Mind the value gap - The Banker

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- Supplements » IMF/World Bank 2007

Mind the value gap

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In India, long-term value is being left on the table as environmental, social and governance issues are ignored. But these issues will be increasingly important competitive differentiators, writes *Dan Siddy*.

Ten years after the Asian financial crisis, companies in India are raising record levels of foreign capital through equity offerings. Overall, portfolio equity flows to developing countries surged to a record $94bn in 2006, 15 times the 2002 level. Along with China, India is one of the most popular destinations; foreign portfolio investment flows into India have risen dramatically in the past five years and are projected to hit $11.5bn by the end of the year, out-stripping foreign direct investment in the country.

But asset owners, fund managers and issuers alike may be leaving long-term value on the table by ignoring sustainable development fundamentals. Attentiveness to environmental and social drivers of business performance will become an increasingly important competitive differentiator, especially when the current boom cycle turns.

Indian corporates issued more than $19bn in shares in 2006, up 23% on 2005, and records continue to be broken in 2007. Investors flocked to Indian real estate group DLF's record $2.4bn initial public offering (IPO) this June. A few weeks later, ICICI Bank, India's largest private-sector financial institution, provided the country's biggest ever share issue with its $5bn secondary offering in Mumbai and New York.

Sustainable investment

Investors in North America and Europe have long since realised the importance of non-traditional risk factors related to corporations' management of environmental, social and governance (ESG) issues. Globally, assets of about $3700bn are now managed under various styles of 'sustainable' or 'responsible investment'. The bulk of this is investment in US and European stocks. But major western pension funds are now shifting their attention to sustainability issues in their emerging market exposure.

Lower labour costs, easy access to natural resources, high demand for property and infrastructure development, and rapidly growing consumer markets are among the key drivers behind the renaissance of the emerging markets. However, these competitive advantages frequently involve critical environmental and social issues, from human rights

and labour standards to rainforest degradation and carbon emissions. Emerging market economies also face major challenges from climate change, poverty and HIV/AIDS.

Sustainable development fundamentals therefore have the potential to create or destroy long-term shareholder value in emerging market companies in a major way.

In the case of India, for example, phenomenal economic growth goes hand in hand with huge social and environmental challenges as the economy struggles to increase capacity. India's woefully inadequate infrastructure will require investment of more than $330bn over the next five years to double power generation capacity and construct new highways and ports. These projects, and India's huge development programme for special economic zones, all involve major environmental and social impacts and associated project completion risks.

More than 70% of the population is still dependent on India's failing agricultural economy, and poverty levels remain high. Water scarcity and groundwater pollution affect all sectors of the economy, and the World Bank has warned that India's demand for water could exceed all sources of supply by 2020 unless action is taken now.

Global climate change is likely to result in severe droughts and floods in India, and will have major impacts on human health and food supplies. Yet the Organisation for Economic Co-operation and Development (OECD) estimates that more than a quarter of India's most highly polluting companies fail to comply with the applicable environmental standards and, on current form, by 2025 India will be world's fourth largest source of greenhouse gas emissions.

Social and environmental performance is already material to the competitiveness and profitability of Indian companies competing in global markets. Within five years, it is likely to become an imperative for corporate survival.

Some of India's publicly listed companies are already gaining competitive advantage based on sustainability-related issues. For example, Suzlon, one of the world's leading wind power generation firms, is a firm favourite in the portfolios of many ESG-oriented investors, including Blackrock Merrill Lynch's $3bn New Energy Fund. Other Indian firms have embedded sustainability into their corporate DNA, such as Tata Motors, Bajaj and HDFC Bank. Transparency and disclosure practices are also slowly improving.

Social awareness

Many of the best companies in Asia have always taken an holistic approach to the business of business, recognising that the 'wealth' they generate includes their contribution to social progress and environmental stewardship as well as the financial bottom line. Leading Indian business groups, such as the Tata dynasty, were founded on a modest, socially aware approach long before corporate social responsibility and glossy sustainability reports became *de rigueur* in developed markets.

But, although interest in initiatives such as sustainability reporting is on the rise, the number of companies publishing annual sustainability reports is still relatively small in comparison with the demands and challenges of ESG issues. Less than half a dozen Indian companies publish reports based on the internationally recognised good practice standards of the Global Reporting Initiative. And information published by CalPERS, the $210bn Californian pension fund, suggests that Indian companies may run a greater risk of failing the responsible investment test than companies from other emerging markets.

ABB Ltd (India), Hindustan Lever and Mangalore Refinery & Petrochemicals Ltd have all failed to make the ESG grade for inclusion in the portfolio managed by DFA, one of CalPERS' three emerging market managers. DFA also maintains a watch list of emerging market firms where ESG concerns could lead to them being screened out in future. India tops the list with 22 firms in the 'fail?' category. Of these, 17 are BSE-100 companies and 11 are among the top 50 companies in the S&P CNX Nifty Index. They include well-known names such as Hindalco, Reliance Industries and Sterlite. Potential areas of concern range from involvement in Burma and Sudan to the use of child labour and disputes over water rights.

The value gap

A recent report, *Sustainable Investment in India*, by think tank TERI Europe and advisory firm Delsus, suggests that inattention to the ESG issues affecting Indian companies may mean that many companies are over-valued or under-valued, at least by long-term investors. For example, the investment prospectus for DLF's $2.4bn IPO in June this year disclosed 42 pages on outstanding litigation and material developments related to numerous residential, commercial and industrial projects. Much of this was linked to the eviction of traditional occupiers of land and failure to obtain the necessary environmental approvals prior to starting construction.

Yet DLF publicly discloses very little analyst-friendly information on its management systems for handling social and environmental problems, and virtually nothing on how issues such as water scarcity or energy efficiency pressures will affect its long-term business strategy and growth objectives.

Lack of basic data, let alone in-depth analytical research, currently restricts investors' ability to derive such long-term insights.

However, buy-side and sell-side analysts, ratings firms and independent research houses are slowly but surely building up on-the-ground ESG capacity in India. CRISIL, India's leading investment research and rating firm and a member of the Standard & Poor's family, is developing a sustainability index product that is due to be launched early in 2008. Sustainable investment products are also now appearing on the domestic mutual fund market – in March 2007, ABN AMRO launched the Sustainable Development Fund, for example.

These trends will gradually increase transparency and enable investors to become more discriminating. According to TERI Europe, however, India lags so far behind other advanced emerging markets, such as Brazil, that more concerted action is needed to maintain the competitive edge of India Inc. Local market participants are now beginning to focus on industry-level strategies for ensuring that India has an investment climate that supports better management of ESG risks and opportunities.

Ultimately, however, the pace of progress depends on the actions of fund managers investing in Indian equities from the remote comfort of London, New York or Zurich. Only a handful of managers offer ESG-enhanced emerging market investment capabilities, and those that do mainly rely on relatively crude techniques such as ethical screening.

Understanding how ESG issues influence long-term shareholder value in an emerging market context, especially in India and other Asian countries, requires more sophistication and deep local knowledge. Emerging markets can differ greatly from developed markets in terms of the types of ESG issues that can be material to risk-adjusted returns; the pathways and timescales over which such ESG risks can be transmitted to the bottom-line. The business culture of corporate disclosure and corporate social responsibility also varies widely. Importantly, there are also significant differences between emerging markets: the ESG issues that are relevant in Mumbai are not the same as those that apply in Shanghai or Bangkok, and different engagement styles are also needed.

With notable exceptions, such as First State Investment, ABN AMRO and State Street Global Advisors, few emerging market managers are developing such 'deep' capabilities for sustainable investment in India and other developing countries. The number of 'sustainable' fund managers to develop emerging market bandwidth is even smaller.

Concern grows

Institutional investors are becoming concerned about this gap in the industry. The International Finance Corporation (IFC), the private sector arm of the World Bank, forecasts that in the second half of this year at least one major European pension fund will begin a thorough review of emerging market managers' capabilities for handling ESG-related risks. The IFC, which recently approved a pilot investment in State Street's new sustainable emerging market fund, also plans to continue pushing the envelope. It has commissioned Mercer Investment Consultants to carry out a similar manager survey.

Mercer's IFC-funded research into the ESG capabilities of emerging market managers should be completed in early 2008, and the IFC expects to make the report publicly available. It remains to be seen which fund managers measure up.

Dan Siddy is director of Delsus Limited, a sustainable investment advisory firm specialising in the emerging markets. He is the former head of the IFC's sustainable financial markets facility.

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