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ESG Insight


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ESG in Emerging Market Debt

Why we prefer corporate bonds to fully state-owned companies in Nordea's Emerging STARS Bond Strategy

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Key highlights

- We prefer corporates over quasi sovereigns because we believe investing in fully state-owned companies can represent an ESG risk in EM debt
- Quasi sovereigns in EM tend to be less efficient because they are often run with political objectives. Many also have low levels of transparency
- We like EM corporate issuers that can offer transparency, high ESG standards and compatibility with the SDGs
- We currently find plenty of investment opportunities within the universe of privately-owned corporates and are excluding fully state-owned companies from Nordea's Emerging Stars Bond Strategy
- Given the high importance that many fully state-owned companies play in their local economies, we will continue to push for a higher level of ESG practices and transparency in the universe on aggregate and will search for individual issuers that fulfill our criteria in the future

Quasi sovereigns, bonds issued by fully state-owned companies, account for a substantial slice of the emerging markets (EM) fixed income market. The largest issuers have tens of billions of dollars of debt—three of the five largest corporate debt issuers from EM are fully state-owned. To many investors, they are an attractive way to enjoy a level of safety similar to that of sovereign bonds, but with a higher yield. This is all the more enticing at a time when yields for many sovereigns and investment-grade corporates are low.

But we take a different approach: In this ESG Insight we explain why we believe investing in fully state-owned companies can represent an ESG risk in EM debt, and why we prefer corporates over quasi sovereigns. Currently, Nordea's Emerging Stars Bond Strategy does not invest in any fully state-owned companies, despite them representing ~20% of the strategy's benchmark (around 80% of the benchmark is made up of sovereign bonds), the J.P. Morgan EMBI Global Diversified.

We prefer corporates over quasi sovereigns

With increasing awareness among issuers and innovation in the market for ESG-related bonds, it is an exciting time to be an ESG-focused investor in EM corporate debt. Since the beginning of 2020, we have been complementing our ESG-focused EM sovereign bond portfolio in Nordea's Emerging Stars Bond Strategy with the addition of corporate bonds.

Today, our corporate bond investments focus on privately-owned (meaning not state-owned) issuers from the emerging markets. This is because there is much to excite us in this investment universe. In particular, many corporate issuers exhibit strong or improving ESG practices and solid financial outlooks. In addition, we find many privately-owned companies with business models that contribute positively to the United Nations' Sustainable Development Goals (SDGs) – a fact that should allow them to have access to capital in the future. The SDGs are 2030 targets for the world to achieve decent economic growth and prosperity for all, without harming the planet. We take them seriously as EM debt investors in part because we expect companies aligned with the SDGs to have easier access to capital in the future. For example, as investors become increasingly concerned about sustainability, a coal-based utility or oil producer will have fewer financing sources than many other companies.

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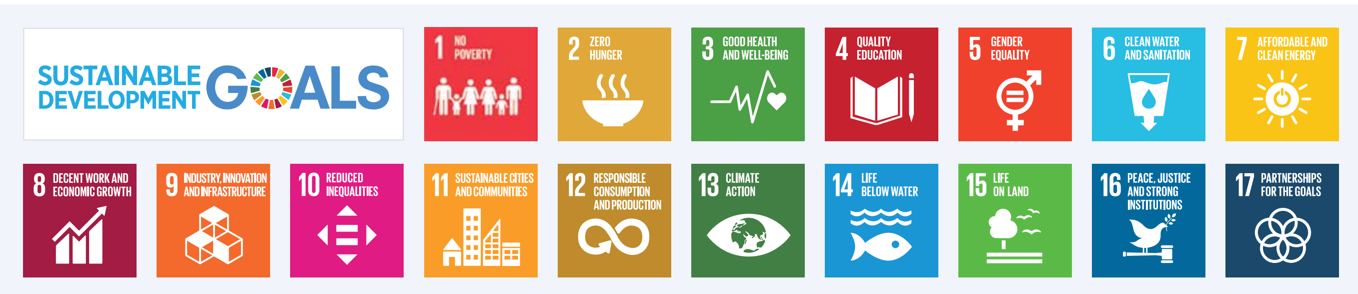
On the flip side, all of the quasi sovereigns on the J.P. Morgan benchmark are fully state-owned. Given the absence of external shareholders, many of those companies follow politically driven business strategies, lack independent oversight, are less efficient and prone to corruption. In other words, they often score poorly in ESG terms—which translates into risk for the investor. Commodity producers like oil & gas companies account for a large slice of fully state-owned companies, given the strategic importance of the sector for many emerging markets countries as well as its high capital requirements. The lack of ESG transparency and the inherent sector tilt make fully state-owned companies in EM a difficult investment universe for ESG focused funds, and in particular for our strategy. Nevertheless, with around 90 issuers to choose from in the benchmark index, the universe of fully state-owned companies is comparably small and thus does not prohibit us from finding more appropriate investments.



Source: United Nations Sustainable Development Goals

What we like in EM corporate debt: strong ESG practices and SDG-aligned business models

"Financials" make up the largest sector among privately-owned corporates, accounting for 30% of the market capitalization of the J.P. Morgan CEMBI Broad Diversified benchmark index, an EM corporate bonds benchmark index. While we place the same ESG demands on them as we do on non-financial corporates, we additionally have a very strong preference for banks that have signed the Principles for Responsible Banking, of which Nordea is a founding signatory. The principles were launched by the United Nations Environment Programme Finance Initiative in 2019 and require signatories to align their "business strategy to be consistent with and contribute to individuals' needs and society's goals, as expressed in the SDGs, the Paris Climate Agreement and relevant national and regional frameworks"[1]. Banks that fall in this category include BBVA Bancomer from Mexico and Bancolombia from Colombia.

We are also enthusiastic about recent developments in the ESG-related bond issuances within the emerging markets. While green, social and sustainable-bonds (which require the issuance proceeds to be used for green projects, social projects or a combination thereof) issuance has grown rapidly in recent years, we have seen the first issuance of a sustainability-linked bond from an EM issuer. Suzano, the world's largest pulp and paper producer from Brazil, issued a bond in September that links the coupon rate to greenhouse gas emission targets. The coupon rate will increase by 25 basis points should the company not achieve a defined level of emission reduction by 2026 (the maturity year of the bond is 2031). We like the sustainability-linked structure for linking sustainability goals to financial incentives; and the transaction has paid off for Suzano with the bond trading with a lower spread than "conventional" bonds from the same issuer.

One other emerging trend that particularly interests us is the involvement of multilateral development banks in new bond issuances. Instead of rolling over existing loans or providing new loans to issuers, they are buying a slice of their bond issuances as co-investors with asset managers from the private sector. We welcome this development. It gives issuers that previously had to rely primarily on development financing access to private capital; it gives bond investors exposure to companies they perhaps could not have funded before, given they were not present in the bond market. An example of such a transaction is a bond issued by Georgia Global Utilities, a water utility and renewable energy producer from Georgia that issued its inaugural bond in July of 2020. Investors in the USD 250 million bond, which is also the first green bond issued out of Georgia, included Deutsche Investitions und Entwicklungsgesellschaft mbH ("DEG"), the Netherlands Development Finance Company ("FMO") and the Asian Development Bank ("ADB").

> **"We like to invest in companies that follow business models that contribute positively to the UN Sustainable Development Goals**

1) https://www.unepfi.org/wordpress/wp-content/uploads/2019/07/FINAL-PRB-Signature-Document-2-Interactive-22-07-19.pdf

Case Study: ReNew Power— delivering renewables to India

ReNew Power is India's leading renewables based independent power producer, and it displays solid ESG characteristics, one of which is strong corporate governance. ReNew's CEO is the only executive director on the Board, and three big institutional investors have Board seats, providing credible oversight. The company also has a strong sense of corporate social responsibility: for example, it is electrifying rural schools in India with solar energy equipment and assisting communities in installing rainwater harvesting solutions. The CEO is deeply involved with these activities and is chairing the CSR committee on the Board of Directors. ReNew Power earns 100% of its revenue from the sale of wind and solar based energy. In 2020, the company won the first ever "round-the-clock" tender award in India in order to supply green energy on a 24/7 basis through the inclusion of storage technology, delivering a "milestone" for the sector[2]. The development of renewable energy is even more important in a country where coal, whose greenhouse gas emissions are even higher than oil, still accounts for more than half of installed capacity.

While the company exhibits high financial leverage due to its sizeable investments in capacity expansion, we believe the long-term nature if its contracts as well as the sector's high importance for the government's green energy goals will benefit the company's access to capital. Although the rating situation of the company has not changed since its first bond issuance in March 2019, its credit spreads have tightened considerably.

The issue with fully state-owned companies

Fully state-owned companies in emerging markets are often less efficient because they frequently are run with political objectives that can threaten the commercial goals and sometimes supplant them completely. Since key management personnel usually gets nominated by the current government, incentives for long-term business planning are low. Additionally, the lack of independent oversight makes fully state-owned companies prone to corruption. In a study that includes state-owned companies from developed as well as emerging markets, the IMF finds that state-owned companies in countries with a low control of corruption have a significantly lower profitability than their private sector counterparts. As the authors of the study put it: "Our analysis also indicates that state owned enterprises (SOEs) are more affected by a corrupt environment than private firms—in a low corruption environment, SOEs can be as, or more, productive than private firms. Our results support the view that when governance is weak, SOEs are more vulnerable likely due to the proximity to government officials and politicians and weaker oversight"[3]. In another publication, the IMF concludes that "SOEs generally have low productivity, distort competition, and can be plagued by corruption. SOEs have fallen short, particularly in developing countries, in providing basic services, such as access to safe water, sanitation, and reliable electricity, to the entire population and further, the model for using and managing SOEs should be strengthened in many countries. The stakes are high because SOEs provide core economic services and could be an important vehicle for achieving the Sustainable Development Goals[4]". Poor management, short-term planning coupled with often high pay-outs to the government (in the form of dividends or taxes) means that for many of the fully state-owned companies leverage is high – a fact that puts pressure on their balance sheets, particularly given the prices of many major commodities have declined over the past years.

2) https://ieefa.org/indias-renew-power-wins-contract-for-24-7-green-energy-with-first-year-cost-of-38-mwh/ 3) "China to stop 'green bond' financing for clean coal projects", Financial Times, May 29 2020. 4) https://www.imf.org/en/Publications/WP/Issues/2019/11/22/Governance-and-State-Owned-Enterprises-How-Costly-is-Corruption-48800 5) https://www.imf.org/~/media/Files/Publications/fiscal-monitor/2020/April/English/ch3.ashx

In theory, fully state-owned companies enjoy one consolation for all this interference: the state will step in as the lender of last resort if they cannot service their debts. This supposition of government backing is a key reason why they are included in several emerging market sovereign debt benchmark indices. Ratings agencies subscribe to this view, and give them credit ratings based on this assumption – reasoning that default risk is reduced due to the sovereign backstop. There is rarely an explicit guarantee, but rating agencies see it as an implicit one. To many investors, bonds of fully state-owned companies are therefore satellite bonds orbiting round sovereigns; this explains why their pricing often moves in line with sovereigns. In times of low yields this has benefited them: yields on bonds of fully state-owned companies on aggregate have fallen in 2020 because yields on sovereigns have done so.

Case Study: A quasi sovereign that is too close for comfort

A Mexican fully state-owned oil & gas producer is the biggest issuer of debt of any emerging market company anywhere in the world, having had a total debt stock of USD105 billion at the end of 2019. It is not hard to see why its debt pile is so large. The company pays a higher rate of tax than private companies, to fund the government's budget. In addition to this burden, the government is compelling the company to build a USD 8 billion refinery to establish energy independence for Mexico – a clear case of a project that might primarily make political sense. The company's cashflow is weak due to the high taxes – and this is increasing the company's cost of debt. The company's crude oil production has fallen from a 2004 peak of 3.4 million barrels a day to only 1.77 million b/d at the end of 2019.

The company's close relationship with the Mexican state could indicate a problem with governance, the "G" in ESG. While half of the board of directors is made up of independent directors, the chairman, who is also the Secretary of Energy, has the right to cast a tie-breaking vote. In addition, three independent board members resigned in 2019 over disagreements over the company's strategy. Several members of the management board have been involved in financial scandals over the years. When it comes to the environment, more than 90% of its revenue is from crude oil and refined oil products and there is little chance of this changing, given the company's business plan does not foresee a prioritization of renewable energy. Looking at its social record, the company's handling of the covid-19 crisis has been criticized in the media, with Bloomberg calling it "the world's deadliest Covid company" in September.

Since the beginning of 2019, the company has lost two out of its three investment grade ratings and the spreads of the company's bonds widened considerably. Reasons for the downgrades included high indebtedness, declining production and a weakening credit-linkage between the company and the state.

And indeed, cases of debt restructurings for fully state-owned companies are rare. We foresee however, that for an increasing amount of fully state-owned companies, investors could start questioning the ability and/or the willingness of their sole shareholder to support the company, decoupling spreads for individual issuers from those of their respective government bonds in the future. Increasing leverage on sovereign balance sheets, impacting the ability to support, might amplify this development. We already see cases of this, as evidenced by the spread of individual state-owned companies' bonds widen to their respective government bonds. Higher funding costs as well as a global push to redirect capital towards more business models that support the UN's SDGs might make the refinancing more difficult for many of those issuers.

There is another crucial reason why we do not invest in fully state-owned companies currently. Many of them have low levels of non-financial disclosure. Because of a lack of information, the majority of the companies do not have ESG ratings from third party rating providers, such as MSCI. According to our analysis, more than 70% of index eligible of fully state-owned enterprises do either not have a corporate-level rating or it is very low ("B" and lower).

We exclude ESG laggards from our emerging market debt strategy on financial grounds, given a poor ESG track record is both a sign of a badly run company and a risk in itself. Think of the USD65 billion compensation paid by BP after the Deepwater Horizon oil spill – a spill caused by the failure of eight different safety systems.[5]

5) "The eight failures that caused the Gulf oil spill", New Scientist, September 8 2010.

Our approach

We like to invest in companies that follow business models that contribute positively to the UN's SDGs (as a minimum, do not obstruct them) and avoid laggards when it comes to corporate ESG practices. Combined with traditional financial modelling, this selection process leads us to a portfolio that looks very different from the benchmark.

The strategy has much less exposure to heavy industry than the benchmark, because of our ESG and SDG focus. Instead, the strategy has more holdings in sectors like telecoms, financials, pharmaceuticals and renewable energy. Given we prepare our proprietary ESG STARS ratings for our holdings, non-availability of third party ratings do not detain us from investing, as long as we can get a holistic picture of the ESG practices of the company based on their non-financial reporting and meetings with management.

Just as poor ESG practices are both sign of poor management and a cause of additional risk, good ESG practices are a sign of good management and an indication of less risk of an unexpected adverse event that could throw the company's business into doubt. Companies contributing significantly to a UN SDG also enjoy an additional tailwind: governments and the public actively approve of and encourage what they are doing, so they are often in sunrise rather than sunset industries.

Three inputs into the investment decision

	ESG Screening (Company focus)	**SDG Analysis** (Product focus)	**Financial Modelling**
Questions to answer	Does the company follow at least average ESG practices?	Does the company produce a product or service that does not harm the SDGs?	What will the credit metrics of the company look like over the next three years?

We are wary of greenwashing

Although we welcome the growth of ESG-related bonds, it always pays, as professional investors, to be wary. We are concerned, in particular, about the risk of "greenwashing" or "social washing", where a bond purports to be sustainable, but is not really so. For example, some Chinese companies have issued so-called "green bonds" to fund "clean coal" projects in the local market, and a majority state-owned bank in India that previously issued a green bond is currently evaluating to help fund a coal mine in Australia. We have avoided such bonds because we do not believe that clean coal is very clean – it leads to less global warming than conventional coal combustion, but still has a large carbon footprint.

The good news is that the Chinese state has proposed excluding clean coal from its regulatory framework that dictates whether bonds can be called green or not[6] and that investor pressure on the Indian bank is growing. This illustrates a wider point: investors can fight greenwashing and social washing by talking to regulators, the syndicate desks at investment banks that help issuers, and the issuers themselves. This process of improving credibility is crucial if ESG-related bond issuance is to keep growing – as we think it will.

6) "China to stop 'green bond' financing for clean coal projects", Financial Times, May 29 2020.

Wuhan city, China.

Conclusion

We like emerging market corporate issuers that can offer transparency, high ESG standards and compatibility with the United Nations' SDGs goals. High ESG standards suggest less risky, better-run companies, and companies contributing to the SDGs tend to be in sunrise industries. We regard companies with poor ESG records as riskier credits. For the same reasons, we welcome the continuing growth of ESG-related bond issuances, while analysing their true sustainability on a case-by-case basis.

What comes next? We think that more companies will resort to bonds to fund their transition from being part of the global warming problem to being part of the solution. It is still early days, but there have been a few pioneers. The transactions of Suzano and Georgia Global Utilities have paved the way and we believe the innovation in ESG-related bond issuances in the emerging markets universe will continue. We are actively engaging with syndicate desks in order to facilitate this development.

We currently find plenty of investment opportunities within the universe of privately-owned corporates and are excluding fully state-owned companies in Nordea's Emerging Stars Bond Strategy. Given the high importance that many fully state-owned companies play in their local economies, for example as large employers or through the fulfilment of policy functions, we will continue to push for a higher level of ESG practices and transparency in the universe on aggregate and will look out for individual issuers that fulfil our criteria in the future.