ROBECOSAM
Sustainability Investing

Unlocking sustainable value in emerging markets

ESG factors are particularly relevant in emerging markets, where growing social and environmental challenges demand a more sustainable approach to both business and economic development. Giving emerging market companies the opportunity to benchmark themselves against their global peers, while allowing investors to identify companies that are creating long-term shareholder value can incentivize sustainable growth.

Over the last ten years, in contrast to the economic conditions of developed markets in Europe and the United States, emerging market economies[1] have evolved into a robust investment opportunity, increasingly attracting investment flows from developed markets. Two key drivers have influenced this shift in global asset allocation. The first is a growing consensus among economic experts of the growth potential of emerging markets. At a time when most developed countries are going through a phase of fiscal consolidation and belt-tightening in the private sector, numerous emerging market economies are showing healthy public finances and increasing private consumption. Secondly, the political landscape in many emerging market countries has shifted over the past decade. As many move towards greater social and economic stability, investors have gained more confidence in the ability of emerging markets to grow over time. A recent IMF Report showing that emerging markets accounted for almost all of global growth in 2012 is a case in point for this.[2]

Different indicators of value creation needed

Emerging economies are facing their fair share of challenges stemming from resource scarcity and a rapidly rising population on a larger magnitude than experienced by the economies that developed at the beginning of the 20th century. Yet, they are converging

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[1] In the context of this paper, RobecoSAM considers the following 20 countries to be emerging markets: Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey

[2] „Resilience in Emerging Market and Developing Economies: Will it Last?" IMF World Outlook, October 2012

Figure 1: Representation of Emerging Market Companies in the DJSI World Since Launch

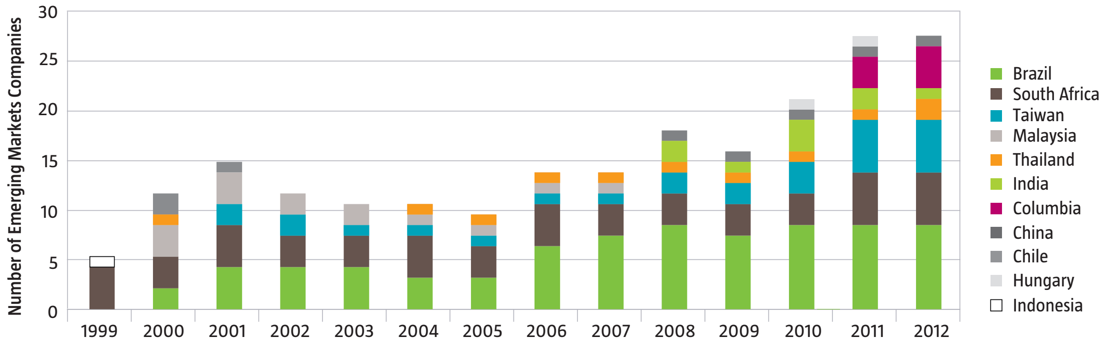
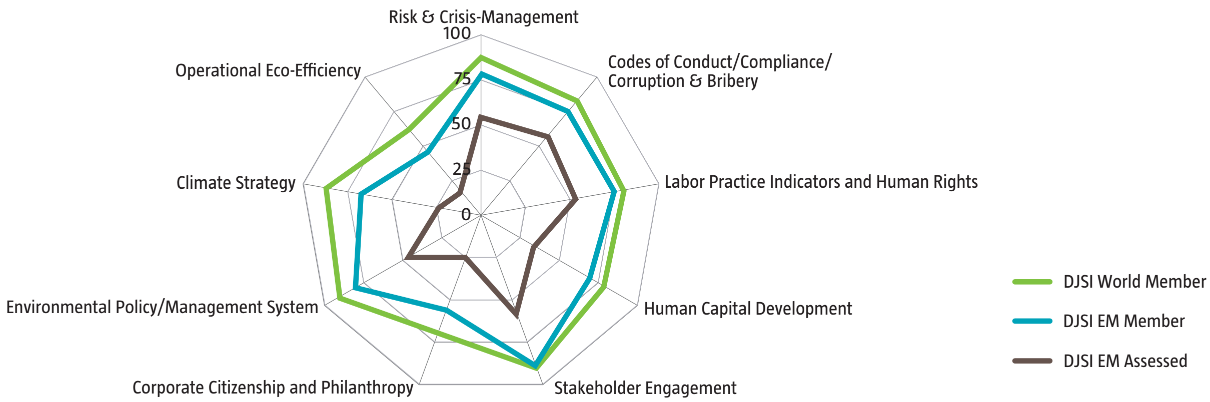


Figure 2: DJSI Emerging Markets Sustainability Performance vs. DJSI World



towards the helm of global economic activity. As a result, traditional models of analysis that investors use to identify investment opportunities may fall short of covering the range of variables that are important for analyzing emerging economies. For instance, the positive relationship between GDP growth and stock market returns that many investors use as an investment signal struggles to deliver reasonable foresight in emerging markets. China's impressive real GDP growth of approximately 10 % per year over the last decade – far beyond the growth rates of Brazil, Mexico or South Africa (ranging from 2 to 4 % per year) – has dominated the news. However, when stock market returns are examined, the returns of widely used stock market indices in China, Brazil, Mexico, and South Africa tell a different story; Chinese stocks have been providing returns of around 5% per annum, compared to returns ranging from 12–19% per annum in Brazil, Mexico and South Africa[3].

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Investors in emerging markets are thus turning to other indicators of value creation, such as examining the role that commodities play in emerging market economies. Emerging market economies – like developed economies – can be sorted into two categories: those that are commodity-rich – such as Russia and Brazil – and those that are commodity importers, such as Taiwan and China. Local and global companies operating in these countries face unique social, economic and environmental risks related to the efficient extracting and exploiting of commodities.

Growing stakeholder pressure

As a result, a growing number of investors are asking about corporate responsibility and sustainability in these parts of the world. In addition to investor interest, stakeholders ranging from emerging market governments to local and global NGOs are raising awareness for the need to apply sustainability practices to the operations of companies in emerging markets. South Africa, for instance, introduced the King III code for corporate governance in 2009, setting reporting standards for companies listed on the Johannesburg Stock Exchange. China, often considered as a laggard in addressing sustainability issues, is now pursuing environmental initiatives within its 12th Five Year Plan, ultimately involving Chinese companies in reducing emissions and raising renewable energy usage. Emerging market companies that effectively address sustainability risks and opportunities are becoming global leaders in their field and in the creation of long-term shareholder value.

Converging sustainability standards and practices

These trends have motivated RobecoSAM to extend its coverage of emerging markets by inviting 800 companies from 20 emerging market countries to its annual Corporate Sustainability Assessment (CSA). Since 1999, RobecoSAM has seen an increasing number of emerging market companies participate in the CSA and earn membership in the established Dow Jones Sustainability World Index. Figure 1 shows that over the lifetime of the DJSI World, the number of emerging market companies listed in the index has grown from 5 in 1999 to over 25 in 2012, with the majority of these coming from

[3] Bloomberg & IMF Data and Statistics, http://www.imf.org/external/data.htm, March 2013

Brazil and South Africa. The improvements emerging market companies have seen in their sustainability strategies from year to year are also laudable. From 2010 to 2012, the Total Sustainability Scores of companies from this region saw an average positive percentage change of almost 23 %, confirming the trend towards long-term thinking and improved sustainable practices that are becoming ever more present in this part of the world.

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RobecoSAM's sustainability data also shows that, across a range of criteria, companies in emerging markets are becoming more comparable to their developed market peers. A simple illustration of this can be found in Figure 2, which displays the 2012 sustainability performance of companies included in DJSI World and DJSI Emerging Markets against a baseline of all emerging market companies assessed by RobecoSAM. From this diagram, it is evident that the difference in practices across social, economic, and environmental dimensions between the DJSI World and DJSI Emerging Markets is remarkably narrow. Particularly along social dimensions such as stakeholder management and labor practice indicators, leading emerging market companies have reached the standards of industrialized nations. In the face of challenges such as the risk of losing the license to operate, or falling into disrepute amongst local communities in which companies are based, the case for sustained strategies towards stakeholder engagement and local development are crucial for long-term success.

Driving the sustainability agenda

Although the business case for environmental responsibility is particularly strong given the nature of the risks faced by emerging market economies, many companies in these regions still lag behind in terms of sustainability strategies along the environmental dimension. A company's ability to effectively address its sustainability challenges is ultimately the product of innovative initiatives spearheaded by the company; however, exogenous factors such as the regulatory environment in which the company operates are also important to consider. It is clear that emerging markets still have some way to go in terms of increasing their sustainability performance. Still, giving these companies the opportunity to benchmark themselves against their global peers is undoubtedly a positive move towards facilitating and encouraging sustainable growth in emerging markets.

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