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Industry Voices

Commentary: EM companies must recognize investors are front-row in the audience for ESG information

Mike Lubrano

By Mike Lubrano

It is no secret that global institutional investors increasingly integrate analysis of environmental, social and governance sustainability factors into their investment decisions.

This reflects a growing consensus that incorporation of sustainability metrics in investment analysis yields greater long-term results. Given the generally less-stringent regulatory environments (or at least poorer records of enforcement) in emerging markets as compared to more advanced economies, emerging market companies present special ESG disclosure challenges. With the exception of the largest firms and those in particularly sensitive industries, the availability of complete and timely ESG disclosure by emerging market companies remains spotty, leaving investors particularly hungry for quality information on sustainability practices.

The incompleteness of disclosure by small-cap and midcap emerging market companies is evidenced by the often-dramatic inconsistencies between the scores an individual company receives from the different ESG research and information services firms, which collect their information in different ways and assign varying weights to particular indicators. This state of affairs undoubtedly contributes to greater risk perception among investors and increased cost of capital for companies. So why does this pattern persist?

As an emerging market investor with an active ownership strategy focused mostly on midcap firms, we often find that our portfolio companies have much more advanced ESG practices than would appear from their annual reports and other capital market disclosures. In fact, we find the companies not infrequently employ competent specialists to identify, measure and address environmental and social risk by adopting best practices. These companies also often have a deeper understanding of the importance of governance and the need for it to evolve in step with the company's development. But the people working on ESG in emerging market companies, and the C-suite executives and board members who oversee them, too often look past a critical part of the audience for communication around their ESG strategy and progress — the investor community.

Most in-house experts on environmental and social issues have technical, regulatory or non-governmental organization backgrounds, with scant experience with the capital markets. So perhaps it should come as little surprise that these small-cap and midcap emerging market companies' specialists are often fully absorbed with their relationships with members of the traditional ESG audience, such as environmental agencies, labor ministries, other regulators, customers and suppliers, unions, human rights groups and local NGOs.

Particularly among newly listed firms, even board members and senior management might think of their environmental and social policies and practices as something of interest primarily to watchdogs and non-financial stakeholders. On the governance side, they might believe it sufficient merely to disclose whether the company complies with basic independence and committee requirements set out in mandatory and voluntary national codes. They are often unaware of integrated disclosure frameworks and standards, such as those of the Global Reporting Initiative and Sustainability Accounting Standards Board that provide models for communicating essential ESG information to investors.

Since even the most ESG-sensitive large global institutional investors don't have the resources to reach out to small-cap and midcap emerging market companies, senior executives can mistake a lack of direct communication as an indication of indifference. As a result, their companies do not get enough credit for the sustainability of their business models — a missed opportunity to reduce risk perception and improve valuations.

A simple example where an emerging market company clearly understood and properly managed environmental and social risks, but did a poor job communicating it to investors, is an Indian vehicle producer that we have owned for several years. This company routinely renewed the ISO certifications of its quality systems and kept its supply chain — considered by its management the only relevant audience for such information – up-to-date on its status. Nonetheless, the company was called out by one of the ESG rating services for failing to maintain such certifications, because nowhere in the company's public reporting were such renewals disclosed.

As with other small-cap to midcap companies in emerging markets, management simply didn't perceive that the company's investor audience would view this as material to their investment processes.

So, what are the solutions? A big step is for emerging market companies to clearly assign responsibility for devising and articulating an ESG and sustainability strategy at the board and senior management level. They must also coordinate sustainability strategy and execution across the company with active participation by the chief financial officer and the investor relations team. Most small-cap and midcap emerging market companies can't sit around waiting for investors to tell them what information they regard as material. Rather, management must direct their investor relations teams to be proactive, and consult with analysts and investors to better understand capital market expectations around their ESG practices and transparency. And in our view, there needs to be a set path and timeline for integrated reporting.

Emerging market companies that fail to recognize that investors are not only members of their ESG audience, but are in the front row, will continue to suffer from excessive risk perception and higher cost of capital. Those that do, and especially those that proactively engage with investors to ensure they understand what this audience is looking for, will reap not just polite applause, but the concrete financial benefits of fuller valuations.

Mike Lubrano is co-founder and managing director, corporate governance and sustainability at Cartica Management LLC, Washington. This content represents the views of the author. It was submitted and edited under P&I guidelines, but is not a product of P&I's editorial team.