AIKYA

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Responsible Investing in Emerging Markets

The name Aikya means oneness in Sanskrit which reflects our core belief that true stewards align their businesses with the interests of all stakeholders. The challenge, however, is that it is not easy to establish whether a business is behaving responsibly from an Environmental, Social and Governance (ESG) standpoint.

Assessing ESG behaviour requires a different analytical approach. It requires investors to look past financial statements and scripted management commentary to consider ESG information that is genuinely relevant. This is no easy task given ESG information is often misleading or covered in greenwash[1]. Moreover, the investment community at large still views sustainability issues as 'externalities' that are immaterial in the context of investment returns.

The reality is that subject to the pressure of stakeholders, regulators or industry change, these 'externalities' could become 'internal' rather quickly, and influence the investment case for a company. And as the examples outlined in this paper detail, by the time these issues become relevant to the financials of a company, they are already reflected in the share price.

There is no perfect company. Every business in the world has multiple ESG challenges it must solve, and some of these issues remain immaterial for a long time. As analysts, we require a framework to assess these issues, and a structure to think about short-tail and long-tail risks.

We believe it is best to focus the analysis on a company's key decision makers.

Through studying historical actions (and inactions) of management teams and major shareholders, we try to identify the highest quality people in our investable universe. These 'stewards' typically have proven track records taking care of minority shareholders, and behave well towards other stakeholders such as customers, employees, government, the community and the environment. Once we invest alongside such stewards, we trust them to make sound judgements on a variety of ESG issues specific to their industry. The idea is that if such business leaders have acted responsibly in the past, they can be expected to do so again in the future.

This paper attempts to describe how we identify high-quality stewards. It touches on how we develop trust in business groups, and how we approach analysing their historical track records. The purpose here is not to describe an exhaustive list of criteria that we apply, but instead to give reader a general feel for the line of questioning we pursue. We also describe a few cases where investors ended up with significant permanent loss of capital by ignoring certain ESG issues, until they became too apparent. While we avoided these events, we still spend time studying the past to better inform future investment decisions.

[1] greenwash is disinformation disseminated by an organization so as to present an environmentally responsible public image.

What is the Purpose?

Deciding on what products to manufacture and which markets to serve is the most important decisions for management teams; such choices reflect their thoughts on Sustainability.

We ask, does a business help solve problems related to Sustainable Human Development[2], while reducing its ecological footprint? While the current strategic positioning of a company is important, what is more important for us as investors is how management plans to evolve their product and market offerings over the next 10-20 years. We find it instructive to look at their past divestments and investment decisions, and their track record in developing new sustainable products and services.

Tingyi was one of the first companies to start marketing Ready-To-Drink (RTD) tea in China in 1990s. Its beverage franchise recorded several years of strong growth thanks to its broad product portfolio and extensive countrywide distribution. But what is the purpose of the business beyond selling greater volumes of sugary RTD products to the Chinese population? Is their offering even relevant to the needs of consumers?

In contrast, Tingyi's competitor Vitasoy is a purpose-driven company. The management team at Vitasoy is focused on providing plant-based drinks that support improved nutrition. This single-minded focus on health has helped their brands better connect with Chinese consumers, growing their addressable market, and driving sales in the process.

Sales, US$m	2013	2014	2015	2016	2017	2018
Vitasoy	584	656	721	702	853	977
Tingyi beverages	5472	5144	4746	4605	4965	5045

Source: Company reports and Aikya research. Vitasoy reporting year ends in March, while for Tingyi their financial year end is in December.

Getting a corporate purpose statement articulated is the easy part; public relations and marketing consultants are more than capable. It is lot harder to win the confidence and support of the broader organisation, and to get a product/market offering aligned with the purpose. The work force must believe that long-term strategy should be aligned with an identifiable purpose, even if it means some pain in the short-term. There will no doubt be bumps in the road, and these short-erm trade-offs are too tough for some management teams whose time horizons are not particularly long.

In this digital age, when information is so easily accessible, it is not easy for companies to 'fake' the existence of consistent organisational purpose, but they still try.

The management team at Unilever was early in talking about purpose-driven brands, with an articulated vision to make sustainable living commonplace[3]. Behind the rhetoric however, even the sustainability credentials of industry leaders like Unilever must be critically analysed. We ask if their strategy is consistent across its various brands? For example, its personal care brand Dove has a mission to ensure that the next generation grows up enjoying a positive relationship with the way they look; it aims to raise the esteem and aspirations of consumers. This is a great purpose, and one that Unilever has skilfully exploited to sell more Dove products through its 'Dove Real Beauty' campaign,

[2] Amartya Sen and Sudhir Anand (1994), Sustainable Human Development: Concept and Priorities, Human Development Reports, United Nations Development Programme. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2294664

[3] https://www.unilever.com/sustainable-living/our-strategy/consumers-and-sustainability/

which is now 15 years old. At the same time, Unilever also markets a skin-lightening cosmetic product called 'Fair & Lovely' in places like India and Indonesia, where consumers obsess about having pale skin. Why is lowering the self-esteem of dark women in India or Indonesia acceptable to Unilever? Is the 'purpose-driven brands' mantra just a marketing trick? If it is, this creates a potentially serious risk to their personal care franchise in the future.

Governance Stewardship

Having a strong and socially relevant purpose is a good start, but it is not enough. In an Emerging Markets context, governance (or lack thereof) usually poses the most significant risk to the long-term investment case.

The first question we ask when looking at a business is whether minority investors are aligned with the key decision makers. There is often a lack of alignment because most companies listed on public exchanges suffer from 'principal-agent' conflict, where the interests of management teams, as agents, are too focused on short-term financial incentives. This problem is more pronounced within state-owned business and companies with no dominant shareholder. In contrast, there is greater natural alignment with family businesses and management teams who own significant shares in the business. In our experience, economic ownership encourages people to think more holistically about the long-term interests of a business.

Most family-owned businesses in Emerging Markets still fail our governance tests on integrity grounds. The most obvious warning signs come in the form of weak listing structures, related party transactions and overly aggressive major shareholders.

Li Hejun, the entrepreneur and founder of solar energy group Hanergy was briefly China's richest man, and regularly described as China's equivalent to Elon Musk of Tesla. He was never short on purpose, and at the peak of his popularity he spoke about owning solar farms across China. His vision was lapped up by investors, who in 2015 valued the company to be worth $40bn at which point it traded at an astronomically conceptual valuation.

The twist was that there were skeletons in Li Hejun's closet[4]. Hanergy never went through the formal Initial Public Offering (IPO) process in Hong Kong, meaning it had circumvented serious regulatory scrutiny. Instead, the company entered the Hong Kong Stock Exchange in 2009 via a serious of opaque transactions that culminated in the reverse takeover of a small toy manufacturer. Hanergy's accounting practices were very aggressive, and there were multiple related party loans and transactions between the business and its founder. In May 2015, when many of these truths became well-known, Hanergy shares collapsed by more than 70% and never fully recovered.

We attempt to establish honesty by simply asking whether the source of a business group's wealth is credible or not. Before giving business groups the benefit of the doubt, we ask if there is 'original sin', and evidence of unfair and potentially unsustainable privileges. The examples are countless in every corner of Emerging Markets; there were Central American business families that got rich creating exploitative cartels under the protection of corrupt politicians; Chinese entrepreneurs who acquired shares in previous state owned businesses through opaque 'ownership reforms'; and corrupt businessmen in India, who built their empires during the infamous 'license raj' during 1970s.

[4] Miles Johnson, Lucy Hornby and Cynthia O'Murchu (2015), FT Investigation: The Strange Tale of ticker '566'. https://www.ft.com/content/68842bf4-24c9-11e5-9c4e-a775d2b173ca

Yukos was the leading Russian oil business in late 1990s, and it was one of the first companies in the country to adopt Western governance standards. They adopted International Accounting Standards (IAS) in the late 90s, appointed a big four auditor in 2002, and had a board majority controlled by independent directors. At this point in time Yukos's main shareholder, Mikhail Khodorkovsky, was the darling of investors in the West. He was focused on reforming the business and driving shareholder returns. However, in the early hours of October 25, 2003, Khodorkovsky was arrested from his private jet, and Yukos was charged with tax evasion of almost $30 billion. The company was soon forced into bankruptcy, and many of its assets were later sold to Rosneft, Russia's state-owned oil company[5].

Expropriation is a risk always present in Emerging Markets, which have fragile institutions and low respect for property rights. The presence of 'original sin' makes it much easier for governments (and political opponents) to bend circumstances to their objectives. In the case of Yukos, the Russian state argued that the company was 'wrongly' stolen from the Russian people during a wave of privatisations in the mid-90s. They argued it was not morally wrong to reclaim state ownerships of the assets.

The challenge for analysts researching successful business families in developing countries is the general lack of free media, and the incestuous nature of business elites. If you are rich, it is likely that you are extremely well connected, and have influenced the media. It is therefore harder for outsiders to obtain a true and unadulterated version of history. We navigate this situation through our network of trusted contacts that have been developed over the years. There are a few clean families in most Emerging Markets, and we make it our mission to develop close relationships with such people.

This is how we avoided Steinhoff, one of the worst corporate scandals in South Africa[6]. Its leader Marcus Jooste was never really accepted by traditional and honest business families in Cape Town, where he was based. He was typically described as a brash deal maker with far too much aggression. We decided against owning shares in Steinhoff for the best part of two decades because we could not get a sense of the accounts, nor could we find a positive reference from our network of trusted contacts. We watched on the side-lines as the shares went up until one day in early 2018 when its auditor refused to sign off the accounts and a great fraud was exposed.

Financial accounts can be faked relatively easily if there is an undesirable willingness, and as outsiders it is almost impossible to spot an accounting fraud. Fortunately, local reputations cannot be falsified as easily, and the truth is often readily available. In this context, our aim is to find those business groups with honest reputations that have stood the test of time.

Social Stewardship

Companies that pursue profit at the expense of the local communities' risk losing their social licence to operate. When they do, the results are disastrous for the business and shareholder returns.

Vikram Akula worked for McKinsey before starting SKS Microfinance in the mid-90s. The company, inspired by Grameen Bank in Bangladesh, claimed to lower financing costs for poor farming communities in the Indian state of Andhra Pradesh. Strangely, the business was not structured as a non-profit organisation, but instead funded by Silicon Valley financiers. These external investments helped the loan book balloon from $13m in 2005 to $450m on the eve of IPO in 2009. The average interest rate charged by the business was a staggering 28%, whilst its own cost of funds was only 10%.

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[5] Yuri Schmidt (2010), Khodorkovsky and the rule of law, New York Times.
https://www.nytimes.com/2010/12/28/opinion/28iht-edschmidt28.html

[6] Rob Rose (2018), Steinheist: The inside story behind the Steinhoff scandal. Daily Maverick.
https://www.dailymaverick.co.za/article/2018-11-14-steinheist-the-inside-story-behind-the-steinhoff-scandal/

The economics excited the investment community and the IPO was many times oversubscribed, with the company valued at more than 50x earnings.

In the fall of 2010, 57 people from poor rural communities in Andhra Pradesh committed suicide. They were deeply indebted to Microlending Financial Institutions (MFIs) active in the state. The families of the victims blamed their demise on pressure from aggressive collecting agents. This led Andhra Pradesh to put a blanket ban on the operations of MFIs in the state, and SKS Microfinance collapsed[7].

In Latin America, American property tycoon Sam Zell invested into a small Mexican home builder called Homex in 2002. The company's owners, the De Nicolas family, spent the next decade relentlessly expanding their scale until they were producing nearly 60,000 homes per year, at which point they were the largest home building in North America. Homex's investor brochures claimed that they were helping the poor in Mexico, and that they could build an entire house in just a few days.

With hindsight it is easy to question the sustainability credentials of their actions[8]. They weren't solving a problem, far from it. The developments were of such poor quality that they ended up creating new slums. The location of these housing communities was so far outside cities that many residents would spend 5 hours per day commuting to their jobs, and when the federal government funded housing program stopped in 2014 the music stopped and the bubble burst. Homex quickly went bankrupt, but long after Sam Zell had cashed out his shares in 2008. The point is that if a business does not solve a real problem, it is hard to justify its existence longer term, even more so if it is propped up by government subsidies.

South Korea is world's most wired country. Internet and smartphone penetration are almost 100% and download speeds are extremely high. Amongst the population of 51 million, South Korea has close to 5 million internet-addicted children and teens. That's almost 50% of the population between aged 10 and 19. What is Korea's problem today could one day be a problem in many other countries of the world[9].

Chinese enterprise Tencent is possibly the most influential internet gaming platform in the world and it is already waking up to the problem of gaming addiction. Taking guidance from the Chinese government, Tencent is regulating the amount of time that teenagers can spend playing games, but the company has stopped short of taking 'proactive' measures to help counter addiction. Such inaction is not unique to China, and we ask if it's only a matter of time before governments question to social utility of these gaming companies?

Environmental Stewardship

The first question we ask when it comes to environmental stewardship is whether a product needs to exist. For example, do we really need water in plastic bottles, at least in the developed part of the world, where we can have clean water from our taps? Do we really need fast fashion, or the need to

[7] M Rajshekhar (2010), Microfinance: What's wrong with it? Economictimes (India). https://economictimes.indiatimes.com/industry/banking/finance/microfinance-whats-wrong-with-it/articleshow/6904778.cms?from=mdr

[8] Richard Marosi (2017), Homex: A boom and a bust. Los Angeles Times. https://www.latimes.com/projects/la-me-mexico-housing-chapter-2/

[9] Brian Clark (2018), South Korea's lost generation of gamers offers a preview of what's to come. The Next Web. https://thenextweb.com/gaming/2018/11/13/south-koreas-lost-generation-of-gamers-are-a-preview-of-whats-to-come/

replace our clothes every few weeks, while knowing that there is an enormous environmental cost to those clothes?

If a product is indeed needed, is the current way the best way to fulfil that need? And what are the key environmental externalities that are still not being factored by the companies? If a management team is trying to hide, or greenwash, it is usually a bad sign. Because there are no statutory reporting standards around these issues, companies usually report what they want to, and not what they should; or they report things that do not represent reality.

Take water usage by Coca-Cola as an example. Coca-Cola claims that it is able recycle 100% of the water it uses; it claims that 'for every drop we use, we give one back'. However, such a statement is a serious exaggeration when the water demands of the wider value chain are considered.

The whole value chain needs to be taken into consideration when analysing a company. For example, to manufacturer a t-shirt in isolation uses limited water, but when we consider the water incentive nature of cotton farming, a t-shirt suddenly becomes a huge burden on the natural environment, consuming a staggering 712 gallons of water. Back to Coca-Cola, whose manufacturing demands for water pale in significance when placed in the context of the broader supply chain. To produce half a litre of Coca-Cola, it takes 28 litres of water to grow sugar, 7 litres of water to make PET bottles, and 0.4 litres for operational purposes. When Coca-Cola talks about replenishing every drop of water, it is simply commenting on its plant operations and ignoring the broader supply chain, which makes up 98% of the total water consumed.[10]

Plastic recycling is another similar problem[11]. Many consumer goods companies try to gain a lot of public relations points on the just using recycled plastic. But what is really recycled plastic? Is plastic ever recycled, or does it simply end up being shipped to poor countries where it is dumped into landfills?

In Emerging Markets, personal care products are often sold in small single portion sachets to help locals afford the products. South East Asia alone accounts for almost 50% of the global sachet market; some 855 billion sachets were sold globally in 2018, and at current growth rates, 1.3 trillion sachets will be sold in 2027.

The sachet economy was pioneered by Unilever in India and Southeast Asia. The products in sachets are aggressively marketed to low-income consumers in rural communities, who are unable to afford larger sized products. The sachet is a combination of plastic and other materials such as foil, which means it cannot be recycled. There is no economic incentive to collect used sachets that have been improperly dumped, so no one bothers picking them up. Contrast this with a one litre plastic bottle that might be worth something once collected and returned for its deposit. These sachets clog drains contribute to flooding, and often end up in landfills where they struggle to biodegrade[12].

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[10] Christine MacDonald (2018), Coke claims to give back as much water as it uses. An investigation shows it isn't even close. The Verge. https://www.theverge.com/2018/5/31/17377964/coca-cola-water-sustainability-recycling-controversy-investigation

[11] John Hocevar (2020), Report: Circular claims fall flat. Greenpeace. https://www.greenpeace.org/usa/the-myth-of-single-use-plastic-and-recycling/

[12] Dennis Posadas (2014), Sachets help low-income communities but are a waste nightmare. The Guardian https://www.theguardian.com/sustainable-business/sachet-packaging-low-income-communities-waste-nightmare

Rather than developing accessible reusable packaging systems, consumer goods companies appear intent on proceeding with sachets[13]. Unilever in India and Philippines reportedly sells almost half of its products in sachets. Should Unilever take initiatives in solving this problem, given this segment of customers is so important to them? Despite their carefully crafted image as a sustainability champion, what does this really tell us about the stewardship at Unilever?

Conclusion

Thinking on ESG issues is integral to our investment process. The work we do assessing ESG related issues helps us two-fold: it allows us to avoid companies with poor sustainability positioning, and it forms the starting point for an active engagement agenda with the companies which make it to our portfolio. Our long holding periods build a sense of partnership with investee companies, which, over time, become increasingly open to engagement. Our relationships allow us to discuss critical sustainability issues with top management; positive engagement on such issues becomes a powerful tool for enhancing the value of our client portfolios.

[13] Leila Abboud (2019), Can we overcome the curse of single use sachet? Financial Times https://www.ft.com/content/1aa60666-f64b-11e9-bbe1-4db3476c5ff0