Why social factors matter in emerging markets

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Social factors – the S in ESG – have been a driver of company performance in emerging markets since long before sustainability became a mainstream consideration for investors.

Sometimes it is the simplest questions that reveal the most insight. Take this basic one on ESG: why are environmental, social and governance factors grouped together at all? At face value they seem to be three quite disparate issues.

Here we plan to answer that basic question first, and then to use that foundation as a base from which to explore the importance of social issues to us as investors in emerging markets.

One of the first lessons taught in any economics class is that all economic output stems from one of four factors of production: labour, land, capital and entrepreneurship. Any successful account of economic sustainability must therefore explain how to maximise the quality and duration of these.

Seen through this prism, the idea of "environmental, social and governance" starts to make more sense. Rather than a disparate group, the three elements represent a complete account of the relationship between the corporation and the factors of production.

- "Environmental" mediates the relationship between a company and land (the natural resources it requires).
- "Governance" mediates the relationships between a company, its providers of capital and, where relevant, its entrepreneurial founders.
- "Social" is then the missing piece of the jigsaw, mediating the relationship between a company and labour, including labour both on a narrow definition (the company's own employees) and on a broad definition (the people who make up its customers, supplier base and surrounding communities).

This explanation also makes sense of some other important linkages.

It explains why the terms ESG and sustainability are interchangeable: the only way to ensure sustainable growth is to ensure the factors required to create more output are well managed by participants in the economy, of which corporations are the most relevant to us as investors.

It also explains why ESG and the profit motive are not disconnected: profitable businesses create more capital, and capital is one – but not the only – factor required to grow economic activity.

To begin to connect this discussion to investment, the 98 question risk profile we use as a core part of our research process in emerging markets considers both ESG and broader questions of economic sustainability for exactly this reason.

AUTHORS

John Citron
Portfolio Manager

Amit Mehta
Portfolio Manager

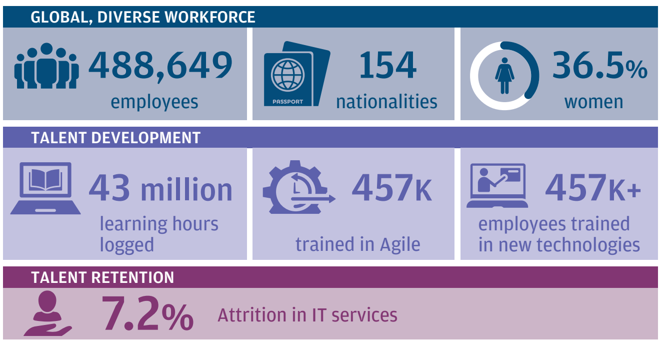
Emerging market countries combine lower average household incomes with higher levels of inequality and a greater level of state interference in the domestic economy. Together, these factors mean companies that get it wrong on social issues tend to pay a high price, both with their consumers and their regulators. Conversely, companies that embrace the opportunity to make positive change at the individual, community or national level can create significant value.

We can consider three sets of company examples to help bring this theory to life.

First, consider the relationship of a company with its employees. It is obvious that companies with happier employees are likely to perform better, but we think this is particularly true in emerging markets, where the gap between the best and median employment experiences are likely to be much larger. This is why employee attrition is a key metric we track for all our investee companies who disclose it, and why we engage with those who don't disclose the measure and ask them to publish it.

At the centre of our investment case for **Tata Consultancy Services (TCS)** is the fact that its current 7% attrition rate is one third to a half of that of its peers, creating a virtuous circle between employee satisfaction, customer satisfaction and growth.

EXHIBIT 1: TCS EMPLOYEE FIGURES



Source: TCS annual reports

How does it keep its employees happy?

- **By giving them significant autonomy to make their own decisions.** This is best understood by looking at the organisational structure. Although the company has $25bn of revenues and 500,000 employees, it is organised into over 50 separate business units, each with its own P&L and its own "mini CEO". This empowers more junior levels of management and allows for quicker decision making.
- **By putting staff welfare at the centre of management decisions.** Covid-19 created significant disruptions for the Indian technology sector, but TCS not only sent employees home without any business loss but also developed a new working model, Secure Borderless Workspaces™, which has become an industry standard for distributed working. It then directly arranged vaccines for all employees and their families and made a 24/7 medical helpline available to staff.
- **By offering them significant training opportunities.** TCS employees logged over 43 million training hours in the last fiscal year, and the company has built its own internal learning platforms to encourage employee participation through gamification and by tying skills gained to employee career journeys.

How did this better treatment of employees translate into superior business outcomes? Over time TCS's lower attrition rate has driven better client experience and higher profit growth. The graphs below compare its employee turnover and profit growth with its nearest competitor.

EXHIBIT 2: TCS COMPANY REPORT - EMPLOYEE TURNOVER

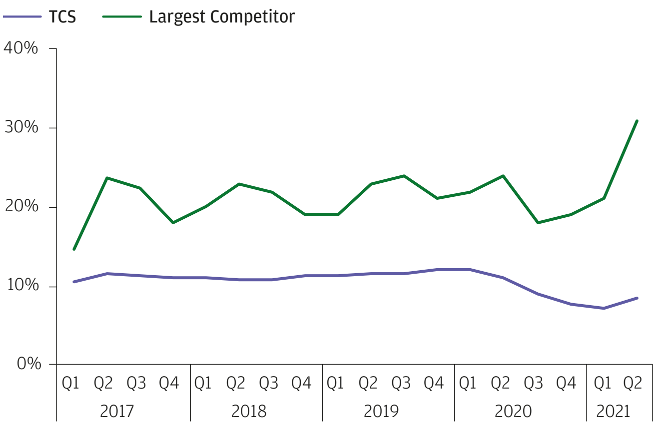
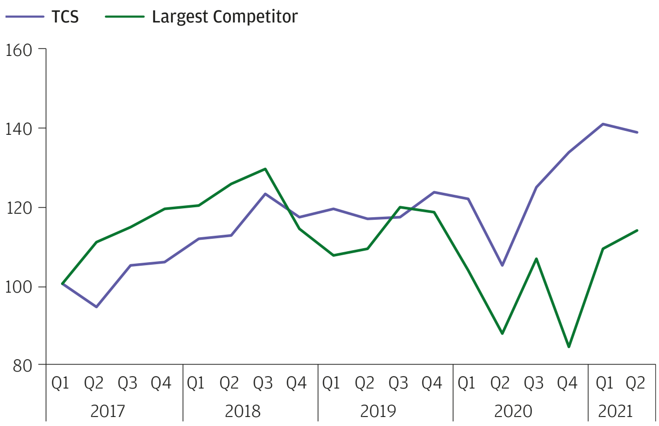


EXHIBIT 3: TCS COMPANY REPORT - $ OPERATING PROFITS (Q1 17 = 100)



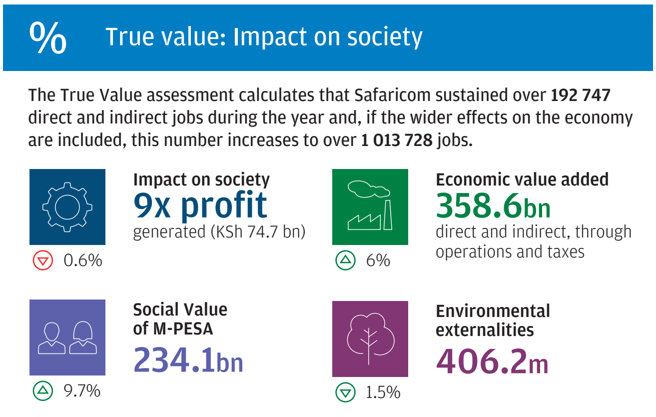
Source: TCS annual report

Second, consider the relationship of a company with its surrounding communities. The question "How can we improve the lives of people around us?" has been a particularly profitable one to ask in emerging countries in recent years. **Safaricom**, the leading telecom operator in Kenya, launched its mobile money service M-Pesa in 2007 to help bring financial services to the large unbanked domestic population. This was one of the first mass scale financial inclusion programmes in the world, and has bought much wider benefits. What are these?

- **Creating higher productivity and more jobs.** Although Safaricom only has 6,230 permanent, contracted and temporary employees, it estimates that it supports more than 1 million jobs directly and indirectly in the local economy.
- **Enabling payment distribution.** The existence of a digital payments layer in the country meant the Kenyan government was able to distribute payments to its population efficiently and safely during the Covid crisis. Safaricom also suspended payment fees on peer-to-peer money transfers below KES 1,000 in value to encourage the domestic population to use electronic money rather than cash, to reduce disease transmission risks.
- **Supporting the community.** Safaricom's business is sufficiently profitable to create excess capital that the company can reinvest back into community projects. In 2021, for example, the company started the Keeping Girls in School initiative, through which it distributed three months' supply of sanitary towels and underwear and information on menstrual hygiene to around 800,000 girls.

Safaricom was an early corporate adopter of the UN Sustainable Development Goals, aligning its strategy with the goals back in 2016. As well as benefiting its local society, Safaricom has also been a world-beating investment, with profits up 5x and the shares up 10x over the past 10 years. This demonstrates that there don't have to be trade-offs between societal impact, profitable growth and return to shareholders.

EXHIBIT 4: SAFARICOM ANNUAL REPORT - TRUE VALUE ASSESSMENT



Source: extracts from Safaricom annual report, 31 March 2011 to 31 March 2021.

Finally, consider the relationship between a company and its customers, and thus ultimately its regulators. Time and again, we have seen a failure to respect social obligations to customers come back to haunt companies, particularly in emerging markets, where the state is often more interventionist than elsewhere. Let's look at a decade of history in China by way of example. The infant milk scandal of 2008, when baby formula was found to contain melamine, continues to echo in the market today, with foreign players still controlling a majority of the market due to the mistrust of domestic brands. The regulatory and reputational problems that engulfed Baidu in 2016 after its search engine promoted potentially dangerous medical treatments continued for several years, and lost the business its once dominant position as a trusted information source.

Of course, with the right focus, consumer trust can be regained. A change in management team and corporate strategy eventually allowed Yum China to recapture consumer hearts after a food quality scandal in 2015; we now view it as best-in-class on sustainability. What did Yum China do to turn around its corporate image? It has continually put doing the right thing ahead of short-term profits.

- **Prioritising wages and conditions.** The company has ensured employee wages and working conditions are significantly better than regulatory minimums or industry averages. This goes beyond basic financial packages – for example, it provided health insurance to restaurant managers and their families as the Covid pandemic started. To take an even simpler example, delivery drivers who work for KFC can enjoy heavily subsided meals, which is not the case for their peers riding for delivery platforms.
- **Investing in food safety standards.** Yum China has invested significant sums in ensuring food safety standards are upheld. Most recently, this involved investing several hundred million dollars in an upstream poultry farmer that is the company's key supplier. This might not please short-sighted investors who like their companies "asset light", but Yum China has sought to take a more balanced, long-term approach. Even with this investment, it can deliver attractive profits and free cash flow, and it has secured the resources to keep delivering this performance even further into the future.
- **Supporting the community.** The company has used its physical infrastructure – upwards of 10,000 stores and 400,000 employees – as a base from which to benefit the local community, for example by setting up education initiatives such as reading clubs onsite. This type of activity raises staff morale while also enhancing brand quality and government relations.

EXHIBIT 5: YUM CHINA ANNUAL REPORT - SUSTAINABILITY HIGHLIGHTS

SUSTAINABILITY HIGHLIGHTS

We [Yum China] prioritize and track sustainability goals and commitments in three strategic areas: Environment, Food, and People.

Material Topic	Goals and Commitments	Progress in 2020
Climate Action	• Commit to setting science-based emissions reduction targets, in line with SBTi criteria • Reach net-zero value chain GHGs emissions by 2050	• Achieved the 10% GHG emissions reduction goal as compare to 2017 baseline ahead of schedule • The total amount of GHG emissions in 2020 was 2,009,372 tons of CO2
Water	• Reduce average restaurant water consumption by an additional 10% by 2025, as compared to the 2017 baseline	• Reduced average restaurant water consumption by 2,710 tons, representing a 22% reduction from 2017
Packaging	• Reduce non-degradable plastic consumption by 30% by 2025, as compared to the 2019 baseline • All customer-facing and plastic packaging is recyclable	• Used recyclable plastic materials for all newly developed plastic packaging items • Saved 1,200 tons of plastic packaging by the end of 2020

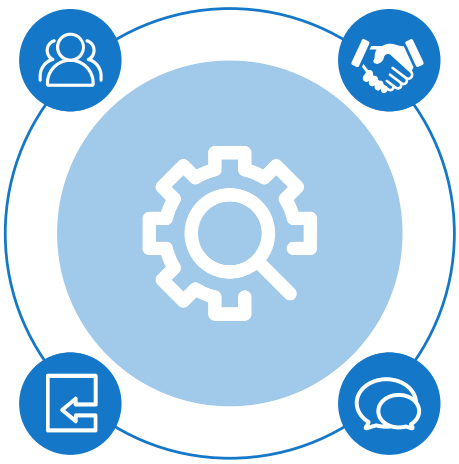
About 400 active suppliers in our [Yum China] sourcing systems

400

(Excluding special suppliers such as 2020 grade A suppliers, suppliers providing services only, suppliers involved small quantity purchase, construction suppliers)

The supplier participation rate of online training reaching

97%



New chapters and content for audit:

business ethics, social responsibility management system, and environmental management system

Corrective and preventive management:

CAPAP (corrective action and preventive action plan) submission rate after the audit

100%

Source: extracts from Yum China annual report: http://www.yumchina.com
The companies above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

CONCLUSION

In emerging markets, social topics get magnified. The gap between the best and worst performers is wide, and the opportunities available to those who can address problems are vast. This is why integrating social issues into decision-making is a vital part of any emerging markets investment approach.

NEXT STEPS

For more information, contact your J.P. Morgan Asset Management representative.

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