**In Emerging Markets, Does It Pay to Worry About ESG Factors?**

As a value investor, we are very much in the affirmative camp.

**KEY INSIGHTS**

- Emerging markets (EM) have made great progress in relation to environmental, social, and governance (ESG) considerations in recent years, with many companies today displaying ESG standards in line with global best practices.

- Yet there remains a general perception among investors that EM continue to suffer from an “ESG shortfall.”

- This presents opportunities for active investors to find mispriced companies where strong or improving ESG standards are underappreciated, thereby offering long-term price improvement potential.

While environmental, social, and governance (ESG) investing has entered the mainstream in developed markets, these factors are still not as widely incorporated when investing in emerging markets (EM). However, while there are many EM companies that are still behind the curve in terms of ESG best practices, there are also many that are committed to improving or maintaining high ESG standards. And in answer to the question, “Does it pay to worry about ESG factors in EM?” we only need to look at the comparative long-term value creation between those companies that do versus those that do not (Fig. 1).

Ultimately, we make investment decisions based on financial considerations, however as part of our objective to make money for investors, we also consider ESG factors as part of our company analysis. We look to invest in businesses on the right side of change, and integration of ESG factors is an important part of our investment process.

There remains a general perception among investors of an “ESG shortfall” when it comes to EM. This broad-brush view, in turn, presents good opportunities for active investors to identify mispriced stocks, where strong or improving ESG standards are being underappreciated. Our firm belief is that strong ESG standards are a clear and important influence on long-term business sustainability.

**Simply Being Cheap Is Not Enough**

As a value investor, incorporating ESG factors is a fundamentally important part of our investment framework. We look for forgotten companies where the long-term value potential is either unrecognized or not fully understood.
Simply being cheap is not reason enough for us to invest in a company. We also need to see clear potential for fundamental change. This could be the result of external factors, such as a change in government or a recovery in the economic cycle, or it can also be driven internally through cost-cutting, new management, or restructuring of the business. Similarly, strong or improving ESG standards can also provide a positive impetus for stock price improvement. This is where the ESG theme fits closely with the value style of investing—both are about trying to achieve long-term change.

**ESG Standards Within EM Are Rapidly Improving**

Given the general perception of weaker ESG standards within the emerging world, and the size of the universe, there are good opportunities to find underappreciated value in those companies with strong or improving ESG ratings. We continue to find many EM companies that display best practice standards when it comes to ESG factors—standards that are equal, or even superior, to developed market counterparts. And in certain cases, some EM companies do have good ESG standards, but they score poorly simply due to a lack of proper disclosure. Even among those EM countries and industries where ESG considerations are less progressed, there are many companies that are clearly committed to change and that understand the importance of ESG considerations for the long-term sustainability of their businesses. Conversely, there are also companies that continue to ignore, or give little attention to, ESG considerations, particularly in the area of governance standards. Our experience tells us that these companies tend to be higher risk, as they will potentially experience higher costs, greater capex, and reduced profits over time, undermining any longer-term value creation for investors.

**Past performance is not a reliable indicator of future performance.**

Sources: MSCI (see Additional Disclosure); data analysis by T. Rowe Price. Total Return Indices (Net Dividends), rebased to 100 in USD.

---

1 Source: MSCI (see Additional Disclosure), as of August 31, 2019.
For a long time, the stock price of a Russian energy giant, Gazprom, effectively flatlined, stuck within a narrow range over an extended multi-year period, and little value created for investors.

Given Gazprom’s large weighting within the MSCI Emerging Markets Index, and the relative cheapness of its share price, we had monitored the stock for some time. However, despite the deep value seemingly on offer, it looked and behaved like a classic “value trap” company.

As recently as the start of 2019, Gazprom was among the very cheapest stocks in the EM investment universe, on a price-to-book ratio basis, yet we continued to avoid the company as we could not identify a thesis for fundamental change.

In incorporating ESG factors as part of our analysis, we focus on the materiality of each and the potential positive or negative impacts on a company’s long-term financial performance.

The company’s management were seemingly unable, or unwilling, to implement the kind of reforms needed to improve the business and so create value for investors.

However, the landscape shifted in the early months of 2019, with the announcement of a change in management at the company. A number of long-serving, senior personnel were relieved of their positions, replaced by younger, more progressive, executives. The new management team announced plans to allocate capital more effectively and generally improve the overall efficiency of the business. This change in management, and early signs of a commitment to reform, signaled the type of fundamental, potentially value-creating, change that we look for in forgotten or unloved businesses.

The company’s new management team appears willing to prioritize improved returns for shareholders. In mid-May, Gazprom announced that it will pay out a record dividend of around 8.5% to its shareholders in 2019—equating to roughly 30% of the company’s total net income. What’s more, market expectations are for the company to increase this payout ratio further, to around 50% in the coming years.

This shift in strategy, placing a greater focus on shareholder returns, had an almost immediate impact on Gazprom’s share price, which rose by more than 35% since the dividend hike was announced in May 2019. This change in policy—should it be fully implemented—is encouraging and came at a time when the company had largely been forgotten by investors.

While the signs appear positive so far, it is still too early to determine whether this reflects a real and sustainable change in Gazprom’s business. As such, we continue to monitor its progress closely.

---

2 Source: Thompson Reuters, © 2019 Refinitiv. All rights reserved. As of September 30, 2019. Data analysis by T. Rowe Price. For the period May 13, 2019 to September 30, 2019. The company announced it would pay an increased dividend on May 14, 2019.
it deals with. These key relationships are crucial to the operational efficiency of a company and, ultimately, to the long-term sustainability of the business itself.

**ESG Factors and the Avoidance of “Value Traps”**

In incorporating ESG factors as part of our analysis, we focus on the materiality of each and the potential positive or negative impacts on a company’s long-term financial performance. For example, a company’s selling practices, its use of fossil fuels, its employee relations track record—these are just some of the material ESG-related factors that can, in turn, impact operational areas such as pricing power, market share, operating costs, employee retention, and productivity. As a value investor in EM, specifically, these considerations are particularly important as there are many companies that appear very cheap and to have solid long-term upside potential based on traditional financial factor analysis alone. However, by also including analysis of nonfinancial ESG factors, it soon becomes clear that many of these companies are cheap for good reason. With little attention given, or commitment made, to improving ESG standards, these “value traps” in EM are likely to remain cheap for a very long time.

While potential value traps are prevalent in EM, it is not always appropriate to assume the worst. Rather than poor underlying practices and procedures, it can often be a matter of disclosure, with management not really understanding why these factors are of such interest to investors or how they can be most effectively reported on. Indeed, our experience is that there is an increasing appetite for engagement among EM companies and a willingness to learn about many of these important issues—a keenness that is sometimes stronger than that exhibited by their developed market counterparts.

**Harnessing ESG Insights**

From an investment perspective, while we have long incorporated ESG factor analysis as part of our investment decision-making process, the quality and consistency of this analysis has been greatly enhanced in recent years with the addition of a dedicated, in-house responsible investment research team at T. Rowe Price. Particularly within EM, where ESG research can be inconsistent and much of the third-party data available are outdated or backward-looking, being able to draw upon timely ESG analysis where factor materiality is the primary focus adds an important and differentiated component to our investment decision-making.

---

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

**Additional Disclosure**

MSCI and its affiliates and third party sources and providers (collectively, “MSCI”) makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.
T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

Important Information
This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purposes, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) S.a.r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—The Strategy and/or any Securities associated with the Strategy being offered or sold hereinafter have not been registered with the Securities and Exchange Commission under the Securities Regulation Code, any future offer or sale of the Strategy and/or any Securities is subject to registration requirements under the Code, unless such offer or sale qualifies as an exempt transaction.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd. #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4T2 which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2019 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.