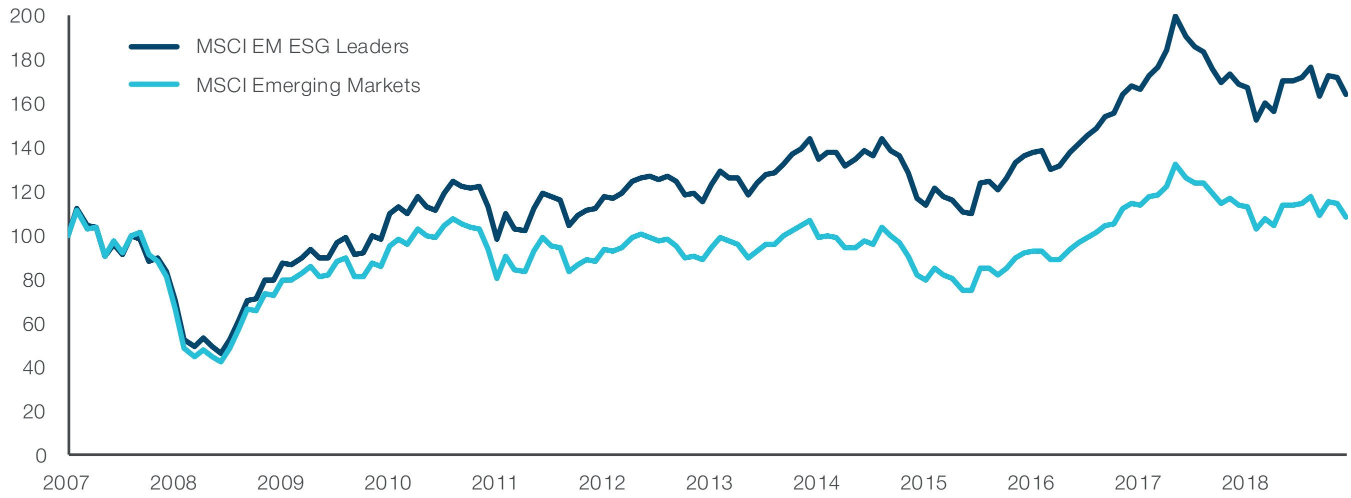
IN EMERGING MARKETS, DOES IT PAY TO WORRY ABOUT ESG FACTORS?

- Emerging markets (EMs) have made great progress in relation to ESG considerations in recent years, with many companies today displaying ESG standards in line with global best practice.
- Yet, there remains a general perception among investors that EMs continue to suffer from an “ESG shortfall”.
- This presents good opportunities for active investors to find mis-priced companies, where strong or improving ESG standards are under appreciated, thereby offering good potential for long-term share price improvement.

Ernest Yeung
Portfolio Manager, Emerging Markets Discovery Equity strategy

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 (EMs). 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 emerging markets? We only need to look at the comparative long-term value creation between those companies that do, versus those that do not. (Fig 1).

FIGURE 1: Having an ESG Lens Has Delivered a Long-term Performance Advantage in EM
Cumulative Index Performance – Net Returns
30 Sept 2007 – 30 Sept 2019



Past performance is not a reliable indicator of future performance.
Source: MSCI (see Additional Disclosure), data analysis by T. Rowe Price. Total Return Indices (Net Dividends), rebased to 100 in USD.

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 EMs. This broad-brush view, in turn, presents good opportunities for active investors to identify mis-priced 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. The reason behind this is that the region is full of value traps, and some stocks can remain cheap forever. This change 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 long term sustainability is key and why the ESG theme fits closely with the value style of investing – both are about trying to achieve long-term change.

ESG Standards Within EMs 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 are displaying 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

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Number of stocks listed on the MSCI Emerging Markets Index[1] — a broad opportunity set, but where ESG standards vary significantly.

[1] Source: MSCI (see Additional Disclosure), as at August 31, 2019.

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.

Standards of corporate governance are particularly important because they essentially determine how a company is managed. While governance is perhaps the area where EM standards, in aggregate, lag developed markets the most, it is also the area where considerable progress has been made. More and more EM companies are focusing on increasing long-term shareholder value, understanding that this is central to attracting capital, especially from foreign investors. Therefore, we always consider factors like how a company is allocating its capital, its management remuneration structure, the make-up and independence of its board and any acquisition/disposal plans. Ultimately, we need to feel comfortable that the management team is capable of running the business efficiently, profitably, and with the best long-term interest of shareholders in mind.

> *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.*

Investors also need to be aware of different ownership dynamics that exist in emerging markets. State ownership, for example, is more prevalent than in developed markets, and this can prove a hindrance to efficient management, as well as not aligning business objectives with the interests of minority shareholders. Family ownership of a listed company is also a more common occurrence in EM than it is in developed markets. Once again, these structures are often characterized by weak standards of governance. Company boards, for example, tend to be dominated by members of the controlling family, with no independent voice or input, meaning the interests of minority shareholders are generally poorly represented.

If we look at the social aspect of ESG, this includes all the key stakeholders of a business along its entire value chain – from suppliers to customers to staff, and even the regulatory bodies that 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.

GAZPROM

From Value Trap to Value Creator

For a long-time, majority state-owned Russian energy giant Gazprom was looked on unfavorably by investors in emerging markets as a weak performer. It would either be held for benchmark reasons, given Gazprom's large weight in the MSCI Emerging Markets Index, or as a tactical play on energy prices. Despite apparently offering "deep value," trading at a price-to-book ratio of just 0.23x[2] at the beginning of 2019, the stock historically had behaved like a classic "value trap." Despite being among the very cheapest stocks in the EM universe, it was not possible to identify a catalyst for fundamental change in the business.

Gazprom's management were seemingly unable, or unwilling, to implement the reforms needed to improve the business and create value for investors, including minority shareholders. However, this may be changing, following a change in Gazprom management in early 2019.

Long-serving senior managers were replaced by younger, more progressive executives with plans to allocate capital more efficiently and improve business performance. The change in corporate governance at Gazprom is the kind of ESG signal that, we, as an investor in EM, are on the lookout for.

Gazprom's new management team has continued along a positive path, prioritizing improved returns for shareholders. The company recently announced a record 2019 dividend of around 8.5%, roughly a 30% payout of Gazprom's net income.

[1] Source: Thomson Reuters, as at 4 January 2019..

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 emerging markets specifically, these considerations are particularly important as there are many companies that appear very cheap, and where traditional financial factor analysis alone might suggest solid long-term upside potential. However, by including analysis of non-financial ESG factors, as well, 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. We collaborate with our dedicated Responsible Investment (RI) research team when we initiate new positions as well as the outlook for existing positions. We aim to invest in companies on the “right side of change” from an ESG angle – for example when investing in utilities we aim to look for companies that value renewable energy investments.

While potential value traps are prevalent in emerging markets, 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. We engage with companies to unearth these inefficiencies rather than relying on third party research. We have our proprietary model that guides us in our investment decisions.

Indeed, our experience is that there is an increasing appetite for engagement among emerging market 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 (RI) research team at T. Rowe Price.

Particularly within EMs, where ESG research can be inconsistent and much of the third-party data available is 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..

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