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Avoiding unpleasant surprises

Considering country governance risk exposure for telecom companies



TeliaSonera. Telenor. MTN. All of these telecom companies have one thing in common: they have recently been levied huge fines relating to their involvement in corruption & bribery cases or the arbitrary application of the law by local authorities. Another factor linking these companies is that they all had operations in countries with relatively high governance risks. Matthias Müller, Senior Research Analyst at RobecoSAM and Jankees Ruizeweld, Credit Analyst for the telecom sector at Robeco, demonstrate how data collected through the RobecoSAM Country Sustainability Ranking can be used to systematically assess telecommunication services companies' exposure to governance risk and explain how this information is integrated into our investment process.

Over the last few years, several large telecommunications companies have been subject to large fines relating to corruption or arbitrary law enforcement. Companies conducting business in countries with higher corruption levels or where legal security is not fully assured have a greater exposure to risks with a potentially substantial financial impact, as is often the case in emerging countries. Emerging market countries have a lower penetration rate of telecommunication services, implying higher potential growth rates for telecom operators. This, in turn, attracts foreign telecommunications companies. Still, companies must carefully manage potential risks of doing business in emerging markets. Likewise, investors must also understand the telecommunication services companies' exposure to country-specific governance risk. More importantly, they should be aware how companies have managed governance risks in the past and how they are prepared to mitigate such risks going forward.

Measuring country governance risk

One useful tool for evaluating companies' exposure to country governance risk is the [RobecoSAM Country Sustainability Ranking](#)¹. Jointly developed by RobecoSAM and Robeco, the Country Sustainability Ranking is a comprehensive framework for analyzing countries' ESG performance. This framework evaluates 60 countries on a broad range of Environmental, Social and Governance factors that RobecoSAM considers to be key risk and return drivers relevant for investors. As part of the Governance component of our country analysis, we look at three of the six Worldwide Governance Indicators² (WGI) published by the World Bank:

- control of corruption
- rule of law
- regulatory quality

¹ For more information on the RobecoSAM Country Sustainability Ranking, please visit: <http://www.robecosam.com/en/sustainability-insights/about-sustainability/country-sustainability-ranking/index.jsp>

² For more information on the Worldwide Governance Indicators, please visit: <http://info.worldbank.org/governance/wgi/index.aspx#home>

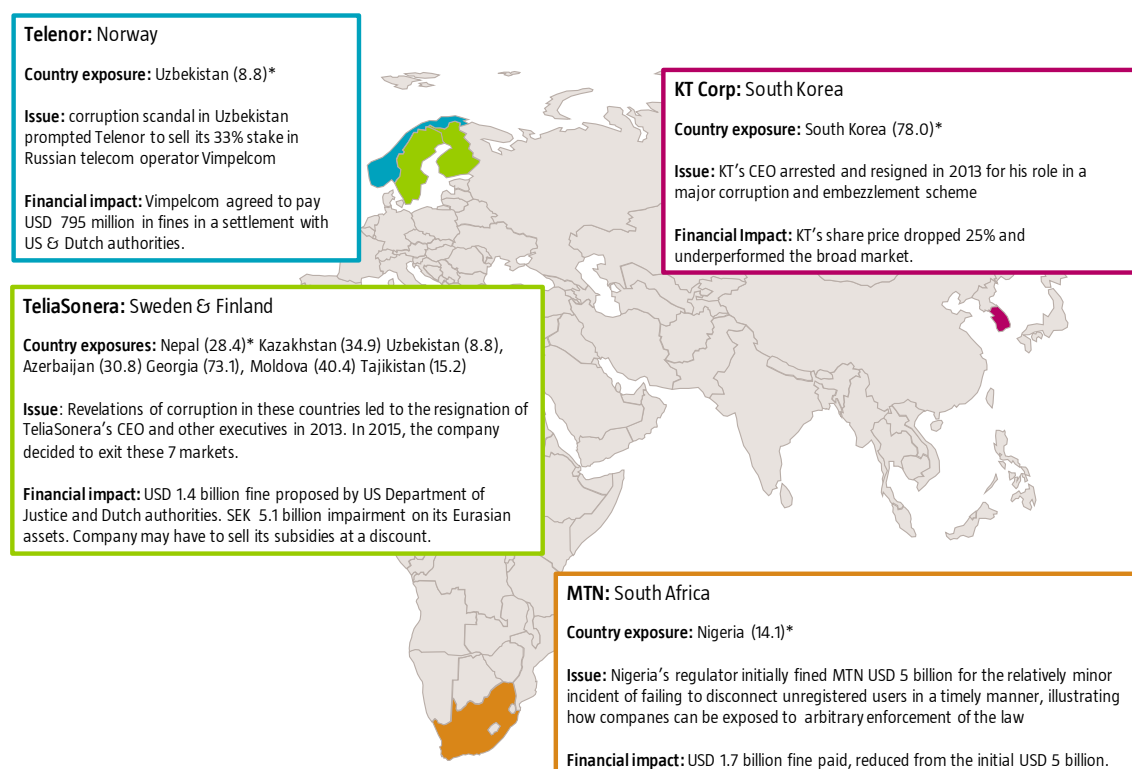
The WGI measures are expressed as a percentile rank among all countries ranging from 0, (weak governance), to 100 (strong governance). For each country, we calculate a combined average WGI score based on the three indicators listed above. It is also important to note that the WGI only cover general country governance criteria and do not take telecommunication sector-specific regulation into account.

The telecommunication sector is more exposed to country-specific regulation and corruption than many other sectors. Historically, state-owned monopolies provided telecommunication services, but over the last two decades most of these companies were privatized, allowing for more competition in the sector. However, the sector has remained highly regulated, mainly because states are expected to provide communication services to their citizens at a reasonable price, and because a strong communication network is critical to economic development. Telecommunication companies entering a country are usually aware of local regulations. However, because they need to invest heavily in long-term assets in these countries, the long time horizon exposes companies to the risk that regulations may change over time, creating an environment in which politicians may pressure these companies to benefit them. In addition, in order to set up a network, telecommunication services companies usually need to obtain a network license, which is granted by the government. Such licenses are often valuable and difficult to obtain, creating an incentive to bribe corrupt officials.

Telecommunication sector is highly exposed to country governance risks

As exemplified by the following cases, exposure to countries that rank low on governance can have financially material consequences if the risk is not managed appropriately:

Figure 1: Financial consequences of exposure to governance risks



* Numbers in parentheses represent the average of the 2014 WGI (World Governance Indicators) ranks for "Control of Corruption," "Rule of Law," and "Regulatory Quality"

Source: WGI, RobecoSAM

Mapping company exposure to country governance risks

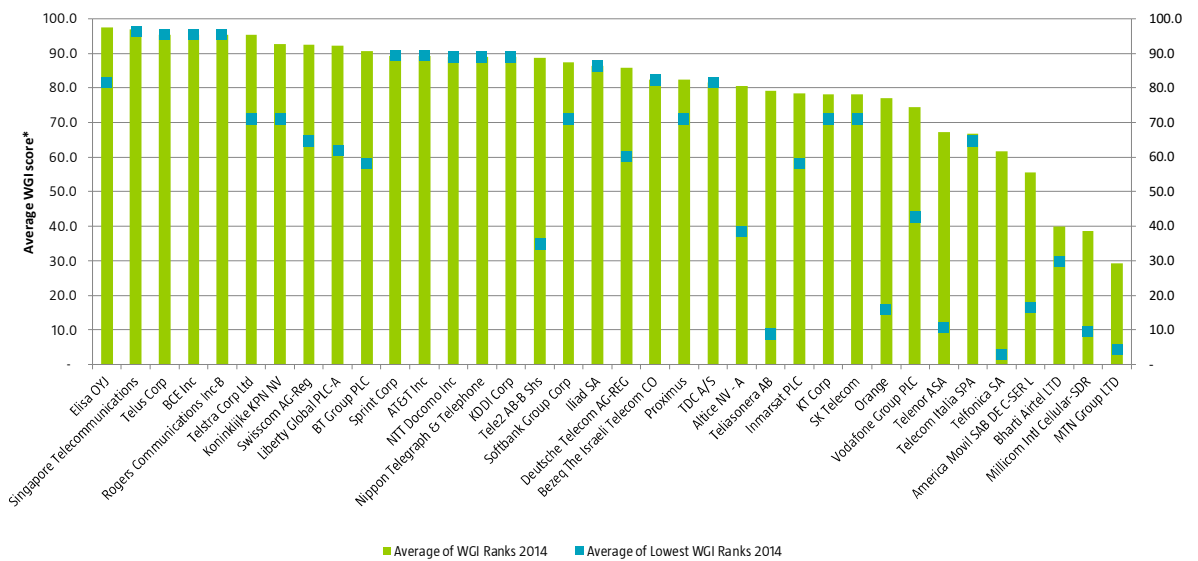
We began our research by determining the extent to which telecom operators are exposed to governance risk in the countries in which they have operations. Our sample includes the largest listed global telecommunication operators, companies in which RobecoSAM and Robeco are currently invested, as well as companies that represent potential future investment opportunities, for a total of 36 companies.

Box 1: Calculation of average country governance risk per company

1. First, we determine country governance risks using “control of corruption,” “rule of law” and “regulatory quality” measures to calculate an average WGI rank for each country.
2. Using country specific revenues reported by telecommunication services companies, we calculate the weighted average WGI country rank based on geographic revenue (see the green bar in figure 1) for each company. In cases where companies only report revenues for a geographic region rather than for specific countries, we calculate a GDP-weighted average WGI score for that region.
3. In addition to the revenue-weighted WGI score covering all geographic regions, we also look at the WGI score of the lowest ranked country in which a company operates (see turquoise squares in Figure 2). The lowest score is important because the financial impact can be substantial even though that country’s contribution to the company’s total revenue is minor.

As shown in Figure 2, the average governance risk for companies whose main operations are located in developed countries is fairly low (i.e., they are highly ranked). However, the turquoise squares indicate that some companies with a relatively good average governance exposure score also have some exposure to more risky countries.

Figure 2: Country governance risk exposure by company



*Average WGI Score - Corruption, Rule of Law & Regulatory Quality

Source: WGI, Bloomberg, RobecoSAM

TeliaSonera, for instance, boasts a decent average score thanks to its relatively large exposure to Nordic countries with strong governance. But the lowest ranked country (Uzbekistan (11.1)) indicates that the company has operations in countries with weak governance. The same holds true for **Tele2**, which has operations in the Baltics, Eastern Europe and Eurasia (lowest ranked country Kazakhstan (26.0)), **Orange** with exposure to Eastern Europe and Africa (lowest ranked country Cameroon (11.1)), **Telenor** (excluding Vimpelcom) with exposure to India (38.9), Pakistan (21.6), Eastern Europe and Asia (lowest ranked country is Myanmar (17.3)) and **Telefonica** with exposure to South America (lowest ranked country Venezuela (4.8)).

Companies on the right hand side of the chart in Figure 2 are either located in emerging markets or have a corporate strategy focusing on emerging countries. For these companies both the average WGI rank and the lowest ranked country are low.

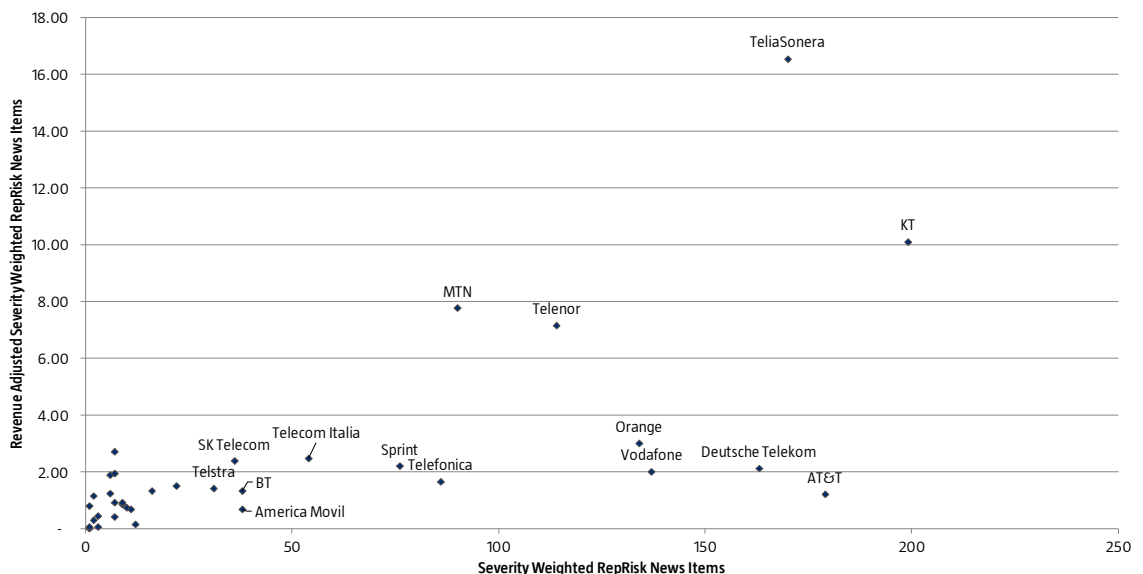
How well have companies managed past incidents?

In addition to evaluating each company's exposure to country governance risk, we are also interested in how well companies have managed such risks in the past. To do so, we use RepRisk³ to identify news items about incidents or issues that may have a negative impact on companies' reputation. For each company, we took the number of news items collected by RepRisk over the last five years, dating back to January 2011, and weighted them according to the severity of each incident using the three categories applied by RepRisk:

- 1) Less severe criticism and incidents (weight of 1)
- 2) Severe criticism and incidents (weight of 4) and
- 3) Very severe criticism and incidents (weight of 9)

Next, we mapped the companies based on "Severity Weighted RepRisk News Items" and "Revenue Adjusted Severity Weighted RepRisk cases," as shown in Figure 3. The revenue adjustment takes into account the size of the companies, which is important to consider because larger companies may be subject to greater media scrutiny. Not surprisingly, Figure 3 reveals that the four companies, **TeliaSonera**, **Telenor**, **MTN** and **KT Corp**, that were involved in recent country governance risk-related cases appear far above the rest of the companies on the chart (see Figure 3). In addition, many companies appear in the lower left hand corner, indicating that they experienced only a small number of issues.

Figure 3: Data security responses in RobecoSAM Corporate Sustainability Assessment

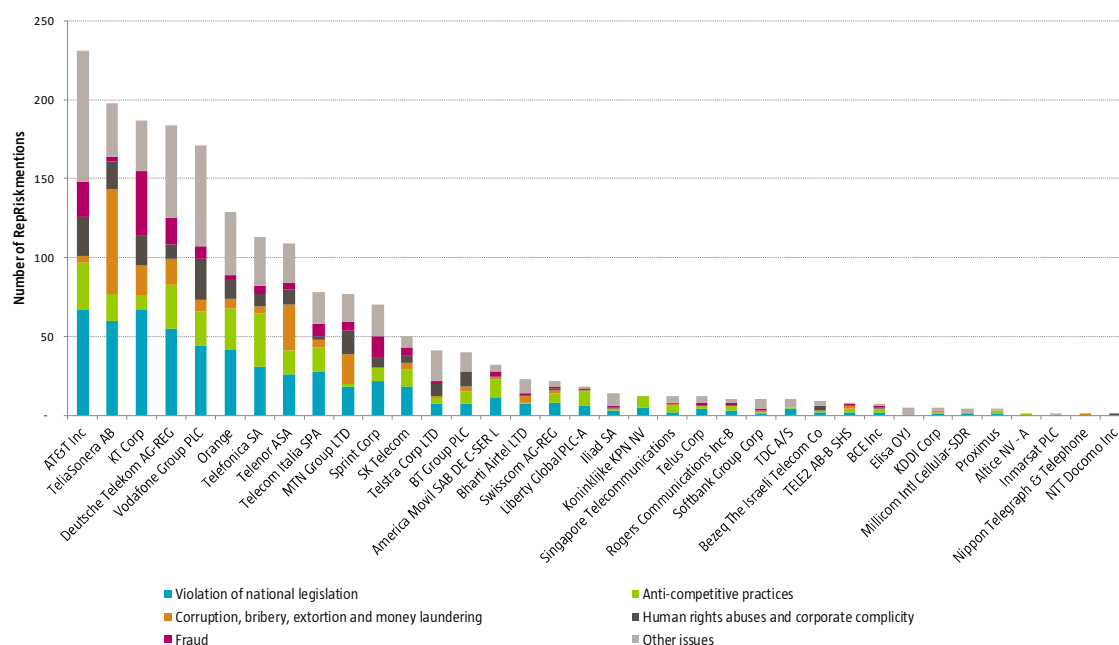


Source: RepRisk, RobecoSAM

In addition to the raw number of news items, we were also interested in the types of issues these news items reported. For each company in our sample of telecommunication services companies, Figure 4 shows the breakdown of the top five issues with the most RepRisk mentions. Among these five issues are "violation of national legislation" (number 1 issue) and "corruption, bribery, extortion and money laundering" (number 3 issue). These two issues are closely linked to country governance risks, supporting our view that RepRisk news items are a good proxy for identifying companies that have been involved in incidents related to country governance risks.

³ RepRisk ESG Business intelligence (www.reprisk.com) is a global research and business intelligence provider specialized in dynamic ESG risk analytics and metrics. To assess the risk, RepRisk's research focuses on capturing and analyzing data from media, stakeholders, and other third-party sources external to the company.

Figure 4: Most frequently reported issues in RepRisk news items



Source: RepRisk, RobecoSAM

Assessing potential financial implications of exposure to country risk requires additional research

As described earlier, the goal of our research was to identify:

- 1) companies' exposure to country governance risks and
- 2) evaluate how well companies have managed these risks

To bring these two dimensions together and to depict how companies perform on these two measures, we created the scorecard shown in Figure 5. The scorecard ranks the companies on the two dimensions: exposure to governance risks and performance, and sorts them by the exposure measure. The companies are then grouped into quartiles for each of the measures (with 1 being the top quartile and 4 the bottom quartile). The scorecard is a helpful tool for identifying companies that may have issues relating to country governance risks.

Throughout the research process, we also tried to develop a quantitative figure that measures management quality, which should be an indicator of how well the company is prepared to mitigate its exposure to governance risk going forward. But since this is heavily dependent on company-specific corporate governance and corporate culture, we concluded that an individual qualitative assessment is needed for each company.

Figure 5: High correlation between exposure to country governance risks and involvement in governance incidents

Name	Exposure		Past Performance
	Combined WGI ranks 2014 - Quartile	Combined WGI rank 2014 for the lowest-ranked country Quartile	Severity-weighted RepRisk news items 5Y - Quartile
Elisa Oyj	1	2	1
Singapore Telecommunications	1	1	2
Telus Corp	1	1	2
BCE Inc	1	1	2
Rogers Communications Inc-B	1	1	2
Telstra Corp Ltd	1	2	3
Koninklijke KPN NV	1	2	2
Swisscom AG-REG	1	3	3
Liberty Global PLC-A	1	3	2
BT Group PLC	2	3	3
Sprint Corp	2	1	3
AT&T Inc	2	1	4
NTT Docomo Inc	2	1	1
Nippon Telegraph & Telephone	2	1	1
KDDI Corp	2	1	1
TELE2 AB-B SHS	2	4	2
Softbank Group Corp	2	2	3
ILIAD SA	2	2	1
Deutsche Telekom AG-REG	3	3	4
Bezeq The Israeli Telecom Co	3	2	2
Proximus	3	2	1
TDC A/S	3	2	2
Altice NV – A	3	3	1
TeliaSonera AB	3	4	4
Inmarsat PLC	3	3	1
KT Corp	3	2	4
SK Telecom	3	3	3
Orange	4	4	4
Vodafone Group PLC	4	3	4
Telenor Asa	4	4	4
Telecom Italia SPA	4	3	3
Telefonica Sa	4	4	4
America Movil SAB DE C-SER L	4	4	3
Bharti Airtel Ltd	4	4	3
Millicom Intl Cellular-SDR	4	4	1
MTN Group Ltd	4	4	4

Source: RepRisk, RobecoSAM, WGI

As shown in Figure 5, we consider the companies with low exposure to country governance risks, the ones within the **top 2 quartiles** in the “combined WGI ranks” column and a top half ranking on the “past performance” measure to be safe.

For companies ranked among the top half of “combined WGI ranks” but with low 3rd or 4th quartile rankings for “combined WGI rank of lowest ranked country” or “past performance” more research is needed. For example, **AT&T** ranks well on exposure but is weak on performance. Its low exposure to country governance risks can be explained by the good country governance rank of the United States (89.4), where AT&T generates almost all of its revenues. Checking for the weak performance in RepRisk, we can see that the company has been involved in many incidents in which it was at odds with national law, but in these cases law enforcement was not arbitrary. Conversely, **Tele2** is a good example of a company with high exposure to governance risk but strong performance. The company has operations in countries with weak governance, the lowest ranked country is Kazakhstan (26.0), but the company has not experienced any major governance-related issues. Before considering and investment in Tele2, we would had to further investigate how the company ensures that its governance risk is adequately managed.

Most interesting, are the companies that are ranked in the bottom half with regard to exposure to country governance risk. In the **third quartile** for the “combined WGI rank” we find Deutsche Telekom, TeliaSonera and KT Corp all of which also rank poorly on performance. **Deutsche Telekom** was involved in bribery issues in its subsidiaries in Macedonia (59.1) and Greece (51.4). However, since both regions are only minor revenue contributors and because Deutsche Telekom has a decent corporate governance and compliance structure, we believe the financial impact is limited. Both **TeliaSonera** and **KT Corp** were already mentioned in the introduction of this report as companies that were recently involved in incidents with financially material consequences and therefore, more research is needed to evaluate whether the companies have indeed improved their processes and corporate culture to mitigate this risk in the future.

The companies ranked in the **bottom quartile** for country governance risk can be divided into two groups. Companies such as **Orange, Vodafone, Telefonica** and **Telecom Italia** generate the majority of their revenues from developed markets, while companies such as **Telenor, America Movil, Bharti Airtel, Millicom** and **MTN**, whose main business is in emerging markets. Companies in the first group have been involved in cases of arbitrary law enforcement and corruption, but they claim that they have appropriate processes in place to limit the risk in the future. This means that we need to check whether the companies really are doing what they claim they are doing, as there seems to be a discrepancy between processes & policies and performance. In any case, the higher risk should be reflected in financial models (for two examples, see Box 2). For companies in the second group, in-depth analysis is necessary and investment should only be considered if either there is enough conviction that the company can mitigate the risk going forward or if the margin of safety is large enough (see box 3).

Integrating company exposure to country governance risks into credit analysis

Box 2: Companies based in developed (low risk) countries with operations in high risk countries

Deutsche Telekom's below average score in country governance risk is mainly due to its exposure to several European countries. The two lowest ranked countries are Greece (51.4) and Romania (53.4), and in terms of performance, there were corruption cases in Macedonia (59.1) and Greece. For Robeco's credit analyst responsible for the telecommunication services sector, Jankees Ruizeveld, this raised a red flag, which was a signal to further investigate how well Deutsche Telekom is able to mitigate the risk going forward. The additional research showed that DT is proactive in improving the ESG standards of its subsidiaries and therefore, we expect that the country governance risk should decline over time. The limited risk is reflected in the fundamental credit assessment.

Vodafone is another company that Robeco's credit team is monitoring. Its high country governance risk is based on its exposure to India (38.9) and other countries in Africa, Middle East and Asia. Its performance rank in handling governance-related incidence was impacted by corruption cases in India and Ghana. Additional research on how Vodafone dealt with such issues in the past and how the company is prepared to mitigate the risk in the future revealed that the company is lagging its peers such as Deutsche Telekom. As a result, Vodafone's credit assessment was negatively impacted by its country risk.

Box 3: Companies based in high risk countries

Although Robeco's credit analyst concluded that credit spreads for companies whose main operations are in emerging markets generally do not compensate for the high country governance risk exposure, **Millicom** is one notable exception. The company is headquartered in Luxembourg and has its roots in Sweden, but its operations are focused on Central and South America, as well as Africa, which explains its high governance risk exposure. Even though Millicom is currently under investigation for a bribery case in Guatemala, our research revealed that good policies and processes as well as a business culture with high ethical standards helped the company to run the business in countries with relatively high governance risks without major incidents. Interestingly, the case in Guatemala was self-reported by Millicom's board, which is a sign that internal processes to detect unethical behavior seem to work. Based on this assessment, Robeco's credit analyst concluded that the credit spreads more than compensate for the governance risk exposure and issued a positive recommendation.

Conclusion

Overall, the risk mapping shows us that companies' exposure to riskier countries is highly correlated with company involvement in governance-related cases. This suggests that it is difficult, or even impossible, for companies to fully mitigate country governance risks. The difficulty of mitigating such risk is also the main reason why, for example, Telia decided to divest out of high risk countries in Eurasia. However, even if companies cannot fully avoid issues relating to country governance, we see differences in how they manage this risk. This is particularly relevant because a proactive approach and collaboration with regulators can limit the financial impact of involvement in governance-related incidents. Since entering markets with lower market penetration, and consequently, higher growth rates certainly offers benefits for telecommunication services, companies with high exposure to country governance risk should not be ruled out for investment outright, but this risk should be reflected in the investment case. Therefore we believe that our country governance risk research provides us with relevant information necessary to identify companies with a beneficial risk reward profile and helps us to avoid unpleasant surprises.



Matthias Müller, CFA
Senior Equity Analyst
RobecoSAM



Jankees Ruizeweld,
Credit Analyst, Telecom
Robeco

About RobecoSAM

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RobecoSAM

Josefstrasse 218

8005 Zurich

Switzerland

T +41 44 653 10 10 - F + 41 44 653 10 80

www.robecosam.com · info@robecosam.com