ICGN Seoul Conference – *Corporate Capital Allocation Efficiency and Resilience*
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- **Michael Herskovich, Global Head of Stewardship, BNP Paribas Asset Management**
- **Youngjae Ryu, Founder & Chief Executive Officer, Sustinvest**
- **Nga Pham, Senior Research Fellow, Monash Centre for Financial Studies, Monash Business School**

- **Chaired by George Dallas, Policy Director, ICGN**

George Dallas:
As a Credit/Financial Analyst, capital allocation in governance and stewardship is incredibly important to me. Investors provide capital and have a clear understanding of the complex, multidimensional capital allocation processes. This is where corporate governance meets corporate finance. It's strategically important, it's not explored enough within the stewardship and corporate governance community. ICGN have undertaken more work on it recently. Capital allocation is a process to distribute financial resources for promotion of long-term resilience and sustainable value creation, providing fair, risk-adjusted returns to equity shareholders and creditors. Many investors represent the interests of both.

It's usually strategic. At the end of periods, companies decide levels of resources to invest in internal/external growth, through mergers and acquisition, controversially repurchasing shares, rewarding Executives through pay, and shareholder dividends. This differs geographically, which can cause problems. There are many global Corporate Governance Codes, most don't elaborate on capital allocation, but they should. ICGN's Global Governance and Stewardship Policies prominently highlight capital allocation's role. We've written viewpoints, one published post-COVID, relating to its effect on capital allocation decisions.

Yesterday, Kerrie Waring presented Korean policy priorities, under five headings, capital allocation being one. These are that a clear capital allocation policy is discussed and annually reviewed by boards. Boards should also review business portfolios annually, including unit review on investment capital and cost of capital, including cross-shareholdings. Boards of Directors should be financially literate and able to understand capital cost concepts and economic profitability. We need better disclosure of company calculations of equity and debt cost. Risk weighted adjusted capital reflects economic profitability. The rationale for shareholder returns, share buy-backs or dividends, must be articulated for equity shareholders and creditors.

Our diverse panel will explore the issues from a Western, European, Australasian, emerging markets and Korean perspective. Michael Herskovich is on ICGN's board and worked closely on our Shareholder Rights Committee previously, compiling a viewpoint statement on this. Nga Pham is South-East Asian, as well as currently

working in Australia. Youngjae Ryu provides advice to investors in South Korea. Michael, what are your approaches?

Michael Herskovich:
BNP Paribas is a global investor of over €500 billion under asset. ICGN has worked intensively to start discussion on capital allocation. ICGN's 2019 capital allocation viewpoint, was updated in 2020 with the COVID-19 paper. Capital allocation must be discussed at board level, with corporate level policies and strategies, investors accounting for capital allocation on investment decisions and stewardship engagement.

Most countries vote on dividend proposals. Investors don't often oppose to low or high dividend levels. We had a 5% opposition rate last year, 9% during COVID. It's small compared to overall opposition ratio, around 33%, but important for shareholders to define dividend expectations, because you have voting powers. We consider sustainable dividends most important, those with reasonable pay-out ratios, which don't undermine future investment capacities or effect stakeholder remuneration. The biggest dividend question is finding the right balance between company leaders, for investment and future growth, for capital providers, shareholder debt, creditors, and other stakeholders.

It then becomes tricky to define sustainable dividends and what is excessive or not enough. There are individual case decisions, depending on companies, sectors, financial outlook, but there can be investor flags. Low dividends, being pay-out ratios below 25%, an orange flag. Red flags when companies distribute unsustainable levels of dividend, especially when close to 100% pay-out ratio, or more, particularly in consecutive years. It's always an individual case basis and it's a difficult decision.

George Dallas:
So, sustainable dividends, achieving a balance. Capital allocation is interesting because it manifests differently worldwide. In US, with excess dividends and share buybacks depleting capital base, are companies risking financial structures? Paying excess dividends at expense of other applications is a real issue. In Korea and Japan the issue is inefficient capital management. It's not excessive dividends, but are they sufficient relative to other jurisdictions? We need a local environmental understanding, but there is a cultural difference on capital allocation and efficient balance sheets. Young, is this discussed between shareholders and creditors?

Youngjae Ryu:
Sustinvest was established in 2006, the first Korean ESG service provider, covering approximately 1,200 listed companies for ESG evaluation, research, and analysis. We research for wide-ranging institutional investors, pension funds, asset management, etc. The background in Korea is that the economy is heavily dependent on manufacture, semiconductors, automobile, chemical and heavy machinery, requiring constant re-investment and facility expansion to maintain competitiveness. Average direct stakes of controlling shareholders on Korean listed companies is 3.9%, for conglomerates it's below 2%. Generally, with listed company corporate governance, founders are controlling shareholders, who appoint board members and dominate Boards of Directors, who manage and control companies. Their top priority is closely associated with controlling, rather than minority, shareholder interests. It's difficult to find real Independent Directors, representing minority shareholder interests.

Korea's employee regulations should be labour friendly, restricting ability to fire regular employees. Labour costs are considered fixed, not variable. Given business environment uncertainty, Korean companies need more cash reserve than countries with flexible employment regulations and systems. Most Korean Asset Managers engage passively and conservatively with investee companies on corporate governance issues, including capital allocation. Most are affiliates of conglomerates or have significant interactions with them, causing difficulties for them to represent minority shareholders. Recently 260 companies established ESG Committees under Boards of Directors. Three years ago, few had such committees. These issues will become more important to our companies, so it's more productive to understand the issues when viewing the Korean context.

George Dallas:
Michael, is 3.9% a yellow flag? It reflects cultural differences. Korea's culture is more flexible, and requires liquidity, but can reduce overall investor capital returns. Young, ICGN's policy priorities for Korea are clearer capital allocation policy, boards reviewing business portfolios regularly, understanding economic profitability and capital cost, alongside shareholder buyback rationales. Is this realistic to you?

Youngjae Ryu:
I agree with the recommendations, especially disclosure of clear capital allocation policies, aligned with company strategy, to generate long-term corporate value. Korean companies must agree with ICGN's recommendations to review business portfolios and check whether ROIC can be achieved. Board members should be financially literate, understanding capital cost and expected shareholder returns. The dividend policy rationale should be clearly disclosed.

But we must understand the Korean context. The main reason for conservative views is the dividend-related tax system is higher than elsewhere, with no capital gains tax. Internal reservation is preferred over dividend with tax burden. Average controlling shareholder direct stakes are very low, so those boards have no incentive to increase pay-out ratios. There are few independent institutional investors. Most domestic and institutional investors, except a few independent investors, are passive and conservative. Most listed companies are unlikely to enhance pay-out ratios, but attempt to find ways to get cash, e.g., tunnelling, etc.

George Dallas:
It's logical for local investors to prefer taking profits in capital gains than dividends, although overseas investors may be less relaxed. Nga is a brilliant Co-Chair of ICGN's Financial Capital Committee, and was previously part of the World Bank Group, probably the first impact investor. From both an Australian and emerging markets perspective, your view, please.

Nga Pham:
As a Corporate Governance Consultant in emerging markets, and Researcher, my interest is shareholder activism, corporate governance, climate change and modern slavery. We've seen increasing shareholder activism in Japan and Korea. Foreign investor participation is very low, but shareholder proposals are increasing. Many proposals still focus on capital allocation efficiency, e.g., dividend payments, share buy-backs, mergers and acquisitions, sales and purchases of assets. Shareholder activism, especially in other markets, is not only hedge funds, but pension and superannuation funds, individual investors, where there's disagreement with management of capital.

Shareholder proposal success rates are low, in Japan and Korea around 14-15%. I interviewed active Japanese investors. They felt they had an impact, despite success rates being low. They bring awareness to companies and show that investors care about fund management and demand changes.

In Australia, companies increasingly consider E&S factors in capital allocation. At a high level, it's integrating and aligning it into strategy, consistent with ICGN's recommendations. It's sector dependent. Mining, energy, utilities companies, face decarbonisation pressure, so their structure is centred around their short and long-term decarbonisation commitment. Indigenous consultation is an important issue in Australia, alongside human rights, e.g., modern slavery risks in supply chains. These are transactionally factored in, with effects on cashflows, rates of return.

My work for IFC concentrates on unique factors to emerging markets. Special controlling shareholders are state shareholders and family founders, and there are advantages/disadvantages to both. There are large family-owned listed companies in China, Vietnam, etc., also significant state shareholder ownership. My book outlines how to deal with state shareholders as co-owners of listed emerging market companies. Their political, social and economic motivations are different from other investors, such as dividend and share buy-back preferences, which risks minority investors.

George Dallas:
The low turnout reflects the voting minority shareholders, who would probably support this, but must oppose controlling shareholders. Sometimes controlling and minority shareholders have different perspectives. Young, your views?

Youngjae Ryu:
Korean controlling shareholders have relatively low stakes. There is no incentive to increase dividend pay-out ratios, they choose tunnelling, etc. Minority shareholders want increased pay-out ratios.

George Dallas:
We'll see if 3.9% is a long-term fixture. Most people rightly consider capital allocation's effect on shareholders, as they receive dividends. Stewardship is a multi-asset class proposition, particularly creditors, whether bondholder, bank lender, etc. Creditors and shareholders want companies to be successful but have different wishes. Creditors don't benefit from extra financial risk, so seek to avoid this. Shareholders seek reasonable financial leverage and risk to generate capital returns. Capital allocation is an opportunity to demonstrate running balance sheets and divisions of risks between creditors and shareholders. Does BNP Paribas engage much in these discussions?

Michael Herskovich:
It's a difficult question. But as investors, globally we have activity as bondholders and equity holders. We always engaged companies on behalf of investor position on both assets. There are company and sector specific considerations, and balance is needed. The debtholder favourable view is a conservative approach, but is less positive for equity. Regarding strategy linkage and sustainability capital allocation, it's important for corporates to have clear policies, long-term horizons and clear approach. In growth companies, the momentum is not distributing dividend, but sometimes the opposite. In extreme cases, distressed companies need a balance with decisions positive for only bondholders. It creates more complexity with investors wearing both hats. Each case differs, but company engagement and clear

dialogue is vital. Globally, capital allocation is a CFO key responsibility, not necessarily board discussion, linking strategy, sustainability goal, long-term vision, which needs to change.

Christine Chow:
Youngjae, is there opportunity for international institutional investor engagement on tax and general policy? Dividend is case-by-case, but if there's a framework to improve capital allocation, what can international investors do?

Youngjae Ryu:
Dividend income tax is taxed separately from holdings of 20 million Korean won, but over this is combined with subject to comprehensive taxation. Capital gain is not currently taxed. Internal reserves are preferable to dividend with tax burden. International investors and organisations engage Korean regulators and legislators, not companies, to revise tax problems.

Michael Herskovich:
Public policy engagement is part of ICGN and BNP's mission. To progress markets and returns, there are tax questions relating to public policy, not just corporate engagement.

Lauren Compare:
How do investors consider appropriate capital allocation to decarbonisation effort? It's affecting companies globally. How do we redefine sustainable and robust appropriate capital allocation with focus on E&S investing and financing?

George Dallas:
So, best practice with regard to capital allocation. We discussed sustainability issues with this, but not decarbonisation.

Nga Pham:
When aligning capital allocation with decarbonisation strategies, capital allocation should be integrated into long-term business strategy and risk appetite. Australia's largest electricity company currently occupies 20% market share, representing 8% of total Scope 1 emissions. It's under pressure to decarbonise. They must redesign business strategy on energy mix. 95% of their electricity is generated from coal-fired power plants. This plays a key role economically. The company already commits to shorten closure dates of coal major projects. New retail products must be designed for consumers to join in decarbonisation and invest in flexible generation and storage of renewable energy. New pipeline projects must replace existing ones. There is enormous consumer and investor pressure.

Transactionally, capital budgeting is about forecasting cashflows and applying the correct discount rate and capital cost. Companies must have these processes in place, including inputs, risk factors, etc., considered and the process involved, whether there are different scenarios. Monash has a Real Carbon Index, observing global carbon price trends. Current carbon averages worldwide are $5-6 per tonne, varying with jurisdiction. China is over $8 and Europe can be over $100. The prices considered are very detailed transactionally and must be disclosed to markets and investors.

To summarise output of analysis and its effects on capital decision budgeting, it's important to look at high-level integration between capital allocation, strategy and

risk. Transactionally, companies need clear inputs, process and outputs of decision-making.

Michael Herskovich:
Oil and gas sectors have extraordinary results because of global gas prices. Investor discussions revolve around what is done with excessive important results, whether share buy-back, extraordinary dividend, or increasing capital expenditure towards renewable energy, and finding the correct balance. It's happening with Climate Action 100 and our own discussions, asking companies to spend towards transition.

Youngjae Ryu:
Capital allocation relative to decarbonisation is sector dependent. Automobile factories are fundamentally changing, transitioning from internal combustion engines to electric. This process involves huge short to medium-term investment, which results in deterioration of CapEx and OpEx increases. Automobile companies must bear the burden. POSCO emit approximately 70 million tonnes of CO_2 annually, about 10% of Korean CO_2, so they invest huge sums into decarbonisation.

Youngjae Ryu:
As a Japanese equity Portfolio Manager with Lazard, we spend considerable time engaging with Japanese companies on capital allocation and corporate governance. There's labour inflexibility and issues requiring higher cash balances, but Japanese corporate governance weakness has been a big problem, resulting in lack of attention to capital efficiency and cash hoarding. We engage with companies daily on this. The corporate control market is opening up, with more attention on capital allocation. METI Ministry's 2020 paper on "Business Portfolio and Reorganisation," was excellent.

Discussing with individual companies, financial literacy remains generally low. Some don't understand the question of capital allocation policy. Are there any suggestions for getting qualified people on boards who understand capital efficiency and equity's role in creating stakeholder and shareholder value?

George Dallas:
Cash hoarding is a question of perception. Korea and Japan have capital intensive building. The cultural difference needs exploration. Economic profitability is a way to solve this, which is weighted average capital cost, meaning debt and equity cost not disclosed by companies. Many listed companies produce nominal profits, but adjusted to weighted average capital cost, they are economic losses. We should consider economic profitability more and focus on discussing this with Japanese or Korean Company Directors. Boards of Directors must consider capital cost and understand it and whether their business is making profit. Globally, there isn't enough shareholder literacy.

Michael Herskovich:
Diversity of board expertise is important, especially independent board members, financially, with an ability to challenge strategic decisions, such as capital allocation. It's an historical governance issue, ensuring good oversight and board composition, especially in this market. Continental Europe has identical difficulties with labour cost uncertainty, but our companies don't save cash for this risk. Some historical things will take time to change and board composition and external oversight is key.

Youngjae Ryu:
To improve capital efficiency, corporate governance hasn't been properly discussed. Executives and ownership of businesses must be socially agreed. Western countries are more advanced. In Korea, we started back in 1998, during the Asian Financial Crisis. Some believe we must increase capital efficiency for shareholders, but we must consider those who believe in increasing efficiency of capital allocations for stakeholders. In the Korean economy, business owners may be family members, like Samsung, etc. There are many perceptions of capital allocations focusing on family companies in Korea, so it's difficult to compare and analyse perspectives for capital allocation and efficiency in Korea, compared to elsewhere. Korean businesses, historically, have existed since the Korean War. The reality is there is limited background history for capital allocation. It takes time to mature efficiency and capital allocation in Korean economy. Board members must suggest ideas to increase financial literacy on capital allocations, because we are behind on financial literacy. There is asymmetrical information for company reports. We need more independent and institutional investors to improve engagement and speak up. The Korean economy has historical structural challenges. We must consider whether following Western structures is favourable.

Nga Pham:
Financial literacy on boards is key for capital allocation efficiency. We must consider bringing the expertise and independence to boards. Electing the correct people is about Nomination Committees. If there isn't independence and you haven't got full confidence in them, it's pointless. I interviewed someone nominated for a large Japanese company, who went through the interview process presuming he wouldn't succeed because it's a checklist process and he knew who would be selected. Investors can change compositions on Nomination Committees.

We interviewed an Independent Director for a Vietnamese commercial bank about the nomination process and discovered he was the Chairman's friend. Being one of the two Independent Directors, he wasn't involved with the Risk Committee or Remuneration, Compensation or Nomination Committee, the key committees for investors to push for capable Independent Directors.

George Dallas:
It should involve Boards of Directors and developing fluency and understanding of concepts is critical. There are practical, legal and philosophical differences we'll continue to debate and discuss. It's an important engagement topic for future, with investors and Boards of Directors needing to improve.