SPECTRUM

Bonded: EM Credit and ESG

Nachu Chockalingam
Senior Emerging Market Debt Portfolio Manager
Andrey Kuznetsov
Senior Portfolio Manager

Hermes Credit Newsletter
Q1 2019

For professional investors only

www.hermes-investment.com

HERMES INVESTMENT MANAGEMENT

Emerging-market (EM) credit offers exposure to higher growth countries and companies as well as diversification and the opportunity to deliver superior returns. But incorporating environmental, social and governance (ESG) factors is also key in this space. In this issue of *Spectrum*, we explore our engagements on ESG issues in EM credit.

KEY POINTS

- EMs are becoming larger, more liquid and more sophisticated than the broader market has yet appreciated: EM credit is now $1.5tn in terms of size; 8.5x larger than it was back in 2005.
- We find that corporate fundamentals for EM companies are strong, and they are often materially better than their developed-market peers.
- A large 'EM premium' still exists in terms of credit spreads – and although a certain premium is still necessary, we believe it will narrow as investor sophistication grows and the asset converges more to the mainstream.
- Opportunities to engage on ESG issues with companies and governments in EMs are plentiful.

There is no doubt that EM credit is still deeply misunderstood – and underappreciated – by many asset owners.

The EM universe offers the potential for exposure to higher growth countries and companies, with the added benefit of diversifying a portfolio.

But where value can really be added in the markets is where investors deploy smart engagement on ESG issues.

Deploying ESG criteria as part of an investment process is crucial regardless of the asset class you are targeting, and fixed income is no exception (see our 2014 paper *Giving credit to ESG analysis* for more information)[1].

In EM credit, ESG factors can be a significant driver of the sovereign premium – the extra spread pick up in EMs versus developed markets that can be explained by higher sovereign instability. Another consideration of ESG integration is that it may help decrease the chance of capital loss in EM credit.

Moreover, companies in the EM space are ripe for engagement by investors on the full range of ESG issues, with many companies issuing bonds eager to close the gap with their developed peers to lower their funding costs.

In this issue of *Spectrum*, we discuss cases in which we have engaged with EM credit issuers in the long term and reaped the benefits of their ESG improvements as well as new engagement initiatives.

TAKING A FRESH LOOK AT EM ECONOMIES

An emerging market economy describes a country that is progressing to become more advanced, usually by means of rapid economic growth and industrialisation.

There are several criteria that can be used for this classification. One of the most basic is nominal GDP. In 2018, the US economy was the world's largest economy with a nominal GDP of $20.5tn and China was the world's second-largest at $13.5tn[2]. However, this gap is expected to narrow over the next few years as China's economy continues to outpace the US economy's growth.

EMs are coming onto the radars of asset allocators for a number of reasons, not least because they account for 80% of the world's population and nearly 60% of world GDP overall[3].

According to the International Monetary Fund (IMF), EMs are expected to grow at two to three times the pace of growth in developed markets in future years.

In addition, as investors become more sophisticated and EMs develop deeper financial markets and better-capitalised financial institutions, the risk of contagion in times of crisis becomes more contained. Indeed, right now, it is more contained than ever.

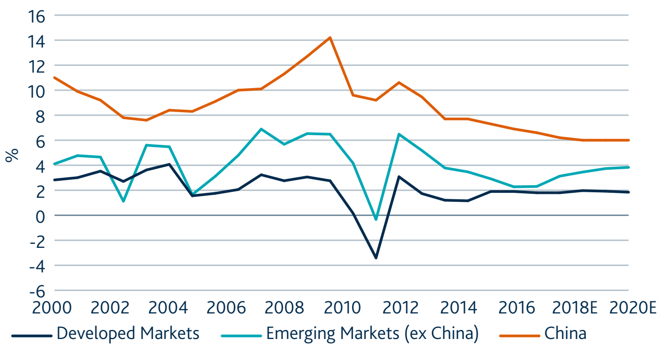
In the late 1990's, a crisis in one EM country could quickly spill over to another, as was seen in the Asian crisis of 1997 and the Russian default in 1998.

More recent country-specific crises, however, have had a more contained effect. For example, the US and European sanctions on Russia in the wake of its annexation of Crimea in early 2014 hurt Russian credit spreads but it left few scars on other EM credit spreads. In addition, last year's financial crises in Argentina and in Turkey were largely localised and did not impact credit spreads of EMs overall.

The EM universe is diverse, and investors are beginning to understand that EMs should not be viewed as a homogeneous asset class to be bought and sold en masse.

For example, there are both oil importers and exporters – fundamentally different types of economies.

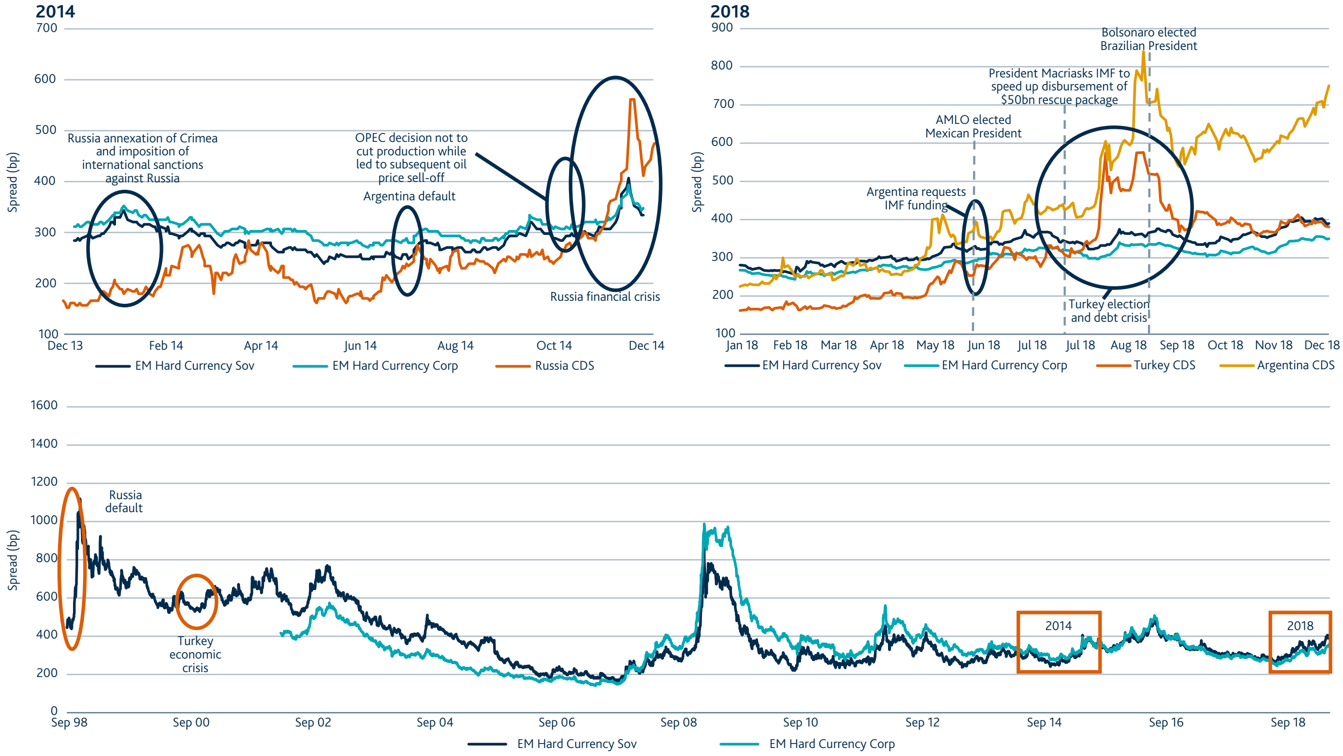
Figure 1. Year-on-year economic output growth in developed markets, EMs and China



Source: International Monetary Fund as at February 2019.

[1] "*Giving Credit to ESG Analysis*," by Hermes Credit in November 2014.
[2] International Monetary Fund as at March 2019.
[3] International Monetary Fund as at March 2019.

Figure 2. EMs are less susceptible to contagion and investor panic



Source: Hermes Credit as at 31 December 2018.

MOVING FROM THE SHADOWS TO THE MAINSTREAM

The EM credit asset class came about as multi-national banks started providing loans to EM governments to fund development and infrastructure spend in the 1970s.

Those loans were largely 'buy and hold' investments with limited trading occurring in secondary markets. Over time, a secondary market developed for investors to manage their exposures more actively.

Indeed, the 1989 Brady Plan, initiated by US Treasury Secretary Nicholas Brady, sought to provide support to EM countries by easing their debt burdens in exchange for progress on reforms.

This created a standardised and more liquid market that attracted more investors to the asset class, helping emerging nations enhance their credit profiles. It also planted the seeds for the fast growth of sovereign and subsequently, corporate credit EM markets.

Fast forward several decades to today and EM fixed income has an issuance size of $2.5tn in hard currency alone – $1.5tn in corporate bonds and $1tn in sovereign bonds[4].

To put those figures into perspective, the EM corporate credit universe is five times larger than European high-yield and global convertible bonds. It is also 50% bigger than the EM sovereign bond universe and 25% bigger than the US high yield market[5].

In the past decade, EM credit was the fastest growing fixed-income asset class and it is now 8.5x larger than it was back in 2005[6].

STRIKING THE BALANCE: SOVEREIGN VERSUS CORPORATE ISSUERS

With size comes a good degree of diversification and higher credit quality. For the most part, the EM credit asset class is rated investment grade (68% of the asset class)[7].

With more than 700 issuers, the asset class provides better diversification than the EM sovereign-bond universe (85 issuers)[8]. In addition, the underlying macroeconomic drivers are much more diverse than the US or European credit markets.

There is a certain mix of corporate and sovereign bonds that optimise the risk-return profile of an overall portfolio, based on efficient frontier analysis.

In our view, looking at return and volatility data over the past 20 years, the optimal mix is about 80% corporate and 20% sovereign over the economic cycle[9].

[4] Hermes Credit as at March 2019.
[5] Hermes Credit as at March 2019.
[6] ICE BAML indices as at March 2019.
[7] Hermes Credit as at March 2019.
[8] Hermes Credit, Bank of America Merrill Lynch Research as at February 2019.
[9] Hermes Credit, Bank of America Merrill Lynch Research as at February 2019.

ASSESSING THE KEY DRIVERS OF PERFORMANCE

EM sovereign returns are driven mostly by geopolitical and macro factors. While it is possible to analyse a country's economic prospects, a change in the political landscape can impact this analysis meaningfully.

For EM bonds issued by corporates in emerging markets, the macroeconomic environment can impact sentiment, but the fundamentals of the issuer are often more important.

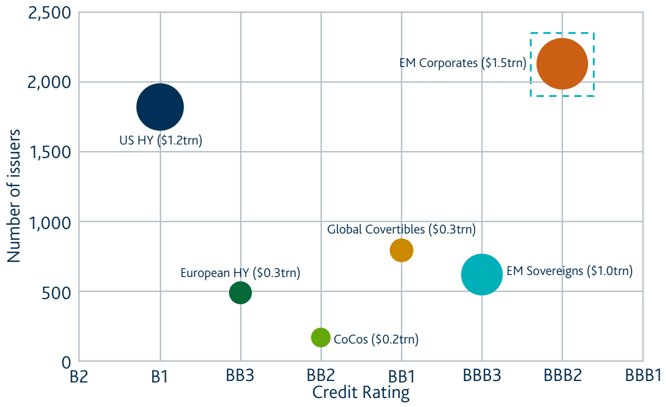
What we find is that corporate fundamentals for EM companies are strong, and often materially better than their developed-market peers. EM companies have been focused on maintaining strong balance sheets and high levels of liquidity.

The issuers have also been much more proactive in terms of dealing with short-term maturities than their developed-market peers, relieving some near-term pressures.

Default rates for EM corporates are still low and expected to remain low – below that of developed-market high yield bonds for the foreseeable future.

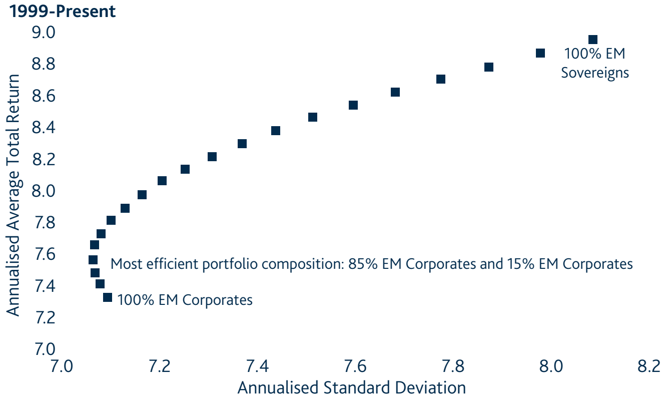
Despite these trends, a large 'EM premium' still remains in terms of credit spreads. While we acknowledge that a certain premium is probably still warranted, in many situations we find that it is too big. What's more, it will likely narrow as investor sophistication grows and as the asset converges more to the mainstream. Indeed, as this investor misconception fades away, there is the potential for bond yields to fall and in turn, prices to rise.

Figure 3. Mapping EM credit against other asset classes



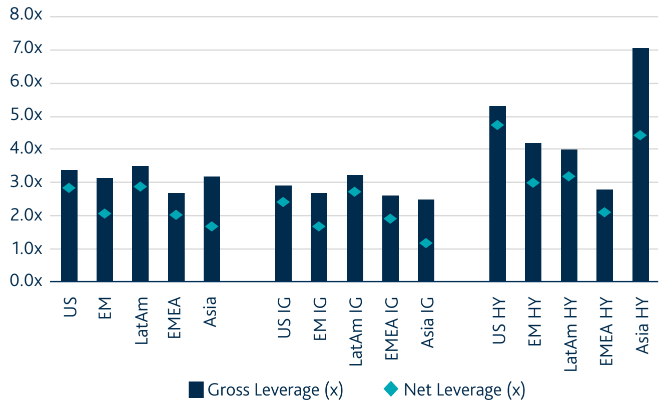
Source: BofAML, Hermes Credit as at February 2019. Note: the size of the bubble indicates market capitalisation of the asset class (in $tn)

Figure 4. The efficient market frontier for EM credit versus sovereign bonds



Source: BofAML, Hermes Credit as at December 2018.

Figure 5. Debunking the myth that EM companies carry more debt



Source: BofAML, Hermes Credit as at 30 June 2018.

INTEGRATING ESG INTO EM CREDIT INVESTING

Finding the right approach to integrating ESG factors into the investment process is essential for delivering attractive returns for investors and sustainable growth for the companies.

To our mind, integration should come at the credit-analyst level with support from full-time engagers.

Training analysts to focus on the impact of ESG factors on future cash flows, enterprise value and, as a result, spread movement is the most efficient approach.

Utilising sector specialists rather than splitting analysts by geography gives them the unique insight to compare the ESG profiles of peers in many industries that are now global in nature, and where issuers often compete in the same marketplace.

Second, rather than excluding issuers it is more prudent to take the 'invest-engage-change-perform' approach that focuses on working with issuers as stewards of capital.

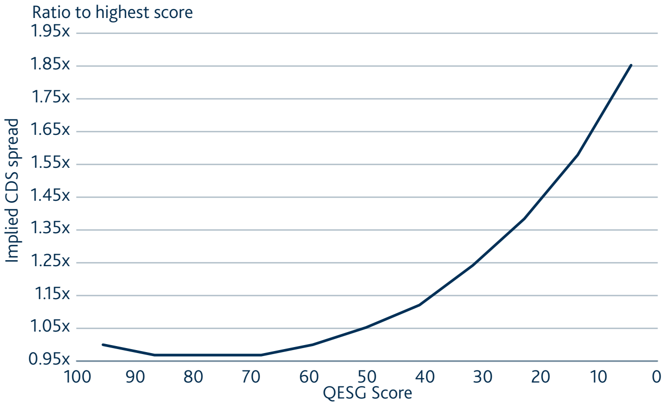
THE TWIN GOALS OF EFFECTIVE ESG MANAGEMENT

When carried out correctly, ESG integration is a dual-goal practice – a combination of risk management and alpha generation.

In terms of risk management, given the rapid underlying-growth momentum supported by structural changes in the economies of emerging nations, one of the biggest risks for permanent loss of capital is ESG failures, such as governance issues.

The alpha-generation element stems from the relationship between the ESG profile of the issuer and credit spreads (see Pricing ESG risk in credit markets: reinforcing our conviction for more commentary[10]).

Figure 6. As perceived ESG scores fall, the cost of CDS insurance against defaults rises



Source: Hermes, Bloomberg as at 20 June 2018.

In short, adjusting for the credit-quality factor, ESG factors have a negative relationship with the cost of funding. That means that improving ESG factors provides a company with cheaper financing and, in turn, the capital to invest for future growth.

Additionally, we have found that this relationship curve has steepened in recent years, driven likely by an increased focus on ESG by the wider market.

We expect this welcome trend to continue.

ENGAGEMENT IN PRACTICE

EM issuers are increasingly acknowledging this relationship and are seeking to narrow the funding gap between themselves and their developed-market peers.

By engaging with those issuers who have grasped and embraced this reality, we are able to help them close the gap and generate alpha for our investors in the process.

However, it's worth noting that engaging with sovereign issuers is not as easy as engaging with corporates, not least because there are so many decision makers involved in changing government policies and practices. We engage with sovereigns during roadshows, conferences, country visits and by working with organisations responsible for promoting better practices, including the UN Principles for Responsible Investment. In the latter, we find that by joining forces with an organisation committed to creating change and like-minded investors, we can build critical mass in pursing policy change at the highest levels of government.

That said, we do not view such engagements as impossible and, while results may take longer to achieve than with corporates, the necessity to engage and the value proposition present are key.

Our case studies below demonstrate the practical application of engagement on ESG issues with EM credit issuers in the long term and how we think about engaging with new sectors in emerging markets.

CASE STUDY 1: SUZANO

Anna Chong, Credit Analyst

Hermes has engaged with Suzano, a leading Brazilian pulp and paper company, on ESG-related matters since 2014 and we have seen significant improvements in disclosures of environmental information.

Our engagement was focused on environmental issues, specifically the disclosure on industrial processes and chemicals used in them. Progress has been made and Hermes' recommendations were included in the company's sustainability reports from 2015 onwards, with disclosure coming in line with its peers. Notably, in its sustainability report, Suzano states that it does not use elemental chlorine in its bleaching process. Hermes has also engaged with Suzano on the use and development of GMO trees.

With regards to governance, Hermes is also engaged on board composition and evaluation and remuneration disclosure. Corporate governance has improved and this has been further precipitated by the shift from a dual share class to a single share class and the listing on the Novo Mercado in 2017, a Brazilian listing segment for companies that voluntarily adopt additional corporate governance practices beyond those required by Brazilian legislation. These governance improvements and single share class enabled Suzano to successfully acquire Fibria, its second biggest competitor in the Brazilian market. This acquisition has enhanced the group's business profile and coincided with credit ratings upgrades and spread outperformance.

Third party ESG research providers can penalise issuers such as Suzano due to issues such as GMO development. However, we feel this is partially balanced by responsible development practices, with GMO trees not being used on a commercial level. Moreover, they have higher productivity per land area and could provide a solution for lower water usage, meaning that these trees are potentially less resource intensive.

Suzano also has certifications from the Forest Stewardship Council (FSC) – but as this doesn't cover GMO trees, Suzano is cautiously managing its GMO programme so as not to put its FSC certification at risk.

[10] "Pricing ESG risk in credit markets: reinforcing our conviction," published by Hermes Investment Management in October 2018.-

CASE STUDY 2: CHINESE REAL ESTATE

Geoff Wan, Credit Analyst

China's real-estate companies have exhibited a period of high growth over the past decade, with rapidly growing enterprise valuations and increasingly larger, and often complex, capital structures.

The cost of debt issuance is relatively high for many of the market leaders in the sector. Corporate issuers are seeking to minimise their cost of financing, from improving their financial ingenuity to broadening the geographical base of their investors.

Homebuilders play a crucial role in driving urbanisation and economic growth in China. New housing stock has improved standards of water sanitation and internet penetration. Urban town planning allows for closer proximity to workplaces and community amenities.

Furthermore, land sales to developers and property sales to homebuyers form a significant contribution to local-government tax revenues.

ESG OPPORTUNITIES FOR INVESTORS

We see substantial unaddressed ESG risks in the sector, associated with the rapid deployment of new urban properties across the Chinese republic.

There is therefore the potential to apply our engagement approach to the management teams of these companies in a bid to reach our common goal of reducing credit risk.

We recently initiated dialogue with two Chinese homebuilders separately, with a plan of engagement focused on addressing three key factors.

The first was human capital management relating to the health and safety of construction workers, and the second was the quality and suitability of construction completed.

Finally, we engaged on issues relating to financing arrangements.

USING ENGAGEMENT TO RESPOND TO A REAL-WORLD INCIDENT

One of the companies had pressing targets set for the completion of a property build within a three-to-four month time frame, from land acquisition to delivery.

Unfortunately, the pressures resulted in major accidents at the site last year.

In addition to our concerns on a human level, we argued that repeated incidents would lead to margin erosion, free cash-flow detriment and reduced confidence in the company's non-Asian investor base.

The company responded by sharing new measures with us to minimise a repeat of the incidents.

These included extending the sale-to-completion target, introducing back-loaded fees to be paid on completion of construction and changes to personnel remuneration schemes to incentivise safe delivery over property completion.

The company also strengthened safety clauses in supplier contracts and established a health and safety committee at the project, district and company level to monitor construction in progress.

TRANSPARENCY IS KEY

At Hermes, we strongly believe that transparency is key to improving ESG results in practice.

We therefore also encouraged the company involved in this engagement to make regular public disclosures in relation to each of these new implemented changes.

This has helped to restore investor confidence and assist investors in analysing the company's improvement in ESG-related practices and behaviours.

In the case of one of the companies, we sought to understand capital-allocation policies and aspirations for the funding of green projects.

We also probed the financial discipline and rationale behind the adoption of a subsidiary structure for a new bond issuance – a decision that had caused concerns amongst investors.

We are now having ongoing discussions with the company amid the adoption of a new structure to segregate onshore and offshore funds, off-balance sheet financing and the issuance of green financing committed to green buildings, to be in line with the government policies and incentives.

AN ASSET CLASS AT THE CONFLUENCE OF POSITIVE TRENDS

Today, EM credit warrants investors' attention: it is a large, diverse and highly-rated asset class that still lies in the shadows of many other credit asset classes. And herein lies a real opportunity: asset allocators can diversify their portfolios[11] and enhance their risk and return portfolios by investing in EM credit.

As we have demonstrated through our case studies, there is much to achieve through ESG integration and engagement in this asset class. Indeed, given the pace of adoption of ESG in the developed-market credit space, we believe that the same can be achieved in EM credit, which will generate material benefits for both investors and issuers.

Issuers are acutely aware that investors are increasingly focusing on ESG and by adopting better practices and policies, issuers can achieve a lower cost of capital. And encouragingly, they are keen to embrace ESG, as evidenced from our many – and ongoing – engagements in EM credit.

[11] "Beyond borders: breaking down silos in credit," published by Hermes Investment Management in September 2018.

HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | Denmark | Dublin | Frankfurt | New York | Singapore

Why Hermes Credit?

Edge
A focus on security selection through the capital structures, and across debt instruments, of issuers worldwide. We believe that capturing superior relative value depends as much on finding attractive securities as identifying creditworthy companies. This approach helps to deliver strong returns through the cycle.

Rigorous, repeatable process
Intensive relative-value investing in bonds, loans and derivatives. This bottom-up credit selection is guided by top-down analysis. Risk management is a core function at all stages of our investment process.

Experienced team
Skilled, integrated team whose principal members have worked together since 2004. We are expert managers of global multi-strategy, high-yield and investment-grade credit strategies.

Aligned interests
The autonomy of a boutique with the operational strength of an institutional fund manager. To ensure our interests are aligned with our clients, long-term outperformance is a condition of incentive pay. The Hermes Investment Office performs independent risk management.

For more information, visit **www.hermes-investment.com** or connect with us on social media: