STATE OWNED ENTERPRISES: THE PRINCIPAL-AGENT PROBLEM

Matt Wagner — Associate Director, Research
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Why exclude state-owned enterprises (SOEs) from equity allocations?

This a natural first question investors tend to ask when they hear of WisdomTree's suite of ex-state-owned equity ETFs.

The rationale is simple: to mitigate exposure to the corporate governance issues that arise from state ownership, which can cause operational inefficiencies and weaker profitability.

WisdomTree was the first to package this type of solution into rules-based ETFs. But we were far from the first to identify the negative impact of the state-ownership structure on shareholders. This topic has been analyzed and written about in many forums—in intergovernmental organization (IGO) reports, the financial press and sell-side research.

Let's review some of the recent commentary.

The Washington Consensus

The International Monetary Fund (IMF) and the World Bank have long advocated for the economic development of emerging markets through a market-based approach, with a preference for the privatization of SOEs. The philosophy of these IGOs is often referred to as the Washington Consensus.

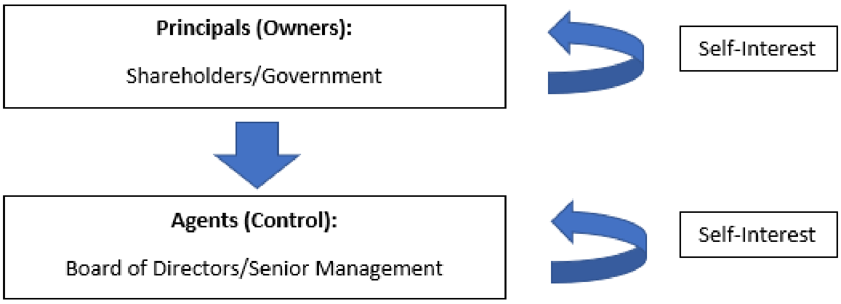
The IMF published a paper in June assessing SOEs in Central, Eastern and Southeastern Europe.[1] Their conclusion was that SOEs in the region generally "generate less revenue than their private counterparts, incur heavier costs of production not least on wages, and as a consequence are significantly less profitable." Political influences often result in SOEs employing too many people that are paid too much.

A broader study written by the World Bank in 2014 came to a similar conclusion. It argues SOE underperformance is in part driven by exogenous factors such as lower commodity prices or other sector-specific factors, but conclude there is "increasing recognition that poor corporate governance of SOEs is at the heart of the matter."[2]

Having multiple owners—shareholders and the government—significantly exacerbates what is referred to as the principal-agent problem. This refers to the challenges of aligning the self-interests of the owners of capital (i.e., shareholders) with those of the agents who are employed on behalf of the principals.

The varying self-interests in the multi-principal model of SOEs makes it difficult for the agent to act in the interests of both principals when they have potentially competing goals and objectives.

Principal-Agent Problem



Operation Car Wash

In November 2014, just a few weeks before WisdomTree launched the WisdomTree Emerging Markets ex-State-Owned Enterprises Fund (XSOE), the offices of the state-owned oil-giant Petrobras were raided by Brazilian police. The cause was the firm's involvement in a vast money-laundering scheme dubbed Operation Car Wash.

This example of corruption, coupled with lackluster profits and performance from other state-owned giants in countries like Russia and China, led *The Economist* to quip that perhaps the scariest words for investors to hear are "I'm from a state-owned firm and I want your capital."[3]

What did they argue was behind the poor performance? A "huge" misallocation of capital—again, because of poor corporate governance structures in which minority shareholder interests were superseded by political motive.

China's Red Flags

As a percent of total market-capitalization, no country has more SOEs than China. And under current Chinese Premier Xi Jinping, the government control over SOEs is only getting tighter, writes the Financial Times in a June article titled "Chinese governance raises red flags."[4] They write that many foreign investors are now hesitant to invest in Chinese SOEs because of these concerns.

As MSCI continues to incrementally add A-shares to its flagship emerging markets index, investors should keep this stat in mind: MSCI says SOEs make up 58% of the constituents of its MSCI China A International Index.

SOEs: Value Opportunity or Trap?

In a May 2018 note, UBS wrote that the return-on-equity (ROE) of emerging markets SOEs was about 11.05%, compared to 13% for non-SOEs. In addition to higher profitability, UBS also found significantly lower leverage and better performance in favor of non-SOEs, going back a decade.[5]

But the valuation opportunity in emerging markets was decidedly in the favor of SOEs, in part due to sector differences, but also because of the greater risks to shareholder interests.

This brings us back to a quote from *The Economist*: "Who are SOEs run for? The public good, as interpreted by politicians? Or shareholders?"

This question is an important one for investors to contemplate as they assess the various risks inherent in investing in emerging markets.

[1]"Reassessing the Role of State-Owned Enterprises in Central, Eastern, and Southeastern Europe," International Monetary Fund, 6/18/19, pp 15–23.

[2]"Corporate Governance of State-Owned Enterprises," World Bank, 2014, pp 11–12.

[3]"Government-Controlled Firms: State Capitalism in the Dock," *The Economist*, 11/20/14.

[4]"Chinese Governance Raises Red Flags," *Financial Times*, 6/1/19.

[5]"SOEs – 2018 Update: Still Lagging the Market," UBS Equity Strategy, 5/31/18, pp 9–14.

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DEFINITIONS

State-owned enterprise : Companies in which governments have a significant ownership stake and the potential to influence the firms' actions over time.

Intergovernmental organization : An organization composed primarily of sovereign states, or of other intergovernmental organizations. IGOs are established by treaty or other agreement that acts as a charter creating the group. Examples include the United Nations, the World Bank, or the European Union.

International Monetary Fund : international organization for global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth around the world.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

A-share : shares traded on the Shanghai and Shenzhen stock exchanges. This is contrast to Renminbi B shares which are owned by foreigners who cannot purchase A-shares due to Chinese government restrictions.

MSCI China A International Index : Captures large and mid-cap representation and includes the China A-share constituents of the MSCI China All Shares Index. It is based on the concept of the integrated MSCI China equity universe with China A-shares included.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.