ENVIRONMENTAL, SOCIAL & GOVERNANCE FACTORS IN THE EMERGING EUROPEAN MARKETS

HOW ADOPTING WORLD'S BEST ESG PRACTICES COULD AFFECT BULGARIAN ECONOMIC GROWTH

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INTRODUCTION

The recent global market turmoil brought to the fore a number of short term, often panic and usually less rational investment and development decisions all across Europe. And this in many cases means healing the symptoms, but not the cause for the illness.

However the successful way out will be to those, who manage to combine both their short-term rescue decisions and long-term sustainable development strategies. Such a long-term approach will typically include environmental, social and governance measures (ESG), which have been widely neglected in the emerging economies, but their importance constantly rises in the recent years.

INTRODUCTION cont.

ESG becomes widely recognizable in the modern corporate world and almost 50% of the managers and asset owners across Europe agree that the **ESG issues play an important role** during their research, selection, portfolio and risk management processes.

Moreover, according to the World Bank, 40% of the asset managers believe that the recent crisis will result in wider use of ESG research. Another 30% say, that **the ESG usage might be reduced in the short term, but in the long run it will be restored and will even grow**.

ESG INVESTMENT DEFINED

Fund managers incorporate sustainability research into investment analysis to identify **"submerged" risks and opportunities** – those outside the traditional boundaries of equity research.

In theory, ESG criteria simply comprise a new set of variables to incorporate into discounted cash flow (DCF) valuations. However, the DCF model depends entirely on the availability of information. Indeed, surveys found that lack of transparency was the main obstacle to incorporating ESG principles into investment decisions regarding emerging market equities.

THE CURRENT PARADIGM

Currently a number of questions rose whether the traditional investment methodology is still working properly. Analysts devote their time to analyze financial statements, estimates and other ratios, while in the same time the ESG offers an instrument to gather a lot more information and **to analyze its impact on company's long-term fundamentals**.

There are many examples of how the ESG contributes to company's long-term growth in revenue and profitability. Any business could shape its financial results in the short run, but **achieving long-term growth** requires different strategies from reducing waste materials to fostering trust through strong governance. The value of a company often depends heavily on its reputation, which the ESG is likely to affect.

CORPORATE AWARENESS

A growing number of managers, asset owner and investors have begun to consider the ESG factors in order to arrive at a more thorough understanding of the corporate risks and opportunities. They share the view that a prudent manager ought to consider ESG issues in his or her analysis because these factors could impact the investment performance.

Another factor is that the regulatory and governance focus on transparency and disclosure has sharpened, as well as has academic research on the link between governance practices and corporate performance. Although the intensity of focus on environmental and social issues does not yet match the attention placed on corporate governance issues, there is yet growing interest in them.

KEY ESG ISSUES

The following are some of the key ESG issues that historically have been of interest for the analysts, managers and asset owners. Disclosure and reporting of these and other issues will continue to offer risks and opportunities in the future.

- Environmental
  - Greenhouse gas emissions;
  - Climate and ecosystem change risk exposure;
  - Pollution;
  - Renewable energy;
  - Waste/hazardous waste disposal and cleanup;
  - Renewable energy usage;
  - Energy efficiency.

KEY ESG ISSUES cont.

- Social
  - Child labor;
  - Discrimination;
  - Community relations;
  - Facilities and social risks;
  - GMO usage;
  - Predatory lending;
  - Political contribution;
  - Political risk;
  - Sexual harassment;
  - Shareholder/Minority shareholder advisory vote;
  - Slave labor and etc.

KEY ESG ISSUES cont.

- Governance
  - Cumulative voting;
  - Dual class share structure;
  - Majority voting;
  - Management and Executives remuneration;
  - Poison pills;
  - Segregation of the executive management;
  - Shareholders/minority shareholders rights;
  - Staggered Board;
  - Etc.

OBSTACLES

Despite the evidence of strong performance, many of the obstacles to sustainable investing practices persist:

- Some investors still fail to see a compelling case to ESG investing;
- Companies and large investment firms rarely have enough staff to conduct the ESG research;
- There is still lack of transparency and insufficient disclosing of information;
- The sustainable investment is still lumped with ethical investment approaches.

INEFFICIENT MARKETS

The investment case in emerging markets and in the EME markets in particular rests most heavily on the concept of inefficient markets. In that case, not all of the information available is being incorporated in the current stock price.

There is a lack of comprehensive research coverage in emerging markets in general and a dearth of ESG related analysis in particular. Given the higher levels of both risk and return in emerging markets, investors who make an effort to understand the impact of ESG have a better chance of reducing their corporate risk as well as boosting returns.

CHALLENGES AND OPPORTUNITIES

The shift to sustainable investing practices offers business opportunities for fund managers, consultants and emerging market companies. All can benefit from the change in investment styles, even at a time when financial markets are in turmoil. However the growth of sustainable investment is still constrained by significant obstacles, like:

- Lack of ESG consultants and managers;
- Shareholders direct engagement;
- Lack of transparency;
- Macroeconomic investment climate.

CONCLUSION

As investor interest in EME flourishes, there is a growing awareness of the importance of ESG practices in the investment process. **Asset owners and corporate managers are all paying more attention to sustainability issues, even in a harsher business climate.** However they recognize that further steps need to be taken before sustainable investment becomes main stream. Major requirements include:

- ❖ Government guidance and regulation;
- ❖ Better ESG reporting and disclosure by the companies;
- ❖ Better evidence on the investment case;
- ❖ More ESG training on investment professionals.

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