Emerging Markets

Theme Report – 5th in a series

Eurosif

This paper provides an overview of global and corporate sustainability trends in Emerging Markets and describes Environmental, Social and Governance (ESG) risks and opportunities for investors seeking long-term returns in such regions.

EMERGING ECONOMIES – BIG POWERHOUSES WITH LARGE POTENTIAL

Historically the term "emerging market economies" appeared during the period of stock markets' expansion in the 1970's to describe the rapid progress in certain developing countries.[1] The definition remains, however, a vague and evolving one. The most important features that differentiate emerging economies from the least developed ones are the advanced levels of institutional and regulatory infrastructure, as well as the liberalisation and internationalisation of capital flows and goods. Among emerging market economies, the so-called BRIC countries (acronym for Brazil, Russia, India and China) have emerged as the largest and most powerful ones.

Emerging market economies are important economic powerhouses with large populations, large resource bases and large markets.[2] Over the last decade, the growth rates of emerging markets have been systematically greater than in developed countries and forecasts confirm a similar trend for the future.[3]

Despite these developments, emerging market economies remain volatile. The recent financial crisis has caused serious setbacks in their development: sinking exports, erosion of stock market prices and a deep recession are reversing the ecological and social progress achieved in previous years.

4 REGIONS	21 COUNTRIES
ASIA Share in Index : 55.8% #companies: 489	CHINA*, INDIA*, INDONESIA, KOREA, MALAYSIA, PHILIPPINES, TAIWAN, THAILAND
EASTERN EUROPE Share in Index : 10% #companies: 75	CZECH REPUBLIC, HUNGARY, POLAND, RUSSIA*, TURKEY
LATIN AMERICA Share in Index : 23.8% #companies: 125	BRAZIL*, CHILE, COLOMBIA, MEXICO, PERU
AFRICA & MIDDLE EAST Share in Index : 10.4% #companies: 78	EGYPT, MOROCCO, SOUTH AFRICA

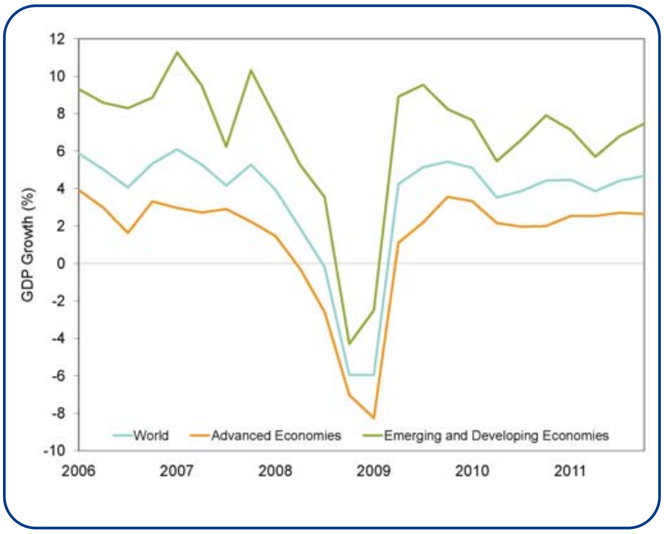
Source: MSCI, * BRIC countries

Economic growth is an important requirement for improving living conditions in developing countries. According to the United Nations, poverty rates dropped from 46% to 27% in developing regions in the first half of the decade, thanks to robust growth.[4] However, growth at any cost can generate problems, including, but not limited to, overexploitation of natural resources, environmental pollution and unequal distribution of income. Investment in emerging markets should therefore support sustainable economic growth.

MSCI Emerging Markets Index vs. MSCI World

Source: MSCI

Global GDP Growth
(Percent, quarter-over-quarter, annualised)



Source: International Monetary Fund

[1] *International Finance Corporation (IFC), "What role did IFC play in coining the term emerging markets?", March 2006.*
[2] *According to the FT Global 500, which ranks companies by their market value, more than 25% of companies are from emerging markets (as of 30 September 2010).*
[3] *International Monetary Fund (IMF), "World Economic Outlook", 7 July 2010.*
[4] *Ibid.*

ENVIRONMENTAL AND SOCIAL TRENDS IN EMERGING MARKET ECONOMIES

Resource exploitation and consumption patterns in emerging markets create environmental and social stress as resources become scarcer. This seems to be exacerbated by the current crisis that has halted recent sustainability progress in those countries.[5]

Rapid growth in emerging markets does not only carry social progress but also environmental challenges. Excessive resource exploitation, land disturbances and potential pollution jeopardize economic viability in many regions. The growing global middle class from (400 million in 2007 to an expected 1.2 billion by 2030), will inevitably consume more resources.[6] China and India will have an important role to play as they are expected to account for the largest increase in resource demand.

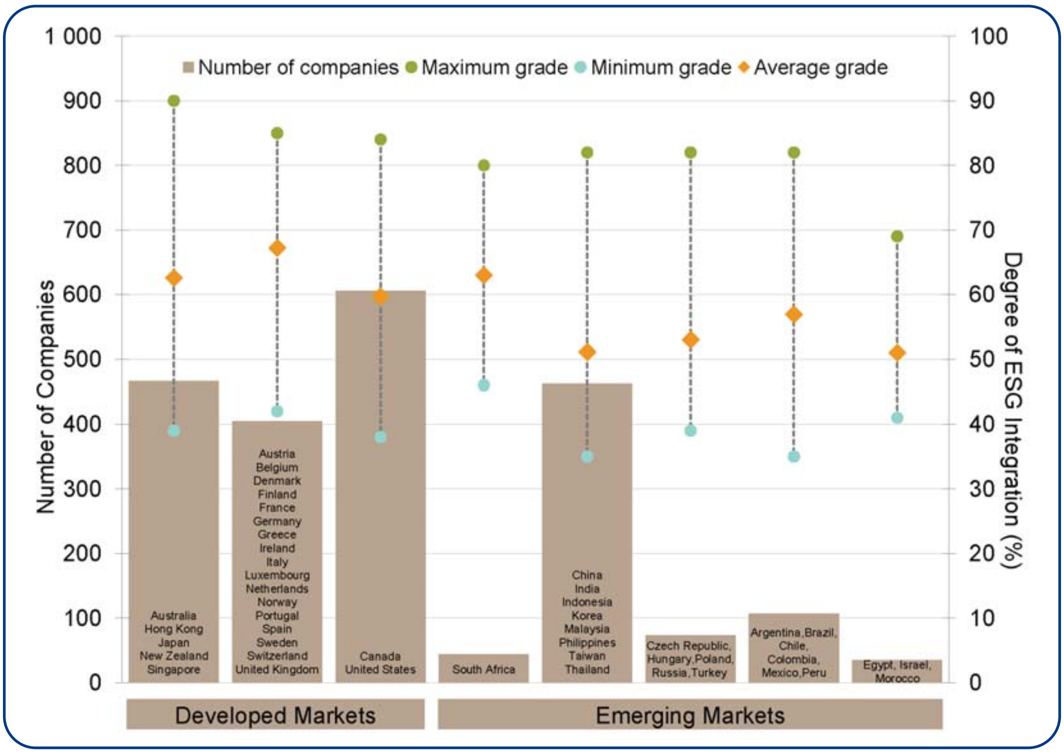
Understandably, emerging market economies want to benefit from their above average growth rates. Developed countries have been able to do so without any restriction in the past decades. However, there is a strong case for integrating environmental and social dimensions into public and private choices in the long term. Choosing today's growth over future sustainability will only make human and ecological challenges even more severe and difficult to address later. In this necessary shift toward a more sustainable future, emerging market economies will need the support of businesses as committed partners and solution providers. This transition serves as an opportunity for business given the lasting demand it represents in term of products and services. Major technological and infrastructural investments will be required in order to meet the needs of a growing population while simultaneously addressing sustainability challenges. Companies in emerging markets can aspire to leading market positions if they are able to anticipate these trends and provide effective solutions. In this context, investors have a prominent role to play in directing (or redirecting) capital flow towards companies that are able to innovate and grow whilst preserving the country's environmental and social capital.

Investors who are willing to take advantage of the economic growth and direct capital towards more sustainable businesses in emerging market regions need to understand how local companies manage sustainability challenges. A precondition for that to happen is clearly ESG transparency. In a context of nascent consensus over sustainability issues by key corporate stakeholders (stock exchanges, governments, societies, analysts, opinion makers, NGOs), companies have a leading role to play and can therefore act as accelerators. As identified by various reports, integration of ESG criteria is generally lower in emerging than in developed markets.[7] However, firms operating in emerging markets are progressively catching up with their developed market peers both in terms of ESG transparency and performance.

The following chart shows the degree of ESG integration in developed and emerging market regions. Companies in Europe are, on average, better positioned in ESG integration. Among emerging market regions, South African and Latin American companies tend to be the most advanced on ESG issues.

Sustainability in Emerging and Developed Market Companies by Region

How to read: There are 466 companies from Australia, Hong Kong, Japan, New Zealand and Singapore in the research sample. The average degree of ESG integration for a company in this country group reaches 62%. The maximum degree of integration reached by a company in this country group is 90%.



Source : Inrate research

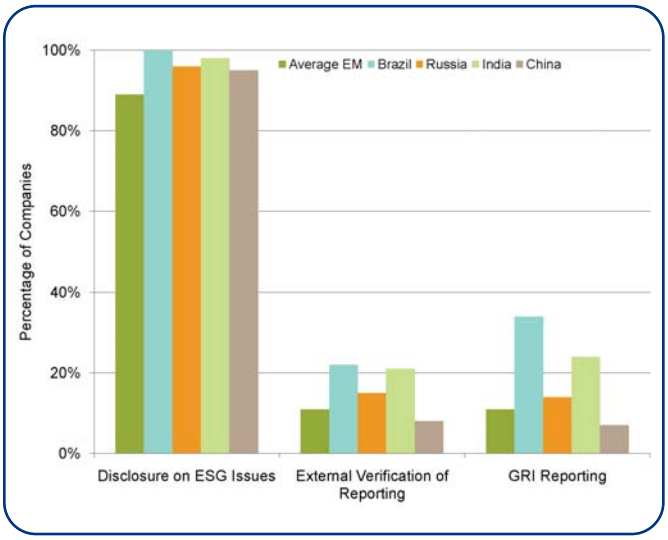
[5] *"Prior to the crisis, the depth of poverty had diminished in almost every region." United Nations, "The Millennium Development Goals Report 2010", 2010.*
[6] *World Bank, "Global Economic Prospects", 2007.*
[7] *Sustainable Investment Research Analyst Network (SIRAN), "Emerging Markets Investor Survey Report", 2009; IFC & Mercer, "Gaining Ground", 2009; SIRAN, "A Review of ESG Practices in Large Emerging Market Companies", 2009; United Nations Conference on Trade and Development (UNCTAD), "Review of the Corporate Responsibility Performance of Large Emerging Market Enterprises", 2008.*

Corporate Disclosure on Sustainability

The level of corporate disclosure on sustainability issues in emerging markets has improved over the past years but remains, on average, below the standards displayed in developed countries. In fact, while nearly 9 out of 10 companies in the emerging market sample[8] provide some sort of disclosures on environmental and/or social issues in their public reporting, such proportion drops when it comes to external verification or the adoption of recognized reporting guidelines. South African firms stand out from other emerging market countries with respect to reporting practices because of the historical heritage with the Anglo-Saxon business culture and an early adoption of sustainability practices. Since 2002, the Johannesburg Stock Exchange has been a key sustainability actor through the implementation of a corporate governance code for listed companies that was expanded to make ESG reporting integration mandatory. Brazilian companies have experienced a similar development through the creation of the national stock exchange of a sustainability index in 2002.

Considering the recent development in some emerging market countries of either ESG-related listing rules or dedicated sustainability indexes, one might expect positive evolutions, particularly in those countries that currently lag behind in sustainability disclosure (for ex. China and Taiwan).[9]

Disclosure Performance of Emerging Market (EM) Companies



Source : Inrate research

How to read: 89% of the Emerging Market (EM) companies in the research sample disclose information on ESG issues. 100% of Brazilian companies in the sample disclose information on ESG issues.

SELECTED BEST PRACTICE CASE – DISCLOSURE ISSUES

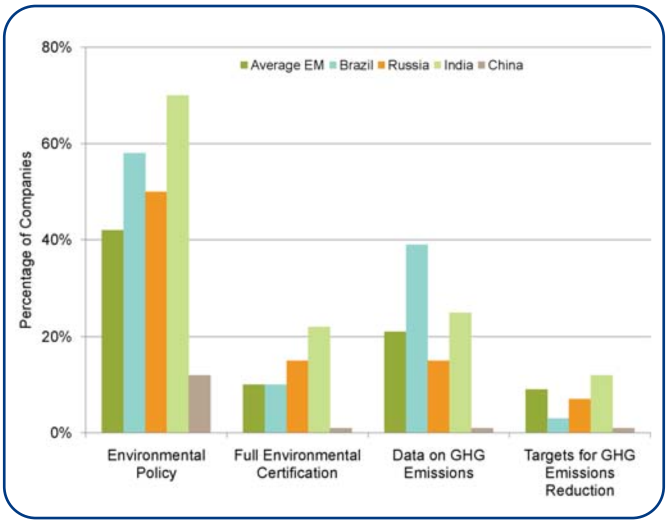
MAHINDRA GROUP, Automobile sector, India

The Mahindra Group is among the top ten industrial houses in India operating in the sectors of automobile, steel, finance, healthcare and information technology. The group is committed to disclosing ESG integration in a yearly Sustainability Review report. Its sustainability reporting covers 92% of group's operations and has been externally verified by Ernst&Young, according to ISAE 3000 (International Standard for Assurance Engagements).

Environmental Issues

On average, while 42% of emerging market companies support environmental commitments in the form of policies or statements, they remain weaker on implementation and progress tracking. Again, South African companies display greater awareness on environmental issues than their emerging market peers and have often implemented strategies and systems in response to the stock exchange requirement for integrated sustainability reporting. On the key topic of climate change, as recent CDP data shows, among the 800 companies included in the survey, only 29% took part in the reporting initiative.[10] Some Asian countries, such as Korea or Taiwan, stand out on specific environmental issues because of their business culture; they tend to recognise environmental certifications (such as ISO 14001) as an important strategy to gain a competitive advantage and to improve company reputation. Moreover, pressure on emerging market companies is likely to grow, particularly in fast-growing countries like India and China as these countries are starting to play a bigger role in the international climate change regime.

Environmental Performance of Emerging Market (EM) Companies



Source: Inrate research

SELECTED BEST PRACTICE CASE – ENVIRONMENTAL ISSUES

SAPPI LTD, Paper & Forestry Products, South Africa

Sappi Ltd. is a global paper and pulp company involved in the production of coated fine paper used in books and many other print applications. In terms of environmental initiatives, the company publishes paper profiles and information detailing key environmental parameters in South Africa, Europe and North America. Moreover, Sappi has achieved certification by the three most internationally recognised forestry products certification programmes (FSC, SFI®, PEFC) and has green procurement programs applicable to all contractors.

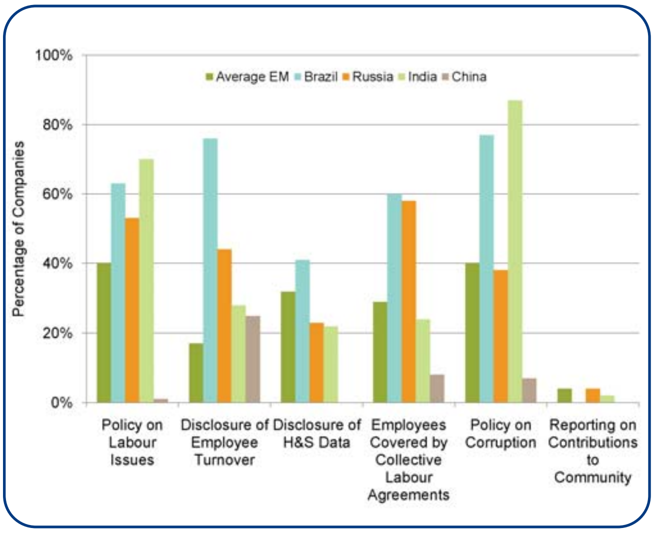
[8] *721 Companies belonging to MSCI Emerging Market Index and 1605 companies belonging to the MSCI Developed Market Index were chosen as the sample for the study.*
[9] *UNCTAD, "Sustainable Stock Exchanges - Real Obstacles, Real Opportunities", 2010; World Federation of Ex-changes, "Green Show for Green Markets", Focus n. 198, August 2009.*
[10] *Carbon Disclosure Project, "Carbon Disclosure Project 2010 - Global 500 Report", 2010.*

Social Issues

There are many social factors that can influence companies' sustainability performance and therefore contribute to the economic and social development of a country. These range from employment conditions and human resources development to relationships with communities, governments and society at large. If the social risks of sustainability are ignored by companies at both the strategic and operational levels, this can weaken companies' competitive positions due to increased external costs, loss of license to operate, boycott, or community opposition. As a conse-quence, long-term financial returns are negatively impacted.

Notably, Latin American and South African companies show an above average integration of social issues. Perhaps even more importantly, Chinese companies underperform significantly in this area, with below average performances on labour and corruption policies, poor coverage of employees by collective labour agreements as well as a lack of disclosure on health and safety data.

Social Performance of Emerging Market (EM) Companies



Source: Inrate research

SELECTED BEST PRACTICE CASE – SOCIAL ISSUES

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO, Water Utilities, Brazil

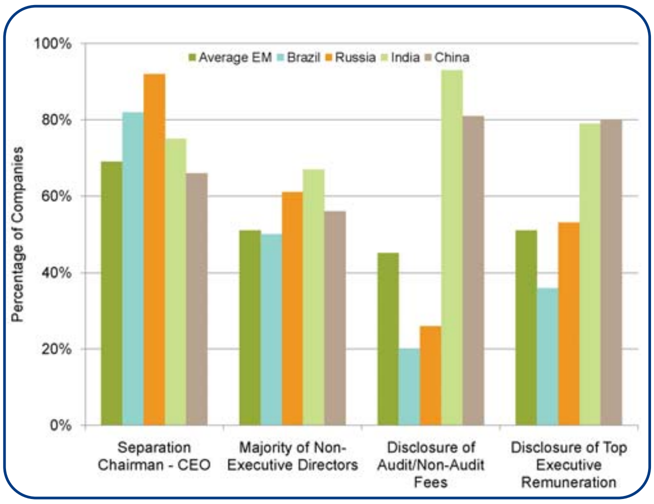
The company provides sanitation services and supplies bulk water to the state of Sao Paulo serving, directly or indirectly, over 26 million people. On social issues, the company has implemented a group-wide policy on labour issues for employees and the collective bargaining process is an important tool of participative management. In order to manage compliance on ethical issues, the company has set up an Ethics Committee and an internal whistle-blowing channel to significantly decrease the number of ethical breaches and implement necessary actions where appropriate. In terms of community engagement, the company holds meetings to identify the major issues and needs of local municipalities that are constituted by high concentrations of low-income populations, particularly in Sao Paulo (properties with unauthorized connections, intermediation in collection of debts at low-income communities, guidance on the rational use of water, proper use of collection networks, and river clean-up).

Governance Issues

Governance structures and practices are important elements that can reassure (or discourage) investors in emerging markets. Some asset managers consider it the most important criterion when assessing their emerging market investment strategy.[11] Governance in such countries is often characterized by a culture of former state-owned companies, concentrated shareholder structures and limited (or weakly enforced) regulations. In such context, investors have an interest to understand local governance structures and powers in order to assess governance-related risks of emerging market companies.

It is important to highlight that ESG practices are differently perceived and implemented by companies in emerging markets due to the different policies and business cultures. Investors would therefore gain precious insight by monitoring ESG regulatory developments and gaining local market information in order to set-up effective sustainability investment strategies (engagement, voting, exclusion, etc.).

Governance Performance of Emerging Market (EM) Companies



Source: Inrate research

SELECTED BEST PRACTICE CASE – GOVERNANCE ISSUES

WIMM-BILL-DANN FOODS, Food, Russia

Wimm-Bill-Dann (WBD) is the market leader in dairy products and children's food in Russia and one of the leading players in the market for non-alcoholic drinks in Russia and the CIS. The company has more than 35 production facilities in Russia, Ukraine and Central Asia and employs more than 18,000 people. On governance issues, WBD scores well above its peers, both in a Russian and in a general emerging market context. While some improvements could be made on the level of disclosure, particularly on remuneration matters, WBD displays a majority of independent directors (meeting NYSE's definition of independence) and a separate chairman and CEO position. Finally, this view is supported by Standard & Poor's corporate governance score that attributes a 7+ grade on a scale from 0 (the worst) to 10 (the best).

[11] *IFC & Mercer, "Gaining Ground", 2009.*

RECOMMENDATIONS FOR INVESTORS

Over the past 20 years, notably due to pressure exerted by sustainability investors and other corporate stakeholders, ESG standards for companies in developed markets have progressively become more stringent. In emerging market economies, this pressure is in a very early stage and is driven by an embryonic information infrastructure. Therefore, from a development perspective, applying identical ESG standards for benchmarking of emerging and developed market companies can prove ineffective.

Views from an Indian ESG research agency

The rapid growth in emerging markets means it is no cliché that "change is the only constant." In such a dynamic and fluid operating context, companies cannot take their markets for granted or operate with the same rules that work in relatively stable developed markets. For example, automobile companies that do not factor in the limited roads available to drive on or the threat to the climate of pollution are rapidly moving towards a dead-end street. This problem is more intense in many emerging markets' cities due to their high populations. In such a scenario, emerging market companies that are going to win the race to sustainability are operating as 'best in context'. Companies that are going to lose are either facing stiffer competition in over-tapped market segments or fighting a proxy battle to change the context through various lobbies or political funding campaigns that block responsible and inclusive growth.

Source: Solaron (India)

Given the rather heterogeneous picture of sustainability integration among and within emerging market regions, the following practices might guide investors to shape and develop their sustainability invest-ment approach:

- Reward corporations that are transparent on ESG issues and that show commitment to sustainable development. This encourages a sustainability culture to emerge within companies and ensures a virtuous circle irrespective of management, economic, political and regulatory fluctuations.

- Monitor unsustainable corporate practices (such as pollution, human rights abuse or corruption cases) to strengthen the effectiveness of companies' management systems. This would help investors to cope with poor disclosure levels in certain markets and to avoid reputational risks.

- Although sustainable development is a normative concept that can be applied globally, it is important to take into account the various stages that emerging market economies have reached and to closely track environmental and social regulatory developments that may impact the competitive landscape.

- Identify "pure players" (renewable energies, waste treatment, mobility, etc.) that are well positioned to provide solutions to major ecological and societal concerns in the market. These companies can act as important catalysts for sustainable development.

- Multinationals from developed markets with operations in emerging market economies[12] can facilitate and inspire local companies. Investors might find it relatively easier to engage with such companies on ESG issues than with their peers in the emerging market.

- Support prominent ESG initiatives (such as CDP, UNDC, GRI, governance codes, stock exchange SRI indices).[13]
- Participate in collaborative networks (UN-PRI) and facilitate the development of local capacities to empower and connect key corporate stakeholders.[14]

[12] *Companies such as Telefónica, Siemens, ABB or Coca-Cola have sister companies quoted on emerging market stock exchanges.*
[13] *Morales, R. and E. van Tichelen, "Sustainable Stock Exchanges – Real Obstacles, Real Opportunities", Discussion Paper, 2010.*
[14] *Jenkins, B. et al., "Supporting Entrepreneurship at the Base of the Pyramid through Business Linkages, Report of a Roundtable Dialogue", Rio de Janeiro: 2008.*

CONCLUSION

With leading emerging market companies performing well enough to be part of traditional global investment portfolios, there is a strong momentum toward investing in emerging market economies and scrutinizing firms about the level of ESG integration in their business practices. The current context favours investment in emerging markets due to the following:

- Emerging economies constitute tomorrow's markets for goods and services and carry huge business opportunities. However, ecological and social externalities caused by unmanaged growth can prove to be costly. Through capital markets, investors can create the right incentives towards sustainable development and have an important economic steering effect.

- As highlighted by the International Finance Corporation, "the investment case in emerging markets rests most heavily on the concept of inefficient markets, where not all the available information is incorporated in the current stock price."[15] In this respect, since risks and returns are generally higher in emerging markets than in developed ones, a deeper recognition of the impact of ESG factors can lead to better risk-control and over-performance in emerging markets.

- The lack of sustainability integration by emerging market companies that is often seen as a barrier to investment in such regions is less common than expected. There are already plenty of opportunities to invest sustainably in emerging markets. The latest figures suggest that sustainable investment in emerging markets has increased above $300 billion (€210 billion) in assets under management in the past five years.[16]

"Just 40 years from now, some 30% more people will be living on this planet. For business, the good news is that this growth will deliver billions of new consumers who want homes and cars and television sets. The bad news is that shrinking resources and potentially changing climates will limit the ability of all 9 billion of us to attain or maintain the consumptive lifestyle that is commensurate with wealth in today's affluent markets."
Vision 2050: The New Agenda for Business, World Business Council for Sustainable Development, 2010.

[15] *IFC and the Economists Intelligence Unit, "Sustainable Investing in Emerging Markets: Unscathed by the Financial Crisis", 2009.*
[16] *IFC & Mercer, "Gaining Ground", 2009.*

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