Re-paving the BRICS*: ESG & End-Market Growth in Emerging Markets

In the 1990’s, when our team members took early steps to integrate ESG (Environmental, Social and Governance) issues into investing in Emerging Markets (EM), their quest seemed an improbable if not impossible one. ESG data for EM companies was practically non-existent and a focus on rapid growth tended to mean weak corporate governance practices. Issues such as water scarcity, forced labor, as well as financial crises and economic volatility posed significant threats to sustainable growth across Emerging Markets.

Today, it is widely recognized that Emerging Markets have become a major driver of the global economy. Now home to a diversified mix of sectors and industries, Emerging Markets are increasingly supported by robust service sectors and a growing middle class. This complex socioeconomic evolution is helping to drive innovation, new sources of profit, and a more diverse profile of business growth.

Meanwhile, innovative actions taken by many actors from governments to stock exchanges, UN organizations, non-profit groups, and engaged investors like ourselves have combined to improve data and raise awareness of ESG issues in EM. While research shows that potential underlying ESG risks remain higher in EM than in Developed Markets, it is clear that ESG issues are now being taken far more seriously by companies, exchanges, and regulators across the Emerging Markets, and data on ESG dimensions has become substantially more robust than in the past.

In our view, the contribution of ESG analysis has expanded beyond identifying potential areas of risk, to highlighting growing sources of investment opportunity. Accordingly, going forward we think that investors who fully integrate ESG considerations into their investment process stand to benefit disproportionately relative to those that do not.

> Emerging Markets (EM) have grown in importance and changed in composition. Against the backdrop of climate change, resource pressure, and new technological opportunities, ESG issues now receive greater attention from consumers, corporations, and regulators across EM.

> Integrating ESG analysis into the investment process both mitigates risks and offers alpha potential for active investors, particularly in Emerging Markets.

> Better ESG practices can lower risk. Corporate governance is particularly critical in Emerging Markets.

> ESG investors can identify companies which provide innovative solutions to social and environmental challenges, unlocking attractive end-market growth opportunities.

> Boston Common’s long history of engagement leadership has helped raise the ESG bar across the board from the company level through the regulatory and exchange-level.

> We have played a leadership role in defining more meaningful metrics and co-chaired the Emerging Market Disclosure Project.

> EM companies have improved ESG disclosures and practices, but data quality is still evolving.

> Data must be understood in context. Our analysts have global experience and meet regularly with companies and other stakeholders. We have built our own networks of contacts and reliable information sources to corroborate vendor data.

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*BRICS refers to five major emerging countries Brazil, Russia, India, China, South Africa. The term ‘BRIC’ was originally coined in 2001 by Jim O’Neill, then-Chairman of Goldman Sachs. South Africa was introduced in 2010.
Rapid Growth in Emerging Markets Brings New Opportunities

Emerging Markets are no longer solely dependent on commodities and exports to Developed Markets, unlike the BRICs argument of almost two decades ago. Fueled by diversifying economies and an expanding middle class, EM countries now contribute more than half of global GDP and are also growing at a rate faster than Developed Markets. This rapid growth, with rising economic aspirations, makes sustainable resource management more critical.

The most dynamic growth areas in today’s Emerging Markets also happen to be in sectors where better ESG practices can build superior performance. For example, more sustainable forms of human capital management can be a key differentiator in sectors like financials, software, and tourism, where talent retention and employee motivation create competitive advantage. The rapidly growing middle class is also paying more attention to ESG issues. As a result, many leading EM companies are actively seeking to adopt ESG best practices to enhance their standing relative to peers. ESG issues have changed and grown in importance in ways that investors cannot ignore.

ESG Offers Better Risk Adjusted Returns for Long-Term Active Investors

In our view, ESG analysis provides investors with additional, independently-derived insights into a company’s management quality, strategic positioning, operational efficiency, and potential risk exposure. This additional source of insight is particularly relevant in EM because the asset class is less efficient and tends to carry a higher level of risk. A recent paper from Cambridge Associates notes that stock-specific ESG measures added value in EM equity investing.

In this regard, corporate governance is a critical area in EM, given that poor governance practices can have significant costs. In contrast, strong corporate governance signals greater transparency and more robust management, and often coexists with better environmental and social practices.

Several industry surveys have found that EM investors are willing to pay a premium for better corporate governance, creating a lower cost of capital for governance leaders. This supports our belief that companies with forward-thinking practices.


Global Health

Surveyed 50 global employers on HIV/AIDS risks, employee support, and human capital management in Sub-Saharan Africa. EM companies: Sappi, POSCO.

IFC Performance Standards & Banks

Led Investor Coalition to engage IFC & World Bank on Equator Principles Performance Standards to include climate change & human rights.

Asia Engagement Trips Begin

First Engagement Trip to South Korea (met with 6 companies) & visited BYD factory in China. Urged Samsung Electronics to join the Electronic Industry Citizenship Coalition (EICC) to improve its supply chain oversight practices.

Responsible Sourcing

Responsible Sourcing; Uzbek Cotton & Child Labor (Olam), Conflict Minerals (Hyundai Motor, LG Electronics, Samsung Electronics), Cobalt & Child Labor (Samsung), Palm Oil (Golden Agri).

governance culture, and managements focused on long-term growth fostered through sustainable relationships with all stakeholders, are better aligned with shareholder value. ESG research can help uncover companies with strong governance standards, reducing risks, and identifying opportunities for better risk-adjusted returns.

Identifying Opportunity in Sustainable Solutions

While risk mitigation has traditionally been a primary consideration for incorporating ESG into investment analysis, today, ESG research can also help identify compelling investment opportunity. EM economies and companies are gaining strength against a backdrop of climate change, resource scarcity, and technological advances. This means they are well placed to find innovative solutions to pressing environmental or social problems, gain scale in their home markets, and become leading suppliers to other emerging markets as well as Developed Market economies. Investors who are keenly attuned to ESG issues can identify innovative companies that can capitalize on the early-mover advantages in new end-markets.

For example, in China, (the biggest emitter of CO2 and greenhouse gases) environmental degradation and poor air quality have created enormous social pressure on the government to curb pollution and emissions. This creates exciting opportunities to invest in companies leading the charge for sustainable development, delivering clean water and cleaner energy such as solar, wind or natural gas. China has also become the largest global market for plug-in electric vehicles. Our portfolio holds positions in Beijing Enterprise Water Group - the largest Chinese waste-water treatment provider, ENN Energy - a leading natural gas distributor, and BYD Co. - China’s largest EV manufacturer. These companies all provide solutions to pressing environmental needs and offer potentially attractive returns.

Financial services provide another example of a growing sector where local companies can carve out a niche strategy in key underserved markets that offer attractive returns while also promoting economic mobility. For example, Bank Rakyat, a portfolio holding based in Indonesia, provides commercial micro-loans to the small and medium enterprise sectors, a target market with dynamic growth and positive societal impact, in our view.

Working to Raise the ESG Bar

From the outset, Boston Common has been a leader in ESG research and on-the-ground engagement in Emerging Markets. We regularly meet and engage with EM companies either in the US or in their home-country. Our discussions cover a wide range of material ESG risks, such as: climate change, water stewardship, supply chain oversight, responsible sourcing of raw materials, conflict minerals, and human rights. We engage companies individually, with research trips to Brazil, India, and South Korea, and collaboratively through initiatives such as the UN backed Principles for Responsible Investment (PRI) and the Asian Corporate Governance Association (ACGA).

Our long and deep engagement on material ESG issues with global multinationals has provided us with a unique perspective and experience for our work in Emerging Markets. Some highlights over the years include:

- Advocating ending slave labor in Brazil and child labor in the cocoa fields of Africa
- Broadening access to medicines in low- and middle-income countries
- Supporting health and safety reforms in Asian supply chains, especially in China and Bangladesh

These issues are all material to EM-domiciled companies; and while the issues may be similar, the way we engage can differ based on local conditions. Our ability to successfully engage companies is supported by partnerships with local research providers, investors, or other stakeholders, such as the International Finance Corporation, as well as our in-person research trips to better understand the cultural context, especially in Asia. Our engagement can create ESG momentum within companies and their peer groups.

Leading EM companies aspire to be global leaders and view ESG best practices as tools for competitive

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Co-authored “Unlocking Investment Potential: ESG Disclosure in Korean Companies” (April 2010) used findings to engage 10 South Korean companies. Joined collaborative engagement efforts by the EMDP Brazilian and South African teams.

Presented at PRI in Person in Brazil; company meetings focused on ESG practices and reporting (Grupo Pão de Açucar, Natura, CEMIG, Itau Unibanco).


Taiwan Semiconductor (TSMC) is part of our Eco-Efficiency Engagement Initiative (more efficient use of water and energy, waste reduction).

Leading 100-member investor coalition focused on banks & climate risk: Axis, Bank Raykat, Bank of Communications, Itau Unibanco.

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South Korea / Research & Active Engagement

Brazil

India

Eco-Efficiency

Banks & Climate Change

2012

2016

2010 - 2017
The Emerging Markets Disclosure Project

Boston Common co-chaired the Emerging Markets Disclosure Project (EMDP), an initiative that brought together local and global investors and research providers to improve ESG disclosure in Brazil, South Africa, Indonesia, and South Korea.

We also co-led the EMDP South Korea team, which engaged with 15 Korean companies and asked them to improve their sustainability disclosure and practices through the use of ESG Disclosure Scorecards, in-person meetings, investor roundtables, and meetings with domestic investors including the Korean Pension Fund between 2010-2012.

Successful, sustained dialogue with a company often begins long before a collaborative effort such as EMDP can take place. For example Boston Common first engaged with South Korean electronics company Samsung in 2005. We urged Samsung to follow developed market peers and join an industry coalition such as the Electronics Industry Citizenship Coalition (EICC). In 2010 we followed this up with discussions around conflict minerals and human trafficking.

By 2012, Samsung had significantly improved its practices and, alongside peer company LG, had taken on a leadership role in the area of conflict minerals management. In 2016 CDP (formerly the Carbon Disclosure Project) included Samsung in its 2016 “Supplier Climate A List”. The Climate A list recognizes companies that are reducing emissions and mitigating climate change, both in their operations and their supply chains.

differentiation. Our engagement builds on those aspirations. Many EM companies have adopted best practices by using tools such as the CDP (Carbon Disclosure Project) questionnaire to assess carbon emissions and water use. Nearly 40% of companies within our EM portfolio responded to the CDP Climate Change questionnaire and 80% of these received either an A (Leadership) or B (Management) score.

ESG Adoption - Progress at All Levels

Brazil and South Africa were some of the first stock exchanges to adopt ESG disclosure requirements and launch ESG indices. In the past three years, six Asian countries – Malaysia, Korea, Hong Kong, Taiwan, Singapore and India – all adopted investor stewardship codes.

Working with and through the UN-backed PRI and ACGA, Boston Common has encouraged stock exchanges to support more relevant ESG disclosure from companies. Through one unique collaboration, we asked 73 global bourses to issue voluntary guidance on reporting ESG information by the end of 2016. And through another, we provided feedback to the Taiwan Stock Exchange on the “Stewardship Principles of Institutional Investors” in 2015.

The number of EM companies reporting on sustainability is also increasing. The Global Reporting Initiative (GRI) database indicates that sustainability reporting has steadily increased across key EM countries; for example, the number of sustainability reports produced by Chinese companies doubled between 2014 and 2016. Strong support from leading EM companies has also helped motivate governments to move towards better disclosure requirements.

The New Road Ahead

Many Emerging Markets have become more complex and economically diversified in recent decades, and they no longer rely solely on volatile commodity markets to drive growth. The path to growth is instead being re-paved by strong domestic development, innovative global solutions leaders, middle-class consumers seeking sustainable practices, and global investors who look to ESG assessments for superior risk management and potential alpha across all sectors. Companies and regulatory agencies in Emerging Markets have made impressive progress in a short time. Indeed, the pattern and trajectory of EM growth have made deep understanding of and active engagement with ESG issues indispensable for investors who want to participate in the promise of Emerging Markets.

Boston Common Asset Management

is an experienced investment manager dedicated to the pursuit of financial return and social change. We invest approximately $2.6 billion* in Global equities on behalf of institutional and individual investors. We analyze investment risks and opportunities from a broader perspective, because we believe understanding environmental, social, and governance (ESG) issues is fundamental to valuing a company. We combine this research with rigorous financial analysis to build diversified portfolios of what we believe are high-quality, sustainable, undervalued companies. We strive to be responsible stewards of our clients’ assets by seeking competitive investment returns from portfolios of companies that can contribute to and benefit from sustainable, global growth. As shareowners, we urge our portfolio companies to improve transparency, accountability and attention to ESG issues. We are proud to have built a strong investment record and believe we have meaningfully improved corporate practices globally through our engagement.

The information in this document should not be considered a recommendation to buy or sell any security. There is no assurance that any securities discussed in this report will prove to be profitable. All investments involve risk, including the risk of losing principal. *As of 9/30/2017