

Emerging Market Debt: Navigating ESG Risk and Uncertainty

Authors



Pelumi Olawale, CFA
Client Sustainability Strategy
Strategist



Katrina Uzun
Institutional Portfolio Manager



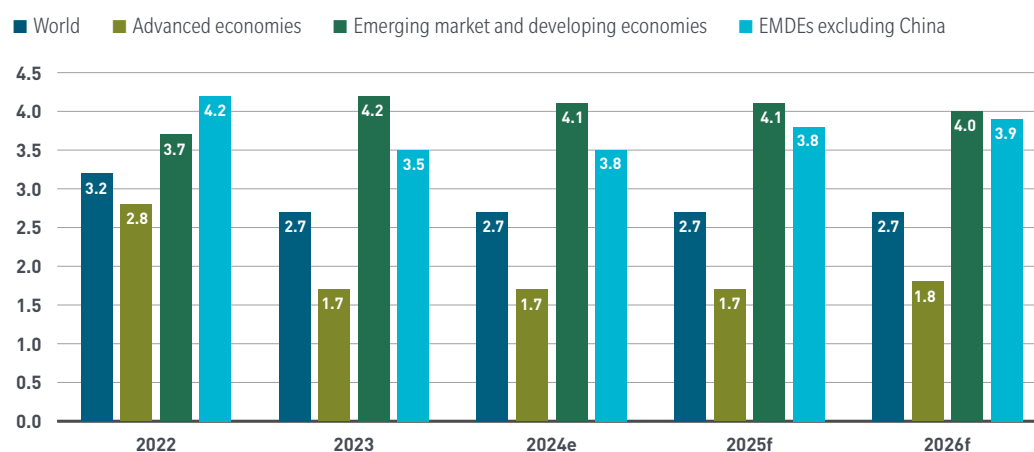
Aimee Kaye
Emerging Markets Sovereign
Research Analyst

In brief

- Understanding material Environmental, Social and Governance (ESG) factors is an important aspect of assessing investments in emerging market issuers in view of their vulnerability to climate change and other social and governance factors.
- The energy transition in emerging markets has its own unique dynamic and risks that need to be taken into account in the investment process.
- We model these risks with the help of our EM ESG dashboard and other tools and engage with issuers to better understand how these factors affect them as part of our long-term active approach.

From diversification benefits to attractive return potential, we believe there are several reasons to consider a strategic asset allocation to emerging markets (EM). According to the world bank's short-term forecasts, GDP growth in emerging markets and developing economies (EMDEs), excluding China, is expected to average 4.1% and 4.0% in 2025 and 2026, respectively, compared to 1.7% and 1.8%, respectively, for advanced economies.¹

Exhibit 1: Real GDP Growth — Short-Term Forecasts



Source: World Bank.

Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information. Consequently, projections presented here may differ from those contained in other World Bank documents, even if basic assessments of countries' prospects do not differ at any given date. The World Bank is currently not publishing economic output, income or growth data for Turkmenistan and República Bolivariana de Venezuela owing to lack of reliable data of adequate quality. Turkmenistan and República Bolivariana de Venezuela are excluded from cross-country macroeconomic aggregates.

1. Headline aggregate growth rates are calculated using GDP weights at average 2010–2019 prices and market exchange rates. 2. GDP growth rates are on a fiscal year (FY) basis. Aggregates that include these countries are calculated using data compiled on a calendar year basis. For India and the Islamic Republic of Iran, the column for 2022 refers to FY2022/23. For Bangladesh, the Arab Republic of Egypt and Pakistan, the column for 2022 refers to FY2021/22. Pakistan's growth rates are based on GDP at factor cost. 3. World growth rates are calculated using average 2010–2019 purchasing power parity (PPP) weights, which attribute a greater share of global GDP to emerging market and developing economies (EMDEs) than market exchange rates. 4. World trade volume of goods and nonfactor services 5. Indexes are expressed in nominal US dollars (2010 = 100). Oil refers to the Brent crude oil benchmark. For weights and composition of indexes, see <https://worldbank.org/commodities>.

Our research shows that factors that include physical climate risk, natural resource management, social stability, the quality of education, income inequality, rule of law, labor rights, voice and accountability are leading indicators of creditworthiness of emerging market issuers. Understanding how these factors affect issuers is critical to our ability to assess their probability of default and potential changes in credit spreads through time; however, materiality is key to this assessment of these risks.

This paper explores how we consider material ESG factors, including climate change, in our investment approach to emerging market debt (EMD), and some of the related questions regarding the energy transition in emerging markets.

Our Approach

1. Assess and model material risk factors using our ESG dashboard

Using an array of metrics, we have constructed an ESG dashboard which our analysts and portfolio managers may use in the investment decision-making process. This tool allows our portfolio managers to understand the range of material risks and opportunities beyond financial reports, allowing them to track and compare ESG performance across issuers over time on a consistent standardized basis and relative to the level of development of a country. When using the dashboard, our focus is typically on two key questions:

- a. Relative performance: Which issuers fare better (or worse) on ESG factors relative to their peers or, in the case of sovereigns, relative to what their level of development would suggest?
- b. Directionality: Which direction are ESG metrics trending in?

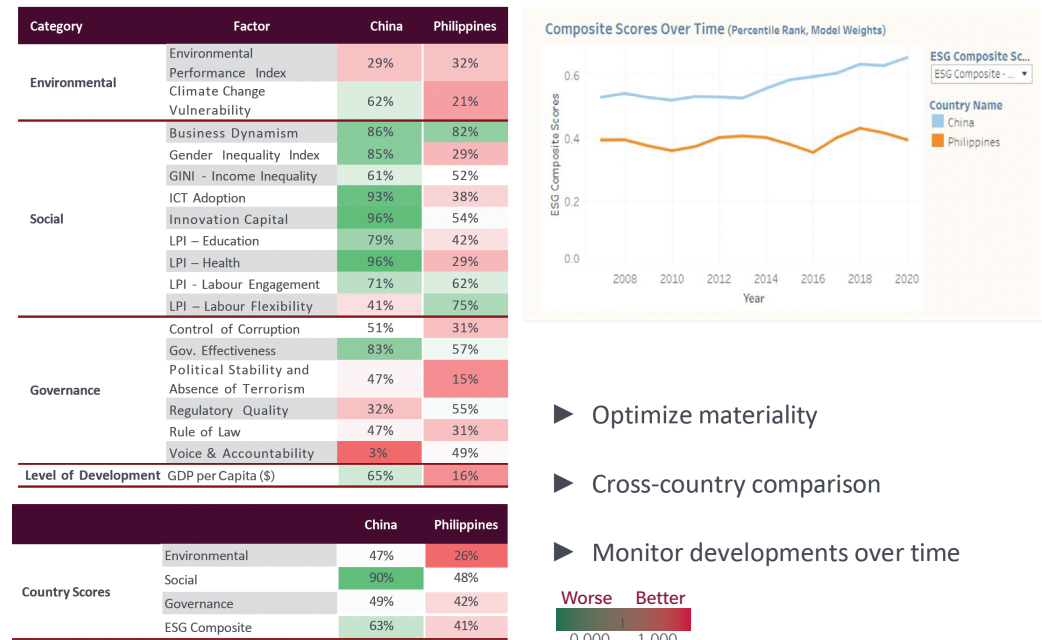
The ESG data we rely on in our dashboard is compiled from a variety of credible data sources chosen for their broad availability across emerging markets as well as their depth and spread across time.

Traditional ESG data sets tend to use static weightings for environmental, social and governance factors — for example, using equal weightings of 1/3, 1/3 and 1/3. Our ESG dashboard on the other hand applies weightings and relevance to factors derived from quantitatively back-tested correlations over time. Since materiality is not a static phenomenon, we consistently run these regressions to determine if spread materiality is changing and subsequently consider these changes in our weightings.

While there is broad consensus in emerging market investing that governance is the most important pillar, social factors such as education and health are also crucial, with environmental factors slowly increasing in relevance. We currently use base weightings of 15%, 35% and 50%, respectively, for environmental, social and governance factors in our dashboard, which our analysts can adjust further to accurately reflect their perceived level of relevance to each issuer.

Our ESG dashboard allows our analysts and portfolio managers to understand the range of material risks and opportunities beyond financial reports. ESG data is compiled from respected data sources with breadth and depth across EMs.

Exhibit 2: MFS Sovereign EM ESG Dashboard



Sample report provided for illustrative purposes only.

It is important to note that the ESG dashboard does not provide a forward-looking assessment of material ESG risk factors. However, it does indicate potential trends and changes in underlying fundamentals that allows our investors to have an informed view on potential changes in these risk factors.

2. Engagement and accountability

We believe that an integrated approach must consider both short-term risks and long-term risks when assessing issuers, and that open communication with issuers is a crucial aspect of bond ownership. We believe that, as long-term asset managers, we can positively influence governance and business practices by encouraging executive teams to recognize that these issues are relevant to an increasingly broad investor base and require further consideration. Our emerging market debt portfolio managers and credit analysts typically conduct numerous meetings per year with government officials, company executives, opposition politicians, economists, academics, journalists and consultants. These meetings include interactions designed to deepen their understanding of issuers as well as engagement meetings to deep dive on material topics affecting the issuers.

In our engagements with two EM issuers (Chile and Uruguay), we noted both countries have strong fundamentals and ambitious sustainable development goals and progress recorded on internal reforms aimed at strengthening macro policy frameworks — all of which factored into our decision to participate in both countries' Sovereign Sustainability-Linked Bond (SSLB) and Sustainability-Linked Bond issuances. Both countries have pioneered bond issuances which feature specific coupon step-ups (and step-downs in the case of Uruguay) tied to performance on key indicators that include meeting their greenhouse gas emission targets by 2030 and improving board gender diversity by 2031.

As part of our continuous risk assessment process, we conduct periodic sustainability reviews on our portfolios. These reviews allow us to refine our understanding of portfolio ESG risks and arrive at our own independent assessment of material risks.

Lastly, in our engagements with issuers, we are careful to be respectful of local norms in our engagement and do not apply a one-size-fits all approach to our expectations.

Navigating the transition in emerging markets

Emerging markets face the challenge of balancing economic growth, access to affordable energy and poverty alleviation while avoiding carbon-intensive pathways. Just Energy Transition Partnerships (JETPs) are nascent financing mechanisms which aim to finance coal-dependent emerging economies' self-defined pathways away from coal.² So, what does the energy transition mean for investors in emerging market debt and how should investors be thinking about the potential economics of the energy transition in emerging markets?

1. **Transition-Related Costs and Debt Serviceability:** The energy transition requires significant investments in renewable energy and energy efficiency infrastructure. Increased borrowing, which these projects will require, must be carefully assessed in terms of their effects on issuers' balance sheets and creditworthiness. Foreign currency borrowings without long-term local monetary and fiscal policy alignment should raise concerns.
2. **Transition Risks and Stranded Asset Risks:** Fossil fuel projects will face increasing vulnerability as the energy transition progresses. The International Energy Agency (IEA) estimates that stranded assets in power generation will be around US\$120 billion by 2035.³ Given that current energy transition partnership plans are primarily targeted towards funding natural gas projects (with lifespans ranging from 15 to 30 years),⁴ investors need to assess what will happen to these investments in the long term should the cost of renewables continue to decline at the current pace in the global north. A solid understanding of the implications of a country's transition plan, including its implications for existing and planned fossil fuel investments, is essential.
3. **Social Impact and a Just Transition:** The United Nations Framework Convention on Climate Change (UNFCCC) estimates that the energy transition could negatively impact 1.47 billion jobs globally in critical economic sectors, including agriculture, manufacturing and transport. However, the transition presents opportunities as well. According to the International Labour Organization (ILO), climate action, if conducted properly, has the potential to result in significant economic gains, including a direct economic gain of US\$26 trillion by 2030 compared to business as usual and a net job creation of 24 million green jobs.⁵ Investors can potentially benefit from lending to sectors experiencing energy transition tailwinds, but need to consider unintended adverse effects on local labor.
4. **Climate Resilience and Adaptation Measures:** Climate risks pose significant challenges to emerging market countries, including extreme weather events, water scarcity and disruptions to agriculture. Assessing vulnerability, climate resilience measures, adaptation strategies and investments in climate-friendly technologies are essential. Monitoring green bond issuance and the quality of use of proceeds could provide insights into countries' ability to attract capital for climate change mitigation projects.
5. **Regulatory and Policy Changes:** Governments worldwide are implementing policies to support the energy transition, including carbon pricing, renewable energy mandates and stricter environmental regulations. Given the experimental nature of a lot of these policies, some reversal is inevitable. Understanding these policies and their implications is crucial for assessing investment opportunities.

Case Study: Morocco

We present the case study below to illustrate how we incorporate ESG factors in our assessment of Morocco's sovereign debt.

- Morocco faces considerable risks linked to climate change, including drought risk and a high level of dependence on imported energy and food products.
- However, the country is making significant inroads on addressing key structural challenges such as health care, education and labor participation. In addition to its steady progress on these issues, Morocco's relative political stability and healthy institutions allow for a favorable environment for tackling future challenges.
- In our view, the aforementioned factors are important parts of a mosaic which make a compelling case for investing in this market. Ultimately, we want to be able to capture the improvement in valuations as issuers benefit from improving ESG performance, and close engagement with issuers is an important mechanism to achieve this objective.

Exhibit 3: Morocco Sovereign Debt – ESG Assessment



Environmental

Drought Risk and Energy Dependency:

- High concentration of economic activity within rain-fed agriculture creates disproportionate risks from drought
- Drought increases dependency on imported food and disproportionately impacts poor rural communities
- Imported oil also drives up the external deficit

Government Mitigation

- Effective implementation of economic diversification agenda
- Heavy investing in renewable energy production (large solar potential)



Social

Improving Health

Within poor rural communities:

- Lower mortality rates; eradication of communicable diseases; increasing life expectancy

Education Challenges

Implementation of the 2019 Education Act may address these issues:

- Elevated high school drop-out rates; low international test scores, limited STEM schooling

Uneven Labor Participation

Development of a robust manufacturing sector challenged by:

- High youth unemployment rate; low (<20%) female participation rate



Governance

High Relative Stability

- Monarchy is stable and well-respected
- Healthy institutions skilled in upholding the rule of law, government effectiveness, and institutional quality

Navigating COVID-19

- COVID-related funds were raised and disbursed efficiently
- On track to effect broader social assistance programs without significant backlash

The country has made slow but significant inroads on its sizable structural challenges

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Conclusion

Successful investors in emerging market debt must contend with complexity and uncertainty on several levels. We believe our integrated approach, our ability to identify and model material risk factors and our engagement-focused model favorably position us to effectively manage risk while focusing on capitalizing on investment opportunities. ▲

Endnotes

- ¹ Global Economic Prospects, June 2023. World Bank. <https://openknowledge.worldbank.org/server/api/core/bitstreams/2106db86-a217-4f8f-81f2-7397feb83c1f/content> (Accessed: 01 September 2023).
- ² Just Energy Transition Partnerships: An opportunity to leapfrog from coal to clean energy. International Institute for Sustainable Development (iisd.org).
- ³ (2016) Energy transition after the Paris Agreement - OECD. Available at: <https://www.oecd.org/sd-roundtable/papersandpublications/Energy%20Transition%20after%20the%20Paris%20Agreement.pdf>.
- ⁴ The life cycle of oil and Gas Fields (no date) Planète Énergies. Available at: <https://www.planete-energies.com/en/media/article/life-cycle-oil-and-gas-fields#:~:text=Oil%20and%20gas%20fields%20generally,the%20very%20high%20extraction%20costs>.
- ⁵ (2019) Discussion paper leaving no one behind planning for a just transition. Available at: https://unglobalcompact.org.au/wp-content/uploads/2019/08/2019.08.27_Just-Transition-Discussion-Paper.pdf.

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Emerging markets can have less market structure, depth, and regulatory, custodial or operational oversight and greater political, social, geopolitical and economic instability than developed markets.

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