



ESG integration in action: Spotlight on emerging market corporate credit

'Who cares wins'. David Jones, the CEO of Havas Worldwide, wrote this book six years ago explaining why the most successful businesses in the future will be the ones that are most socially responsible. However, when investors hear the term 'emerging markets' they assume these principles do not apply. Bill Browder's book 'Red Notice', which explores corruption on an industrial scale, reinforces the perception that environmental, social and governance (ESG) and emerging market (EM) investing are not compatible. We beg to differ. We believe integrating ESG factors in emerging market investing is not only possible, but can deliver tangible results by improving risk-adjusted returns for investors.

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Value in emerging markets

Our experts discuss how ESG factors shape their investment decisions and share their thoughts on the next steps for ESG integration within EM corporate credit.

How does ESG fit within your EM investment approach?

Polina Kurdyavko (Partner)
Co-Head of Emerging Markets,
Senior Portfolio Manager

When we first looked at integrating ESG into our investment process we knew the concept was consistent with our investment philosophy – ESG considerations represent an important set of factors, many of which we already took into account when weighing the merits and risks of investment opportunities. The challenge would be developing a framework to quantify these risks that is robust and evolves with the market. The good news was that it was immediately evident that BlueBay was particularly well positioned to forge this model successfully.

First, we believe integrating ESG effectively requires being an active investor. Limiting ESG analysis to third-party data or taking a passive approach risks relying on an incomplete, backward-looking snapshot. This could not possibly substitute for deeper visibility regarding management commitment and trajectory of change. Our active approach to investment means that our ESG model features as an extension of our investment process rather than a change. Second, implementing and maintaining a substantive, credible framework requires resources. The structure and size of our specialist EM corporate analyst team permits a comprehensive approach to risk management that integrates ESG factors. Empowering our analysts to drive the ESG agenda within their sector and company analysis creates strong buy-in across the team and ensures a more dynamic and broad-based model. Third, and equally as important, our reputation and presence in the market provides direct access to senior policy makers and company management. This brings

opportunities for engagement and higher awareness concerning ESG issues.

The positive and somewhat unexpected outcome of our ESG discussions, particularly when engaging with companies and sectors with weaker ESG credentials has been the realisation that investment managers can, indeed, play a meaningful role in the broader global ESG agenda. That being said, our approach to evaluating EM fixed income through an ESG lens is not about taking a moral stance on behalf of our investors, but more an exercise of scaling the materiality of ESG risks to enhance our risk management processes.

In formulating a view on an ESG risk for a security, BlueBay uses data from third party providers in combination with your own insights. Why not simply rely on the ESG scores from third party research agencies?

Amanda Gray
Senior Corporate Analyst

ESG/sustainability research agencies are a useful source of ESG information but are limited in the depth that they can provide as they are reliant to a large extent on publicly available information. They also fail to effectively incorporate the ESG context of a company's operating environment (sovereign), which in our view is a material oversight in EM investing. For instance, a Nigerian bank under my coverage offers a useful example of where we disagree. Our ESG research provider rates it as 'above average' on ESG. It's true that on paper the issuer meets all the requirements for this rating. However, our investigation into the company flagged individuals who exert control over operations well beyond that which publically disclosed shareholdings would suggest. In addition, Nigeria scores 27



out of 100 on TI's Corruption Perception Index. Operating in Nigeria exposes the bank to a higher risk of bribery and corruption which is not reflected in the third party ESG assessment. I score the bank -1 on a scale of -3 to +3 for investment ESG risk, reflecting a view that I should expect slightly wider spread/lower prices as a result of the ESG risks. Overall, third party ESG scores are a great starting point but especially in EM, often you need to dig a bit deeper.



What tools do you use to incorporate ESG analysis within your existing investment process?

Anthony Kettle (Partner)
Senior Portfolio Manager

As a team we have actively contributed to the development of the firm-wide issuer ESG evaluation tool, a project led by our in-house ESG team. The tool has been very useful in enabling our analysts to generate a fundamental ESG rating and investment ESG score for the companies we evaluate. It also provides a consistent, systematic approach to accessing potential ESG

risks across our portfolios. Making ESG integration an explicit part of our process encourages our credit analysts to naturally incorporate ESG issues as part of their regular dialogue with company management. From a portfolio manager's perspective, the role of the tool is less about flagging unknown risks but rather to draw attention to risks that warrant a re-assessment because of a new ESG development.

How does an understanding of ESG developments translate into opportunities in your sector?

Andrius Isciukas
Corporate Analyst

I cover the pulp and paper sector. You might be surprised to hear that I follow environmental and waste management policy across regions to understand the opportunities and risks faced by my Latin American pulp and paper companies. For example, the public outcry in China over pollution has led to environmental regulation that is presenting an excellent tailwind for my sector today. Pulp prices are enjoying 20-year highs and it is easy to point to strong demand growth in South East Asia as the primary reason. However, one shouldn't overlook the second driver. China, the fastest growing consumer of pulp, is closing its domestic pulp and paper production capacity. Why? China's environmental policy and its drive to reduce pollution is the reason behind hundreds of mill closures in recent years. In addition, China pushed further by banning low-grade waste paper imports and tightening the level of allowed contaminants last year. This provides an opportunity for operators in Latin America which are more efficient and high-quality versus other emerging market regions.

Could ESG analysis help you generate alpha?

Meri-Luiz De Camargo
Corporate Analyst

Yes, absolutely. A well-known Russian aluminium producer is the most recent

example of how ESG factors led to significant alpha in our funds. Despite our constructive medium-term view on aluminium and view that the company was proactively engaging investors on their ESG practices, we did not invest in the company due to material corporate governance concerns. The company has a patchy history of debt re-profiling and shareholder involvement in corruption cases that held us back from participating in its two issues in 2017 and 2018. When the entity was added to the US Sanction list on 6 April due to shareholder corruption, we held none of their bonds and the absolute underweight was a key contributor to relative returns that month.

How do you reconcile the ESG risks in challenging sectors with the objective of delivering performance?

Alan Siow
Portfolio Manager

One of the key ESG risks in EM utilities is the role that fossil fuels and in particular, coal, play in baseload generation across many EM jurisdictions. While we are keenly aware of the risks posed by this type of generation to global warming and local pollution, the reality is that much of the installed capacity in EM countries is coal-based, and given the underlying economics, this is unlikely to materially change in the short to medium term. Moreover, as utilities represent some 8-10% of the EM corporate benchmark indices and tend to be predominantly investment grade rated, this is one sector that cannot be ignored. Against this backdrop, our approach is pragmatic; we focus on utilities that have either have the bulk of their exposure to renewables or gas-fired thermal generation, or to utilities that are structurally increasing their share of non-coal fired generation or pro-actively addressing their carbon and pollution footprints.

The EM sovereign and corporate teams work closely together at BlueBay. How do they collaborate on ESG?

Timothy Ash
EM Senior Sovereign Strategist

I recently worked with our financials analyst, Amanda, on an ESG engagement project which had an interesting outcome. An EMEA-based state-owned bank was found to have violated US sanctions against Iran. This generated considerable market distrust which prevented the bank from accessing primary markets. It was clear that the company was ripe for engagement given management's deep financial motivation to regain investor confidence. The bank hired an independent consultant to assess their compliance shortcomings and make recommendations. We believed that only a very public airing of their weaknesses and a clearly articulated plan for improvement would set them on the path to regaining market trust. Amanda spoke with senior management and, in parallel, I raised our suggestions with the Deputy Prime Minister who has oversight over state-owned financials. In the bank's most recent earnings call, they publically announced they would release the results of the compliance audit. Management has confirmed to us that they will also be publishing a plan for execution of the auditor's recommendations upon completion of the audit. We are quite pragmatic in our approach to engagement. We (1) identify companies and management teams that are motivated to listen to investors, (2) work with companies where we have strong and long-held relationships and (3) suggest changes that provide both long-term ESG benefits and near-term commercial benefits for the company and potentially investors. I also can't emphasise enough the benefits of sovereign and corporate team collaboration when engaging state-owned enterprises.

How much interaction do you have with your in-house ESG team?

Sven Scholze
Senior Corporate Analyst

The ESG team is a great resource for our investment team. They provide sector-level guidance at our monthly meetings and are always available to offer support as needed. This became particularly relevant when I analysed my first company in Guatemala. I was fairly unfamiliar with the country, which doesn't receive a lot of market coverage. The investment case looked strong but I suspected ESG risks given the geographical footprint. The ESG team arranged a tutorial for me with a sovereign ESG consultant on the country, who flagged high corruption risks and alerted me in particular to weak land rights that often result in community conflicts. Further research brought to light that local corporations had allegedly hired paramilitaries to clear indigenous lands for development. I believed that the potential for this to occur at my company was of investment relevance. Management planned to build a new factory in a rural community that would be a material future source of income. I went to management with a catalogue of questions around their standards and procedures that our ESG team had helped me put together. The company was surprisingly cooperative and eventually we got comfortable that their new factory was not a social problem waiting to emerge. Upon discussing it internally, the PMs and I agreed to adjust our spread target accordingly.

What are the team's next steps from here?

Claudio Da Gama Rose
Institutional Portfolio Manager

On many levels broadening and formalising ESG into our investment process doesn't necessarily represent such a big leap from our existing approach. However, we recognise that

we are only at the initial stages of this journey, and the process of defining and developing our framework will be an evolving project. As we roll out our programme, we would welcome the opportunity to have a dialogue with investors to learn about their specific ESG needs. We believe that regular engagement with different types of clients from various regions is necessary to ensure that as our framework evolves, it remains both transparent and relevant to key stakeholders in our investment strategies.



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