THE DRIVE YOU DEMAND

SUSTAINABLE EM CORPORATE DEBT

A new asset class for responsible investors

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties, as defined by the relevant laws.

UNION BANCAIRE PRIVÉE

Asset Management | March 2018

Key points

- *Responsible investment has been growing steadily in recent years, reaching USD 22.9 trillion in 2016.*
- *Nonetheless, the offering of sustainable emerging market (EM) credit portfolios is limited, as investors remain sceptical that environmental, social and governance (ESG) considerations are compatible with emerging markets.*
- *ESG champions already exist amongst EM corporate issuers. EM sovereigns are also stepping up, especially in the fight against climate change.*
- *We believe that the number of ESG-mindful EM companies will continue to rise, as issuers respond to investors' new requirements for sounder business practices and stricter local environmental and social regulations.*
- *This is creating opportunities to construct sustainable EM corporate bond portfolios, which should offer superior and more sustainable risk-adjusted investment returns and provide new, attractive and diversified opportunities for responsible investors.*

Responsible investment has grown but often ignores EM credit strategies

According to the latest Global Sustainable Investment Review[1], **responsible investment** (RI) has been growing rapidly over the last few years. Assets that are professionally managed under responsible investment strategies reached USD 22.9 trillion in 2016, an increase of 72% since 2012. In relative terms, RI now represents 26% of all professionally managed assets globally. Penetration is even higher in Europe, where it reaches 53%.

Nonetheless, when it comes to managing emerging market (EM) fixed-income portfolios, sustainable investment approaches are still marginal, despite the fact that several academic studies have shown that the positive relationship between environmental, social and governance (ESG) criteria and financial performance tends to be stronger in fixed income than in equities and in emerging markets than in developed markets.[2]

A few strategies focus on EM sovereigns, primarily through exclusions of a number of countries. But best-in-class ESG approaches to EM corporate bond portfolios are rare. Indeed, when one mentions the benefits of integrating ESG criteria into constructing EM portfolios, the first reaction is often one of scepticism. Admittedly, the level of extra-financial disclosure by EM issuers is still below that of developed market (DM) countries. Moreover, ESG norms and requirements can be looser in EM countries, and news headlines often point to cases of poor practice, involving, for instance, child labour, severe pollution and corruption.

Despite this, EM corporate issuers with strong or average ESG credentials (rated AAA to BB by MSCI ESG Research LLC), already represent more than half of the JP Morgan CEMBI Broad Diversified index, while companies with poor ESG credentials – so-called "ESG Laggards" (i.e. companies with a B or CCC ESG rating) – represent about 30% of the index.

JP Morgan CEMBI Diversified Index – ESG Rating Distribution

Source: @2018 MSCI ESG Research LLC[3], JP Morgan, UBP – March 2018

EM ESG champions do exist

There is an increasing number of EM issuers which distinguish themselves by their **ESG credentials** or by their positive social or environmental impact, in line with the UN's 17 Sustainable Development Goals (SDG).

Among them, **Arcelik Anomim Sirketi** is a high-yield Turkish company which enjoys an **AAA ESG rating from MSCI ESG Research LLC**. Arcelik produces and distributes consumer durable goods and electronics, and operates across seven countries, including Russia, Thailand and South Africa. It owns recycling facilities, conducts regular internal & external audits, and participates in the **Global Reporting Initiative's (GRI's) Supplier Business Transparency Programme**.

[1] *Global Sustainable Investment Review 2016*, the Global Sustainable Investment Alliance

[2] *ESG and financial performance: aggregated evidence from more than 2000 empirical studies*, Friede, Busch & Bassen, December 2015

[3] @2018 MSCI ESG Research LLC. Reproduced by permission

Also in Turkey, the CEO of **Turkcell Iletisim Hizmetleri A.S.** was recognised by the United Nations (UN) as one of ten **2017 SDG Pioneers**.

Kaan Terzioglu received recognition for creating the "Hello Hope" mobile app, which helps refugees access key health and education services.

Another example can be found in Mexico: **Infraestructura Energética Nova** (IEnova) is a company which develops, builds and operates energy infrastructure. It demonstrates strong sustainability policies, notably in terms of **social factors** – thanks to its **best practices in terms of health and safety standards** – as well as on **environmental factors** – thanks to the development of projects to **preserve biodiversity**, such as reforestation and the protection of wildlife. MSCI ESG Research LLC recognised these best practices by assigning it a **single-A ESG rating**.

EM sovereigns take a leading role in the fight against climate change

The trend is also true at sovereign level. Environmental considerations are by definition global, and emerging countries are aware of this. Among the 79[4] EM countries included in JP Morgan EM sovereign and corporate bond indices, **all are signatories to the Paris Agreement on Climate Change** and only twelve have not yet ratified it.

EM countries' recognition of the necessity and importance of environmental policies can also be illustrated by recent events, which all happened this month:

- 11 March: the **first International Solar Alliance** (ISA) summit, co-hosted by **India** and France, was held in New Delhi. The ISA was launched in 2015 at the initiative of Prime Minister Modi and now includes 121 nations.

In April 2017, India's renewables accounted for 57.5 gigawatts (GW) of its 329.4 GW overall installed electricity capacity. This is expected to triple over the coming years, as indicated by **Prime Minister Narendra Modi** in his opening statement at the ISA summit on 11 March 2018: "*India will produce 175 GW of electricity from renewable sources by 2022. Of this, 100 GW will come from solar energy.*"

- 13 March: creation of **a new Ministry of the Ecological Environment** in **China**, in charge of the country's ecological environment policies, monitoring and law enforcement.
- 18-23 March: the eighth **World Water Forum** was organised in **Brasilia** by the World Water Council (WWC), whose members include over 300 organisations from more than 50 countries. Out of the 99 private company members of the WWC's third college of Enterprises and Facilities, 72 are domiciled in an EM country.

While these government initiatives will not immediately shape their domestic companies' creditworthiness, it seems reasonable to expect that, over time, stricter environmental requirements will affect EM as much as DM corporate issuers, which will need to adapt to the new standards.

China's engagement to reduce pollution has already resulted in **stricter norms** over the last few years, such as the Air Pollution Prevention and Control Action Plan, implemented in 2017, as well as the launch of its national carbon market on 19 December 2017, thereby setting a price for carbon for many of its power-generating firms. Companies have to adapt or face the risks of high litigation costs and fines, or even closure. Not all of them will be able to do so, which is expected to lead to further concentration in industries like aluminium, steel, paper and textile. Over time, this will likely impact companies' operating performance, credit metrics, financing costs and even the returns on portfolios invested in the fixed-income or equity securities issued by these companies.

The Atacama Desert in Chile is among the sunniest places on Earth. Solar energy is expected to skyrocket over the coming years as part of the country's efforts to increase its share of renewable energy from 40% of total electricity production today to 60% in 2035 and 70% by 2050.[5]

[4] This excludes Taiwan which is not a member of the UN. The country has, however, also announced strict targets to reduce its carbon emissions.

[5] *Chile 2018 Review*, International Energy Agency. Energy 2050 policy adopted in 2015.

According to MSCI[6], countries in southern Asia and sub-Saharan Africa face the highest potential GDP losses in the event of a 2.5°C warming by the end of the century. Moreover, collective global efforts to address climate change may force some EM countries, especially those in the Middle East, North Africa and Eastern Europe, to shift their economies away from being fossil fuel dependent. Some countries have already taken measures to diversify their economies, such as Saudi Arabia and the United Arab Emirates, which unveiled their "2030 Vision". This will, no doubt, have an impact on corporate strategies in the countries affected.

ESG integration: a source of risk mitigation

ESG analysis is not only useful to single out "good" companies. It can also be a means of **identifying potential sources of risks**, which may result in sharp underperformance.

In the case of **Samarco** (a Brazilian mining company), the recognition of the poor history of both its parent companies in terms of pollution could have served as a signal of future risks, which eventually materialised when the Bento Rodrigues dam collapsed in November 2015. This disaster released about 60 million cubic meters of iron ore waste, killing 19 people, leaving hundreds homeless or without access to clean water, and damaging the ecosystem across some 600 kilometres. The company faced USD 5.6 billion in charges for damages and its bonds collapsed by close to 60% in a month before eventually defaulting.

Taking ESG practices into account in asset and risk management decisions may therefore prove even more useful when investing in EM than in DM, given the **variety of local EM regulations, which do not always provide investors with the same safeguards as in developed markets**.

ESG credentials can affect creditworthiness

Credit-rating agencies are increasingly recognising the importance of ESG factors in assessing an issuer's creditworthiness. **Both Moody's and S&P Global Ratings are signatories of the UN PRI** (Principles for Responsible Investment) **statement on "ESG in Credit Ratings".**

In a recent report[7], Standard and Poor's noted that, "*Environmental, social, and governance (ESG) risks and opportunities can affect the capacity and willingness of an entity to meet its financial commitments… [S&P's] management and governance assessment includes consideration of environmental and social risk management, as relevant. At the industry level, we also consider industry-specific key credit factors which may include the effectiveness of ESG risk management.*"

S&P has also indicated that in the two years to August 2017, environmental and climate (E&C) considerations affected 717 corporate ratings, and resulted in a direct rating impact (e.g. upgrade or downgrade) in 106 cases. This marked a significant increase compared with their previous study of October 2015 where E&C criteria had affected only 299 ratings and resulted in 56 rating actions.

Similarly, Moody's explains that, "…*for corporates [they] seek to assess how ESG issues influence drivers of credit quality, such as demand for products, reputation or costs of production.*"[8]

Given that consequences of environmental disasters tend to be greater in EM countries due to factors such as wider inequality, the higher share of the agriculture sector in their economies, looser health & safety norms and lower insurance coverage, the integration of E&C considerations will likely affect more EM issuers' ratings. For example, S&P notes that, "…*although climate change poses a negligible direct risk to sovereign ratings on advanced economies, on average, ratings on many emerging sovereigns (specifically those in the Caribbean or Southeast Asia) would likely come under significant additional pressure over time*."[7]

Which ESG criteria are the most relevant to EM credit performance?

The coverage of EM fixed-income issuers by ESG rating providers is fairly recent. Academic research is therefore still limited. However, given the now extensive research covering the effects of ESG factors on the performance of DM equity and fixed income, and on EM equity markets, it seems reasonable to infer that:

- For EM issuers, as for DM ones, high sustainability practices are probably positively correlated with a lower cost of capital;[9]
- ESG considerations should bring more **sustainable performance** over the longer term, in both EM equity and EM fixed-income markets;
- ESG analysis is particularly useful as a means of **mitigating tail risks**;

[6] *2018 ESG trends to watch*, MSCI ESG Research LLC, January 2018

[7] *How does S&P Global Ratings incorporate Environmental, Social and Governance Risks Into its Rating Analysis*, S&P Global Ratings 21 November 2017

[8] *Moody's ratings incorporate ESG considerations with material credit implications*, Moody's, 25 October 2017

[9] *Evaluating the relationship between ESG and corporate fixed income*, Clubb, Takahashi & Tiburzo, Breckinridge Capital Advisors and MIT Management Sloan School of Management, Spring 2016

- Overall ESG ratings, in isolation, may not be the best predictor of a corporate's spread levels. A **detailed understanding of its ESG practices**, taking into consideration the ESG credentials of the country(-ies) and sector(s) in which it operates, is probably needed;
- For EM corporates, **governance & environmental** (G&E) factors seem to have a greater impact on equity performance than social ones. Anecdotal evidence shows that G&E factors are also more likely to influence an issuer's cost of financing (hence the spread on its bonds).

Sustainable EM corporate debt is the new responsible investment opportunity

In reality, with globalisation, EM corporate issuers' business practices have already come closer to that of their peers in developed markets. For instance, the need to access international financing has led them to gradually adopt similar transparency and accounting disclosure requirements.

These sorts of trend exist for ESG practices (though with a lag). One reason for this is that many EM corporate issuers are in fact global players, hence they have to adopt changes in international business standards early on, just like DM companies.

As investors' demand for RI increases, more and more EM issuers are being incentivised to adopt sounder ESG policies and to disclose extra financial data more broadly.

We therefore believe that there are already enough EM companies mindful of ESG issues, or of generating a positive social or environmental impact, to construct viable and diversified portfolios of EM corporate issuers. Moreover, this ESG-compliant investable universe should continue to widen as more and more EM corporate issuers adopt higher ESG standards to meet investors' requirements, as well as to comply with stricter environmental or social regulations in their countries.

This in turn should lead to sounder EM business operations, a reduction in tail risks, and superior and more sustainable risk-adjusted investment returns for those EM credit portfolios which integrate ESG factors into their selection process.

As emerging market fundamentals continue to improve, we believe that this constitutes an attractive and diversifying opportunity for responsible investors.

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