purpose, showcase its corporate values, and give a clearer direction of its execution strategy. To use the goal-setting acronym—SMART—as a framework, this conversation needs to be Specific, Measurable, Achievable, Relevant, and Time-bound.

To be specific, a company's board must specify the business purpose and its targets. To be measurable, the targets should have quantifiable indicators to keep track of progress. To be achievable, targets must be attainable and within the company's capabilities. To be relevant is to resonate with stakeholders. And finally, to be time-bound is to create a deadline so that there is a sense of urgency.

Creating a framework that helps stakeholders find common ground should generate more collaboration and help turn words into actions. While everyone concedes that they want to contribute to the greater good, articulating intentions clearly and being accountable to them will help align interests and ultimately support social and environmental objectives. Although no framework is perfect, the dialogue in Asia can start with family-controlled companies, one at a time.