# Emerging Markets - Governance and Sovereign Risk Assessment

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*This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.*

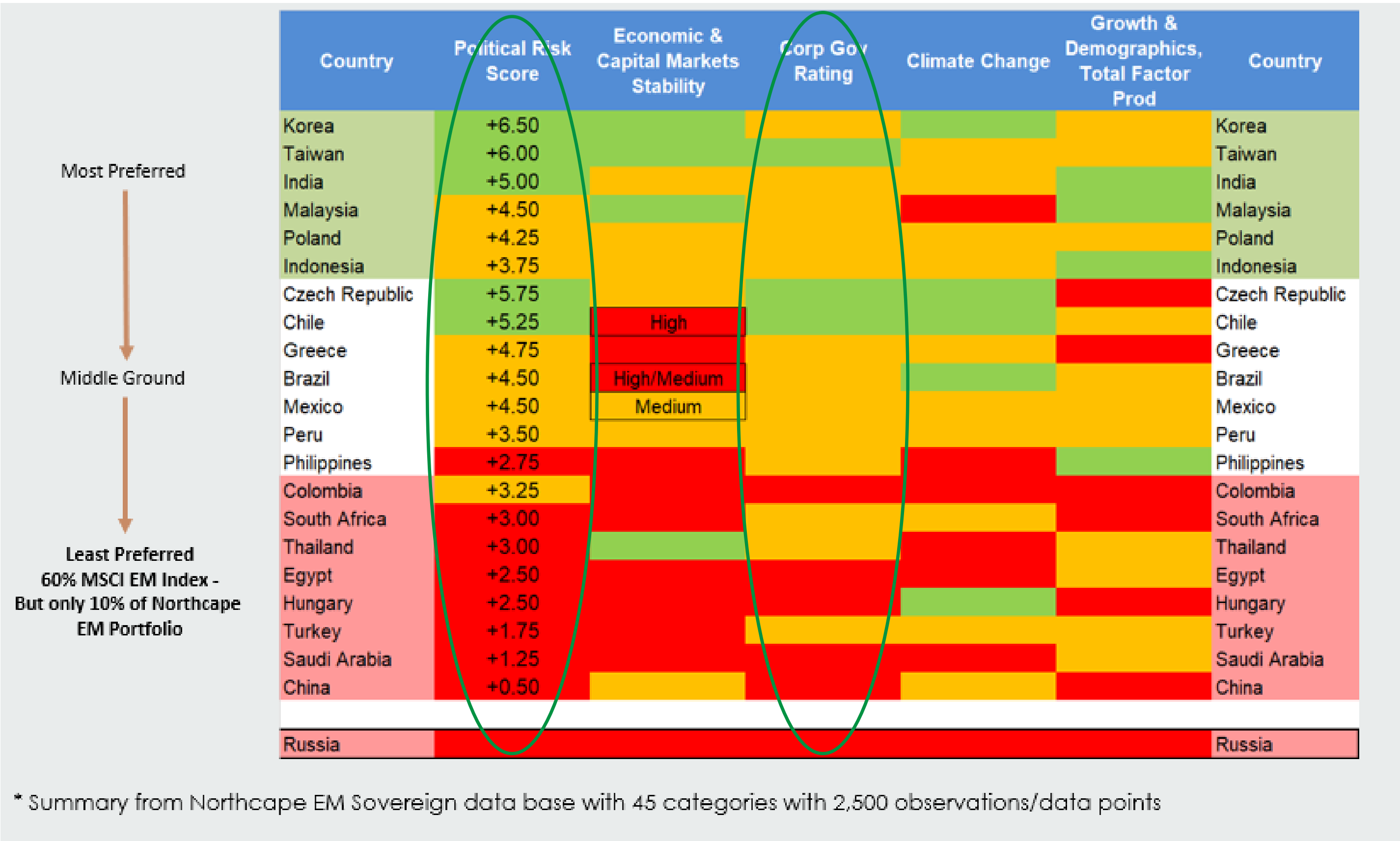
For the Northcape Emerging Markets (EM) Sovereign Risk assessment, which derives our Equity Cost of Capital for an EM country, the Governance factor is an important contributor to our overall risk score. The Governance factor has two parts:

1. "Political Risk score" – this is a top-down macro risk assessment based on key institutional pillars (both constitutional and legal), which support good governance and the integrity of the capital market, especially with respect to foreign investors.
2. "Corporate Governance Risk score" – this comes from the bottom-up company level and is a more detailed assessment of the above as it applies to companies within a given EM.

These two factors are closely inter-linked in our view. That is, when Political Risk score is above average, the right structures are in place for generally good corporate governance, which is seen and practiced at the company level.

Exhibit 1 below summarises our aggregate Sovereign Risk assessment at 4Q23. Under the Political Risk and Corporate Governance columns (both circled in the heat map) – governance is integrated into our overall EM Sovereign Risk model. For the heat maps, an area shaded green has above average score, amber is average, and red is below average.

## Exhibit 1: Northcape's EM Sovereign Risk Assessment Q4'23



Breaking this down further, we can look at seven components of the "Political Risk" score, as per Exhibit 2. A score of "7/7" is the highest (South Korea tops at 6.5 score) and 0/7 is the lowest (China is weakest with 0.5 score). Note these scores are updated at each Sovereign Risk review, with the most marked changes typically taking place after a change of government.

From our experience the genesis of good corporate governance is whether the country has a democracy, freedom of press and assembly (i.e. protest) and an independent judiciary – these are the first risk factors we address. If these factors are in place, then we have a jurisdiction that has the potential to uncover and then allow prosecution of corporate law against renegade activity, corruption. These vital factors set the guard rails for better corporate behaviour. Essentially if a company transgresses, there will be severe consequences, penalties.

From experience over the past 15 years, such guard rails significantly reduce capital loss risks from corruption embezzlement, and accounting fraud. Accordingly, we incorporate these factors into our overall country equity risk premium. We note that properly functioning democracies and judiciaries reduce corporate and government corruption risks, but also improve policy acumen by having the right checks and balances.

In summary, countries that have a good democracy and independent judiciary scores, also have overall the better Political and Governance Risk scores (i.e. corruption and capital loss risk are lower) – and are rewarded with a lower cost of capital. The exact opposite is also true of poor democracies/judiciaries, which ultimately yield poor governance outcomes (with much higher corruption and capital loss risks), and these countries are penalised with a higher cost of capital.

Note the shading on the LHS reflects our current Overall Sovereign Risk Category for the countries (Green = Most Preferred, lowest risk premium; White = Middle Ground, average risk premium; Red = Least Preferred, highest risk premium). On the RHS with respect to the overall Political Risk score we rank from High risk (red, scores < 3) to Medium risk (white, scores between 3-5) and Low risk (green, scores >5). This matches up with coding in the summary Sovereign Risk assessment on the prior page. Note, all the countries with poor political risks and Governance scores are in our Least Preferred category, such is the weighting we put on this factor in our overall sovereign risk assessment. This matrix (Exhibit 2) is updated at least twice year, when we undertake our overall Sovereign Risk review.

### Exhibit 2: Northcape EM Political & Governance Risk Scores

| 3Q23 | Democracy? | Judiciary | Stability | Corruption | Policy Acumen* | Fiscal Resp | CB independence | Total | Previous | Change | Overall Political Risk Assessment |
|---|---|---|---|---|---|---|---|---|---|---|---|
| China | 0 | 0 | 0.5 | 0 | 0 | 0 | 0 | 0.50 | 0.50 | - | High |
| Saudi Arabia | 0 | 0 | 0.75 | 0 | 0.25 | 0.25 | 0 | 1.25 | 1.25 | - | High |
| Turkey | 0.25 | 0.25 | 0.5 | 0.25 | 0.25 | 0.25 | 0 | 1.75 | 1.75 | - | High |
| Egypt | 0 | 0.5 | 0.75 | 0 | 0.25 | 0.5 | 0.5 | 2.50 | 2.50 | - | High |
| Hungary | 0 | 0.5 | 0.75 | 0.25 | 0.25 | 0.25 | 0.5 | 2.50 | 2.50 | - | High |
| South Africa | 0.5 | 0.75 | 0.25 | 0.25 | 0.25 | 0 | 1 | 3.00 | 3.00 | - | High |
| Colombia | 0.75 | 1 | 0.25 | 0.25 | 0.25 | 0.25 | 0.5 | 3.25 | 3.25 | - | High |
| Thailand | 0.25 | 0 | 0.25 | 0.5 | 0.5 | 0.5 | 1 | 3.00 | 3.00 | - | High |
| Philippines | 1 | 0.25 | 0.5 | 0 | 0.5 | 0.25 | 0.25 | 2.75 | 2.75 | - | Medium |
| Indonesia | 0.75 | 0.5 | 0.5 | 0.25 | 0.5 | 0.5 | 0.75 | 3.75 | 3.75 | - | Medium |
| Peru | 0.5 | 0.5 | 0.25 | 0.25 | 0.5 | 0.5 | 1 | 3.50 | 3.50 | - | Medium |
| Brazil | 1 | 0.75 | 0.5 | 0.25 | 0.5 | 0.5 | 1 | 4.50 | 4.50 | - | Medium |
| Malaysia | 0.75 | 0.75 | 0.75 | 0.5 | 0.5 | 0.5 | 0.75 | 4.50 | 4.50 | - | Medium |
| Poland | 0.75 | 0.75 | 0.75 | 0.5 | 0.75 | 0.5 | 0.25 | 4.25 | 4.25 | - | Medium |
| Mexico | 0.75 | 0.5 | 0.75 | 0.25 | 0.5 | 0.75 | 1 | 4.50 | 4.50 | - | Medium |
| Greece | 1 | 1 | 0.5 | 0.5 | 0.5 | 0.25 | 1 | 4.75 | 4.75 | - | Medium |
| Chile | 1 | 1 | 0.5 | 0.75 | 0.5 | 0.5 | 1 | 5.25 | 5.25 | - | Low |
| Czech Republic | 1 | 1 | 0.75 | 0.5 | 0.75 | 0.75 | 1 | 5.75 | 5.75 | - | Low |
| India | 0.75 | 0.75 | 1 | 0.5 | 0.75 | 0.5 | 0.75 | 5.00 | 5.00 | - | Low |
| Taiwan | 1 | 1 | 0.5 | 0.75 | 1 | 0.75 | 1 | 6.00 | 6.00 | - | Low |
| Korea | 1 | 0.75 | 1 | 1 | 1 | 0.75 | 1 | 6.50 | 6.50 | - | Low |

*Source: Northcape. *Assists capital markets stability*

3Q23 Change

Source: Northcape Capital. **Includes factors such as democratic rights, judiciary independence, political stability, corruption, policy acumen, fiscal responsibility and central bank independence

By way of some recent examples of changes related to governance in our EM Sovereign Risk assessment we highlight Thailand and Poland:

We downgraded Thailand in our 1Q23 review to “negative watch” consequent upon changes to its constitution to undermine the country’s democratic principles, by allowing the military PM (Prayut Chan-o-cha) to exceed his 8-year term limit and run for re-election. And in our 4Q23 sovereign risk review, we downgraded Thailand to Least Preferred from Most Preferred – one the most dramatic changes in our risk assessment in the history of our strategy.

The background to this recent change of view on Thailand is as follows:

- The Election in May 2023 saw The Move Forward Party win with 38% of vote in a record 76% turn out.

- Military linked senators did not like this outcome and voted against the Move Forward forming a coalition in July 2023.

- This led to formation of government led by Pheu Thai Party (linked to exiled former PM, Thaksin Shinawatra), which was backed by the military parties. In exchange for Pheu Thai party switching allegiance to the military, Thaksin Shinawatra returned from exile to Thailand, and had his prison sentence commuted on 1 September 2023.

- There has been essentially no change in government control, despite military-linked parties losing 50% of its vote from the previous election in 2019!

History tells us that when a democracy is severely compromised, as is the case in Thailand, it materially increases capital loss risks for investors by way of corruption, property rights theft. Hence the downgrade in our assessment for Thailand. Frankly we are not “waiting” to see if the situation deteriorates, because when it surfaces it will be too late to repatriate our client capital from this market.

In contrast, following our November 2023 trip and our 4Q23 sovereign risk review, we upgraded Poland to a Most Preferred EM sovereign, which was based on the following factors:

- The surprise election result on 15 October 2023 has given the opposition coalition, led by Donald Tusk, a mandate for change.

- Tusk previously served as Poland’s prime minister from 2007 to 2014, and as president of the European Council from 2014 to 2019.

- As such, the new Tusk government is expected to have a much better relationship with the EU, and reverse deterioration in key sovereign, institutional pillars (independence of judiciary, central bank, and media) under the prior government.

Frankly, Poland is the opposite to where Thailand is headed. Hence the upgrade to Poland and downgrade to Thailand. It also demonstrates that we are very open minded, if the situation improves, we will make an upgrade, and it can be expeditious.

In terms of longstanding views, China ranks very poorly on our Political Risk score, and this has contributed to its overall high cost of capital for many years. Also, when Russia was in EM it also had a very weak Political Risk score, and like China it was a key factor in ascribing a high-risk premium to this capital market.

With respect to a democracy and quality of judiciary, it could be in name only (i.e. Russia, has “so called/nominal” democratic elections and courts). To that end in assessing the democracy we want to understand that the elections are indeed free and fair, courts are free of political interference, there is a functioning independent media that can uncover governance breaches and laws that support freedom of assembly. We use a range of sources to look at this, including Freedom House – see summary of “Freedom Scores” in Exhibit 3. This information with other data and observations, feeds into our overall democracy and judiciary risk weighting factors.

At the company level we observe governance through our ESG assessment process. This is first researched under our initial Approval process where a company’s ESG is scored out of 10. A company must score at least 6/10 and a minimum score of 2/4 must be achieved for Governance for a company to pass our ESG test. A score below 6/10 and the company fails the ESG test and by definition cannot go on our EM Approval List.

This ESG research also acts as a cross check in finding out if there is any “leakage" in governance from the macro institutional settings into the listed company arena, which is where we invest. This work is then fed into our sovereign risk assessment.

This more detailed ESG framework takes account of governance factors at the listed company level, such as securities laws, stock exchange regulations, minority shareholder voting rights, takeover laws, reporting requirements, and insider transparency. Generally, the linkages are good, that is, strong macro institutional policy frameworks with the good checks and balances, usually means better governance at the company level in practice.

Should a company pass or fail our ESG test, we observe factors behind the score and use this as valuable insight into our Corporate Governance rating in our Sovereign Risk assessment. Again, we have found several examples of companies in China and Russia which have failed our ESG tests, and this has been extremely insightful in helping us form a view about overall corporate governance in these capital markets.

There are examples to the contrary where overall Political Risk scores are weak (i.e. not attractive), but company governance risk levels are low (attractive). South Africa comes to mind here, where overall corporate governance at some of the leading companies has held up well despite the deterioration of political and macro governance risks, reflecting the fact that corporate law is still prosecutable through an independent judiciary.

A part of the ESG framework, we pay particular attention to the quality of the judiciary and ability to prosecute corporate law.

We know from experience that if the governance score is high generally this sets the scene for the entity to have strong risk controls, practices in crucial environmental and social factors as well.

Northcape update their company ESG scores annually for every company on the Approval List, and this information is fed into their Sovereign Risk assessments.

In sum, this interaction incorporates Governance risks into a Sovereign Risk assessment from both the top-down and bottom-up.