FRANKLIN TEMPLETON

NAVIGATING ESG DISCLOSURES IN EMERGING MARKETS

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Sustainable investing is more than about seeking companies with top-notch environmental, social and governance (ESG) profiles. It is also about uncovering companies that are improving their ESG footprints, and their disclosures go a long way toward signaling and evidencing such progress. Yet, across emerging markets (EMs), corporate ESG disclosures are uneven and broadly lag those in developed markets (DMs). Investors relying solely on published information to assess EM companies' sustainability efforts and ambitions risk missing the mark significantly.

Therein lies the opportunity for investors who can look beyond the surface. In our decades of investing in EMs, we have developed insights into companies' sustainability journeys through our local research and longstanding engagement with managements. We distil three key observations from our analyses and experience:

- EM companies are not entirely behind their DM peers in ESG disclosure. Firms in select EMs have been more transparent. Also, encouraging is the increasing openness that EM companies have displayed in recent years. Our local presence is an advantage here as we are often able to establish deeper insights though our relationships with companies.
- Market-wide ESG policies and initiatives are gaining ground in EMs. We expect this trend to boost companies' ESG disclosures and public accountability. In fact, we have been heavily involved in driving the agenda around policy advocacy.
- Investors can advocate better disclosures and other improvements through engagement with companies, regulators and other stakeholders. The relationships of trust we have built often give us the leeway to discuss material issues and help shape change.

We believe that some of the most overlooked sustainable investment opportunities in EMs lie in companies making positive ESG transitions. Evolving ESG disclosures—and their impact on investors' ability to perceive and position for these transitions—will be key to watch.

A varied disclosure landscape

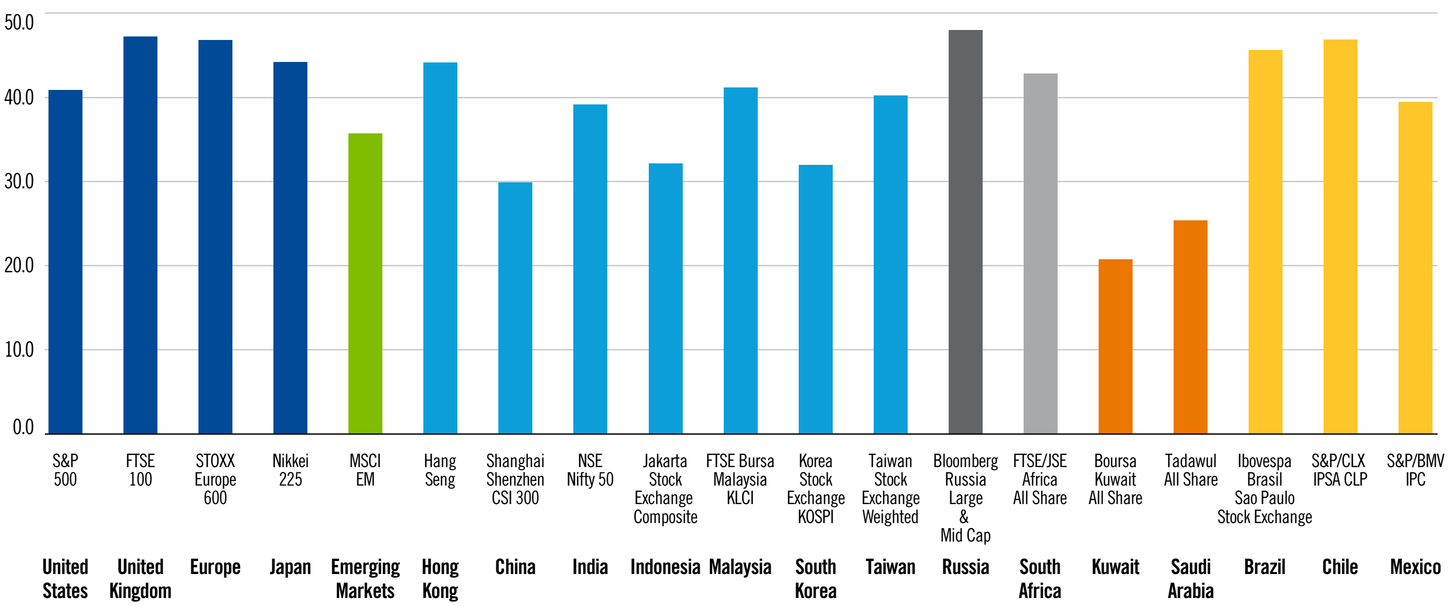
Sustainable investing is often associated with the search for ESG leaders, but that focus can overshadow the investment opportunities that also lie in companies boosting their ESG credentials. This pitfall deserves particular attention in EMs, where a general perception of their ESG gap relative to DMs has kept them off some sustainable investors' radar. That caution has persisted despite EMs' growing ESG awareness over the years.

To some extent, EM companies' ESG reporting shortfalls may have held back investor confidence. Using Bloomberg's ESG disclosure scores as a proxy, we see that EM companies as a whole trailed DM firms in the amount of ESG data that they reported publicly.[1]

By individual market, however, the picture is a lot more nuanced. Levels of corporate ESG disclosure varied widely across EMs, with select markets such as Malaysia and Brazil faring better than the United States. Markets such as Taiwan and India also scored comparably well. Taking a broad-brush view of EM companies' disclosure deficit would discount the pockets of strong reporting practices that exist.

EXHIBIT 1: BRIGHT SPOTS IN EM CORPORATE DISCLOSURES

Market average Bloomberg ESG Disclosure Score (0–100)

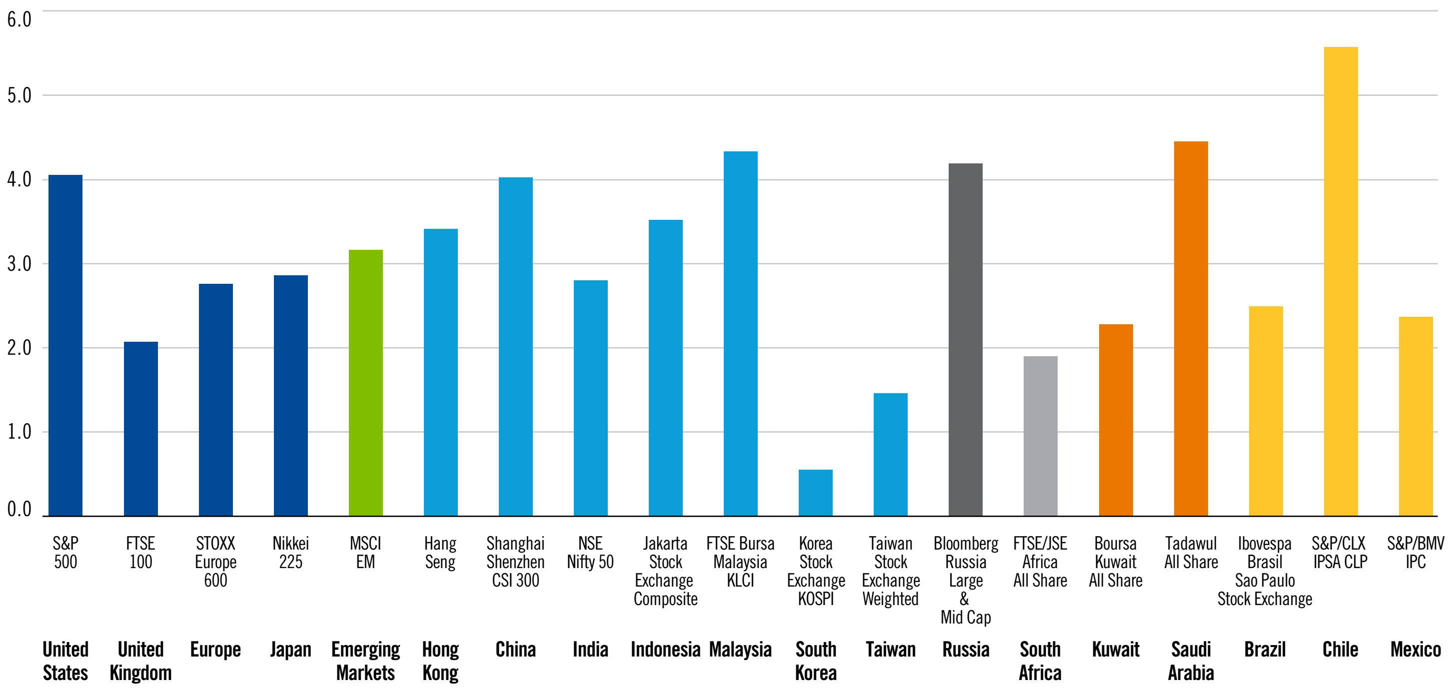


Source: Bloomberg. Latest data as of FY2020 (or, if unavailable, FY2019). Proprietary Bloomberg score based on the extent of a company's ESG disclosure. Companies that are not covered by ESG group will have no score and will show N/A. Companies that do not disclose anything will show a value of '0.' The score ranges from 0.1 for companies that disclose a minimum amount of ESG data to 100 for those that disclose every data point collected by Bloomberg. Each data point is weighted in terms of importance, with data such as Greenhouse Gas Emissions carrying greater weight than other disclosures. A consistent list of topics, data fields, and field weights apply across sectors and regions. This score measures the amount of ESG data a company reports publicly, and does not measure the company's performance on any data point. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

What we also find promising is the growing transparency that most EM companies have shown. Over the past few years, corporate ESG disclosure scores rose more for EMs than for Europe and Japan.[2] The faster pace of advance for EMs could partly reflect the lower base that they started from, and we think they have room to progress further.

EXHIBIT 2: EM CORPORATE DISCLOSURES ARE ON THE RISE

Change in market average Bloomberg ESG Disclosure Score (FY2017 to latest)



Source: Bloomberg. Data based on change from FY2017 to FY2020 (or, if unavailable, FY2019). Proprietary Bloomberg score based on the extent of a company's ESG disclosure. Companies that are not covered by ESG group will have no score and will show N/A. Companies that do not disclose anything will show a value of '0.' The score ranges from 0.1 for companies that disclose a minimum amount of ESG data to 100 for those that disclose every data point collected by Bloomberg. Each data point is weighted in terms of importance, with data such as Greenhouse Gas Emissions carrying greater weight than other disclosures. A consistent list of topics, data fields, and field weights apply across sectors and regions. This score measures the amount of ESG data a company reports publicly, and does not measure the company's performance on any data point. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

Top-down policy tailwinds

ESG disclosures in EMs have improved along with the introduction of market-wide ESG policies and initiatives. We expect this trend to accelerate as regulators and investors become increasingly ESG-conscious, and especially as interest in sustainable investing grows.

Stewardship codes, corporate governance codes and other directives play an influential role in encouraging disclosures. Several EMs with above-average Bloomberg ESG disclosure scores have continued to strengthen their policies. Taiwan, for example, launched a new three-year corporate governance roadmap for listed companies in 2020. As part of measures to enhance information transparency, more companies would have to issue sustainability reports. With Chinese being the predominant language in Taiwan, our analysts' local language skills are often pivotal for accessing critical information here.

India began to apply a stewardship code for mutual funds in 2020, urging institutional investors to boost their monitoring of investee companies and engagement with them. This year, policymakers expanded the scope of companies' business responsibility reports, requiring them to file more quantifiable and granular ESG information.

Meanwhile, certain EMs lagging their peers in ESG disclosures have sought to improve. South Korea's state pension fund and leading institutional investor National Pension Service adopted a stewardship code in 2018, galvanizing a push for greater corporate accountability in the country. While Korea could benefit from a clearer corporate governance roadmap, it has implemented some long-awaited reforms. These include mandatory ESG reporting for KOSPI-listed companies with over 2 trillion won in assets starting from 2025, which would be extended to all KOSPI-listed firms from 2030. We expect improving governance standards in Korea to help lift stock valuation multiples and limit downside risk. Should progressive changes occur, we believe they can translate into higher dividend yields.

China's relative weakness in ESG disclosures belies its considerable step-up over the years. Although China does not have a stewardship code, the China Securities Regulatory Commission (CSRC) released a new corporate governance code in 2018. This year, the CSRC revised annual and semiannual reporting rules for domestically listed companies, requiring them to disclose environmental and social responsibility information under a separate section. The new rules are a meaningful signal of positive change, especially in light of China's carbon neutral pledge and overall elevated emphasis on ESG. In our view, China's move toward mandatory ESG reporting will also likely improve the quality of disclosures that we see from companies.

Stock exchanges pave the way forward

Also noteworthy are stock exchange initiatives aimed at boosting listed companies' ESG practices—and drawing sustainability-focused capital to their markets. Some 93% of EMs have stock exchanges that are members of the Sustainable Stock Exchanges initiative, a United Nations (UN) partnership program that explores how bourses can enhance ESG performance and encourage sustainable investment.[3]

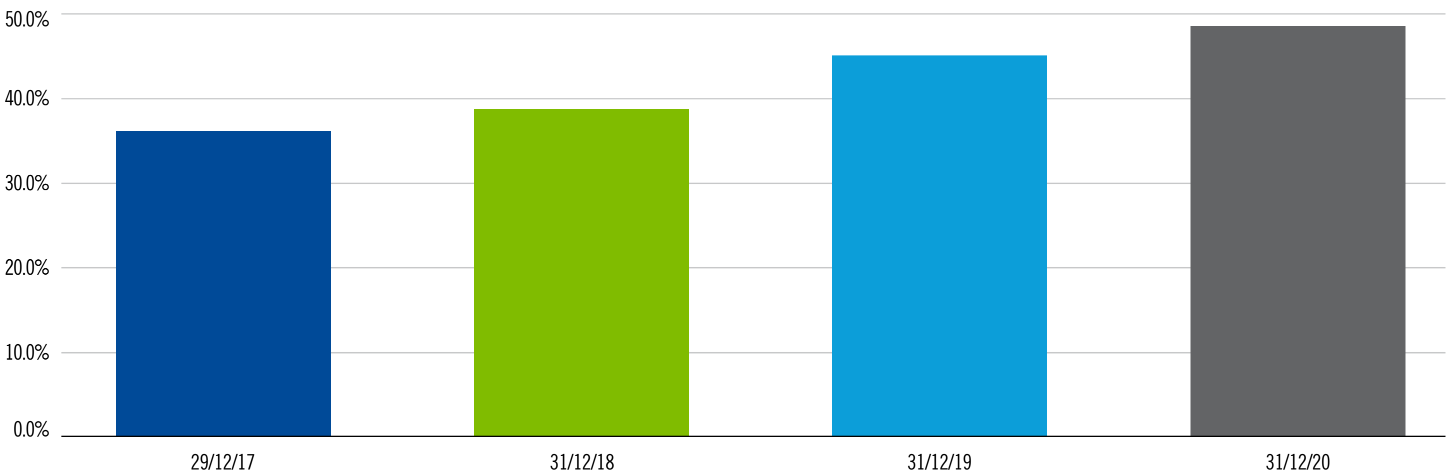
Some stock exchanges have actively pushed for more ESG disclosures. In the Middle East, where disclosure rates have largely trailed both EMs and DMs, almost all exchanges have communicated the need for companies to incorporate ESG considerations into their business strategies and reporting. Several exchanges have developed ESG reporting guidelines for companies. Some, including Tadawul stock exchange in Saudi Arabia and Boursa Kuwait, have announced plans to launch ESG indexes.

We expect ESG indexes to advance the sustainability agenda considerably. Companies seeking inclusion in such indexes have powerful incentives to meet qualifying ESG criteria and report the relevant metrics and targets. Increased disclosure, in turn, deepens their public accountability on ESG issues and could spur them on to bolster their ESG credentials.

Taken together, we think that ESG policies and initiatives have a favorable impact on corporate behaviors. Backing our belief, we have seen many EM companies display increased shareholder friendliness over the years, often reflected in a greater willingness to repurchase shares or raise dividends. In line with the latter, the overall dividend payout ratio in EMs climbed from 36.2% at end-2017 to 48.6% at end-2020.[4] South Korea has been one of the strong improvers on this front, riding on the momentum of policy shifts in the country. Improved corporate behaviors could also manifest in stronger business models and earnings quality, as well as lower ESG risks. Market recognition of all these changes could drive upward valuation re-ratings.

EXHIBIT 3: EMs' DIVIDEND PAYOUT RATIO HAS BEEN ON AN UPTREND

EMs' dividend payout ratio (based on MSCI Emerging Markets Index)



Source: Bloomberg, as of December 2020. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

The value of research, engagement and partnership

Seeking companies moving up the ESG curve is likely to prove challenging for investors without the resources and relationships to make well-informed assessments. Recall that ESG disclosures across EMs are uneven. While third-party ESG ratings are available, research agencies differ in their scope and focus of company coverage. Data gaps and subjectivity can also lead to inconsistent ratings. At times, we have found companies receiving low ESG grades, more due to patchy disclosures than to fundamental problems.

We use published information as a starting point for research and incorporate our own findings to form forward-looking views on companies' ESG prospects. The additional work requires in-depth local studies of individual markets and companies, as well as first-hand access to managements and other stakeholders. Our history of direct engagement with companies is especially integral in enabling us to evaluate their sustainability commitment, understand their ESG strategies and anticipate their potential ESG trajectories.

In the process, we often gain opportunities to work with companies on their ESG disclosures and support other improvements. Many businesses that learnt of our stewardship responsibility, long-term investment mindset, ESG knowledge across EMs and on-the-ground presence in 14 countries have turned to us as trusted partners, seeking our feedback and suggestions through candid two-way dialogues. Companies we have engaged with range from firms with fledgling ESG efforts to businesses building on already high standards.

A focus on materiality frames our discussions—we center on ESG issues that are most likely to affect companies' operational or financial health materially. Common issues include resource efficiency, labor practices and capital allocation, though specific considerations differ widely across industries and companies. We tap our proprietary ESG sector framework guides and investment experience to highlight material ESG issues in our conversations with companies, sharing the market's expectations—and ours—in these areas.

Company engagement in action

Encouraging momentum
We participated in the initial public offering of one of the largest fixed broadband providers in the Philippines. We spoke with the company on its ESG plans, and it was keen to work with us to enhance its ESG framework and communications further.

In a subsequent call with the company, we covered the market's take and our expectations on several ESG issues, including industry reporting standards and the setting of roadmaps. We discussed ESG key performance indicators (KPIs) and the linking of these KPIs to business strategy and management accountability. Another area of focus was the company's environmental footprint, given the energy-intensive nature of its business. We shared our views on the UN Sustainable Development Goals and net-zero targets.

The specifics that we went into, coupled with how we related industry standards and our expectations to the company, made for a conversation that it found refreshing. We agreed to continue the dialogue with the company. Through the interactions, we learnt more about its sustainability agenda and how we can offer support as a partner on its ESG journey. The stock market debutant's ESG efforts were also an indication of a growing sustainability movement in the Philippines.

ESG materiality
We have a longstanding relationship with an Indian diversified financial services company, which provides broking, investment banking, asset management, housing finance and other services. Frequent engagements are a hallmark of our relationship. In one of these interactions, we suggested that the company look into its ESG disclosures and other areas that could be limiting market perception of its ESG profile. The company was interested in our views and proposed a follow-up call.

We touched on market developments in ESG disclosures, ranging from global reporting frameworks to best practices. We also discussed ESG issues that we considered material for the company, such as senior management's ownership of the ESG strategy, human capital management, financial literacy and inclusion, credit penetration and data security. We encouraged the firm to further demonstrate its attention to material ESG issues and offered ideas on how it could do so, including the disclosure of business-relevant ESG targets and statistics.

The company welcomed our perspectives, and more interactions followed. We found our deep relationship with the company setting the stage for us to add value in its quest to bolster its ESG visibility. Its endeavor also dovetailed with an increasing level of transparency that we saw among companies in India.

Building on a strong base
One of the leading branded beverage bottlers in Latin America stands out to us for its comprehensive and well-articulated sustainability strategy. We also have a history of open and collaborative engagement with the Chile-based company.

The company commissioned an independent consulting firm to gather feedback that could inform its ESG report, and it invited us to participate in the study. We noted that the company already demonstrated best practices in several areas. At the same time, we delved into where we saw investor expectations on ESG disclosures heading, and what we considered to be material issues it should keep tabs on.

We viewed the company's drive as an illustration of a broad trend in Chile, where many companies already faring well in ESG reporting were striving to improve as standards and expectations evolved.

Our engagements go beyond the corporate level. We have frequent discussions with regulators, stock exchanges, corporate governance bodies and other stakeholders in our advocacy of sound capital market policies, which can have a far-reaching impact on economic development, corporate behavior and investor interests. We are also members of select stock exchange committees that discuss ESG and other issues.

Engaging with regulators

The Bangladesh Securities and Exchange Commission (BSEC) oversees the country's two stock exchanges, including the main bourse, Dhaka Stock Exchange (DSE). In March 2020, BSEC ordered the stock exchanges to introduce price floors for listed securities to curb market volatility as COVID-19 spread. While we recognized its concerns, we also thought that the price floors obstructed price discovery and created investor uncertainty.

As firm believers in free and efficient markets, we engaged with BSEC, DSE and various market participants to voice our concerns on the price floors and the unintended negative consequences that could arise. We requested the removal of the price floors to restore free market trading and investor confidence.

BSEC acknowledged our concerns. In June 2021, it repealed its orders for price floors. We expect the change to create a better balance between risks and returns in the stock markets, which is vital to their ability to channel capital from investors to productive economic uses.

The long-term premise

We believe that meaningful ESG improvements take time. This makes sustainable investing a lot about identifying companies seeking or making progress on their ESG journeys, just as it is important to spot existing ESG leaders. However, varying levels of ESG disclosures in EMs are likely to keep investors from getting a full view of companies' ESG direction. Even amid growing transparency, we still find proprietary on-the-ground research and sustained company engagement vital in discerning businesses' sustainability commitment and intentions.

Our experience investing in EMs has shown us the difference that deep relationships with companies can make. Mutual trust and two-way communications often pave the way for us to partner with them in exploring and shaping improvements in ESG disclosures and other areas. All this work, if done well, could add up to a competitive advantage in spotting ESG advancers before the rest of the market has adequately priced in their prospects.

1. Source: Bloomberg. Latest data as of FY2020 (or, if unavailable, FY2019). Proprietary Bloomberg score based on the extent of a company's ESG disclosure. Companies that are not covered by ESG group will have no score and will show N/A. Companies that do not disclose anything will show a value of '0.' The score ranges from 0.1 for companies that disclose a minimum amount of ESG data to 100 for those that disclose every data point collected by Bloomberg. Each data point is weighted in terms of importance, with data such as Greenhouse Gas Emissions carrying greater weight than other disclosures. A consistent list of topics, data fields, and field weights apply across sectors and regions. This score measures the amount of ESG data a company reports publicly, and does not measure the company's performance on any data point. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

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3. Source: Sustainable Stock Exchanges Initiative (member list cross checked with current list of emerging market countries based on the MSCI EM Index), May 2021.

4. Source: Bloomberg, as of December 2020. Based on MSCI Emerging Markets Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

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