Regional analysis ESG

ESG potential high in SEE

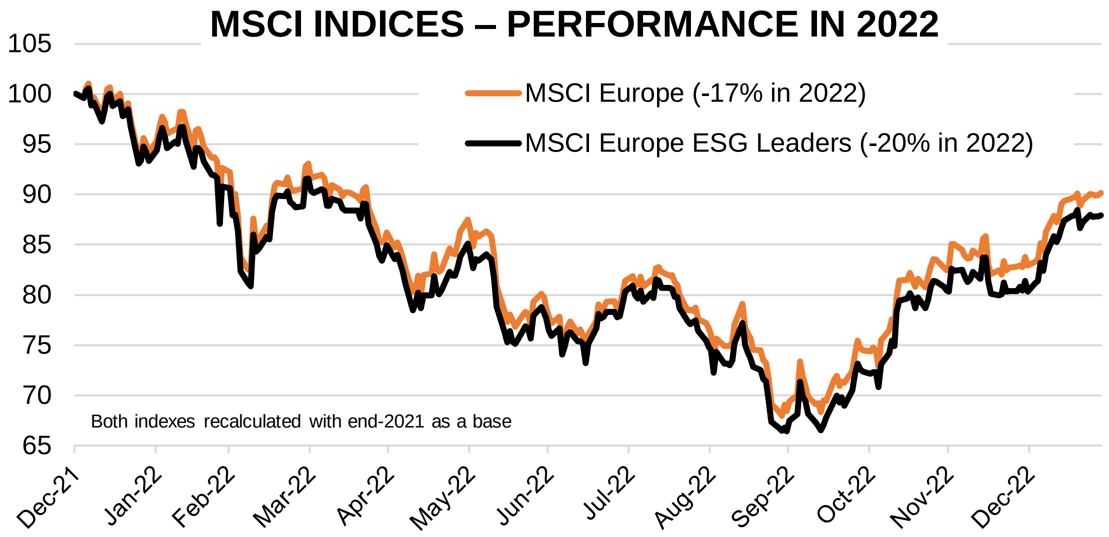
Authors:

Andrej Knez, Chief Markets Analyst

Highlights

ESG is a topic increasingly becoming important for the capital flows. Global stock indexes started the year on a positive tone, with the support largely coming from the idea that most of negative elements in terms of macro fundamentals is already priced in. This mostly concerns the magnitude of the remaining key central banks' tightening and economic growth slowdown ahead. In the same time, **ESG is gaining more traction, with growing regulatory requirements and investors' interest** towards companies implementing ESG requirements. As such, we are going through the performance of ESG assets and outlook for ESG the implementation.

In order to explain the **performance of stocks with ESG grades**, we are **comparing returns of MSCI Europe Index and MSCI Europe ESG Leaders Index**. In terms of member structure difference, the latter contains stocks by companies with high ESG scores, while the MSCI Europe Index is setup regardless of the companies' ESG ratings. A brief overview shows that the **last year's hurdles for the global capital markets lead to underperformance of ESG indexes, while on a long term ESG indexes are posting better returns than the wider benchmarks.** In details, in 2022 as a whole, the ESG index fell by 20%, while the wider MSCI Europe benchmark outperformed having dropped by 3 percentage points less i.e. posting a -17% return. The same pattern was observed with other highly traded equity gauges as well. The key rationale for such development lies in the very structure of the named indexes, where the ESG benchmarks are typically relatively heavier with tech stocks and carry less energy companies. Tech companies were under pressure in the recent months due to deteriorated mid-to-long term earnings prospects, while energy companies posted strong business results in 2022 largely on the account of costlier commodities. However, observing longer time series, the ESG indexes performed better than the wider benchmarks – the MSCI Europe ESG Leaders Index posted a 43% return since end of 2009, while in the same period the MSCI Index increased by 31% i.e. 12 percentage point less than the ESG equity gauge. These outcomes come very much in line with the basics of the current stage of ESG development – investing in ESG topics is more a long term strategy.



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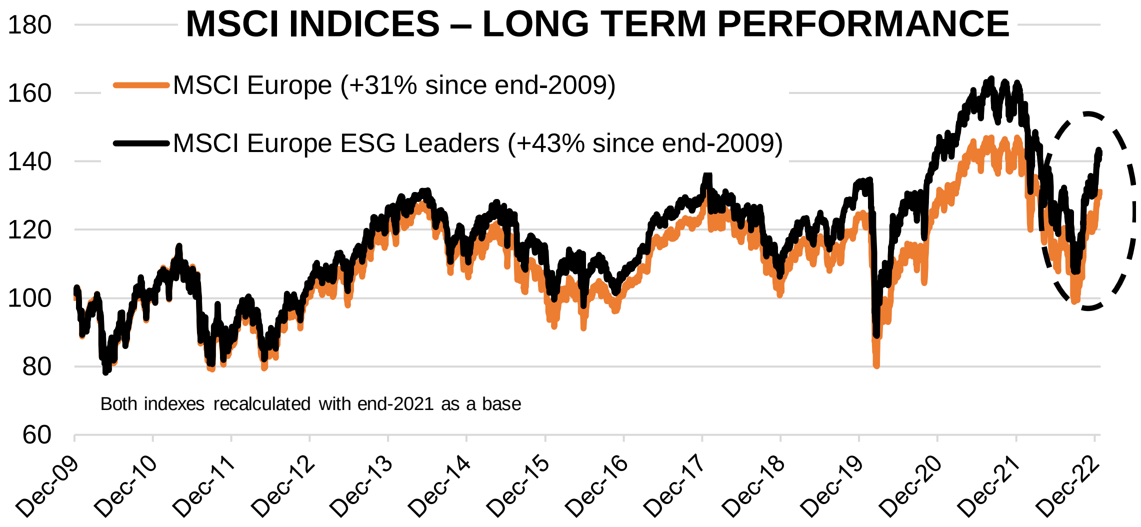

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Highlights

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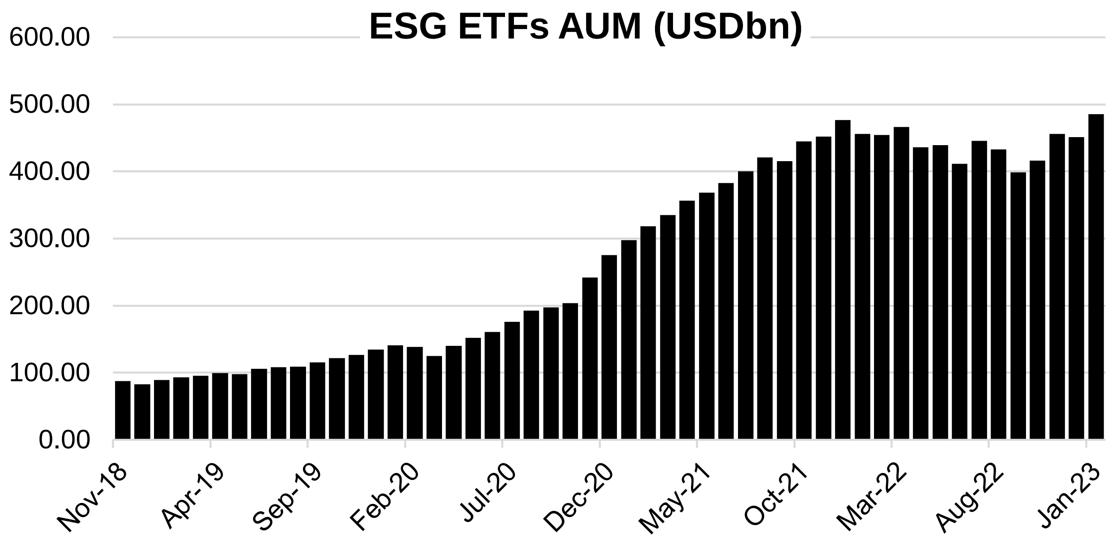
With ESG increasingly gaining investors' appeal, the recent years were also highlighted by the **development of ETF ESG supply**. The last year was dominated by risk aversion driven by geopolitical concerns and a turnaround in the low/negative interest rate environment courtesy of fight against high inflation. In such environment, the **2022** was also in a big part **highlighted by reduction in the ESG ETFs AUM to just below 400 bnUSD**, however the recent stabilization in the global financial markets has also seen some stabilization and even small increases in the AUM values. Indeed, the **current value** of globally-tracked **ESG ETFs AUM is at a historical record of 486 bnEUR.** The fact that the latter figure is almost **3 times higher than in mid of 2020** reflects the best the pace of development of this category in the financial instrument universe.

The annual **issuance of ESG bonds** has followed the similar pattern, with the **2022 being highlighted by 16% less new debt issuance (1.5 trUSD) than in 2021** as the primary market activity was likewise affected by headwinds hitting onto the global capital markets. In terms of overall ESG bond issuance volume, the last year was still the second biggest on the records, with **green bonds issuance (523 bnUSD) again taking the biggest share**. Segment-wise, **most of new bonds issuance** is coming from the **government/supranational sector**, followed by the financial industry. It is not as strange to see banks high on the new issuance ladder, given the (in)direct benefits onto their capital management from such kind of instruments.



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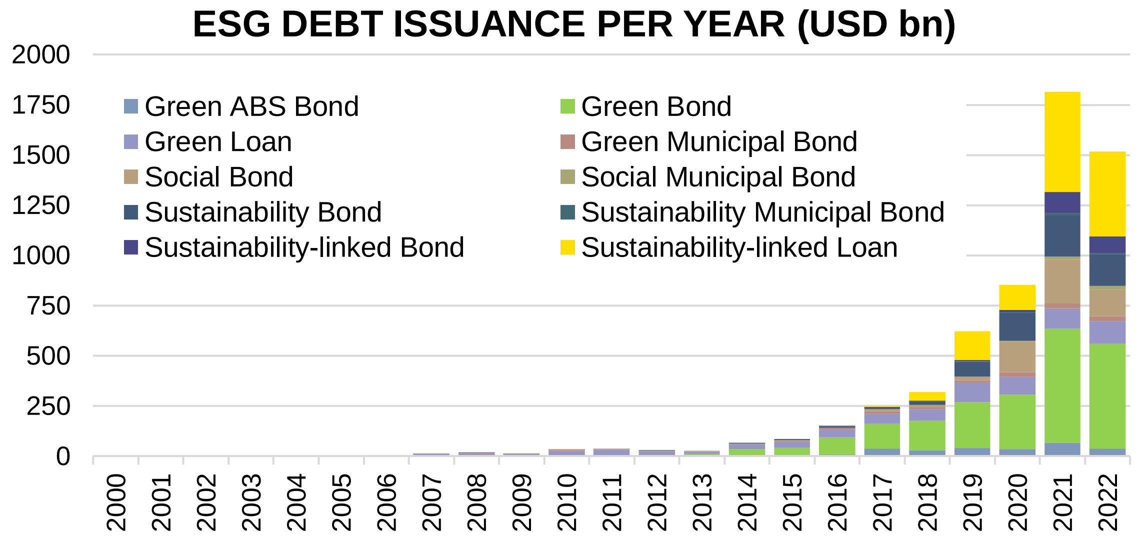

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Special case – ESG in Adria region

Bloomberg Adria

Implementation and usage of the ESG benefits for capital market participants is in a quite early stage in **Adria region**. Firstly we are touching the **sustainability bonds** and then move to **companies' ESG reporting profiles**.

On **bonds**, there are only **four cases in the whole region**, with **Slovenia leading the way**. The named sovereign has by now sold **two 10Y sustainability bonds in total worth 2.5 bnEUR**. The first one came in middle of 2021, when the market conditions were still very beneficial for borrowers. That said, we think the best example of the ESG benefits is the second bond, worth 1.25 bnEUR and being issued in early January this year. The price itself does not really reflect the ESG benefits, with the bond priced at 77bp spread over midswaps i.e. fully fitting on the sovereign's bond yield curve. **Investors' demand for the named bond issue is the best indicator of ESG benefits**, with the bond attracting investors' demand of 10 bnEUR or 8 times more than the final issue size. A successful bond issue is considered when investors' demand surpasses the final issue size by 2-4 times. The magnitude of oversubscription for Slovenian bonds is the element suggesting that ESG topics are attracting capital flows and puts the borrower in a better negotiating position. Aside from Slovenia, Adria region has seen the markets being entered by Republic of Serbia with a sale of 10Y sustainability bond worth 1 bnEUR in 3Q 2021, and in 2022 a small corporate bond issue by M+ Grupa in amount of 40 mEUR and a five year maturity.

On **stock exchange-listed companies' ESG profiles**, conclusion is rather short - ESG reporting is in an early stage of implementation in Adria region. The proof comes when looking into the ESG ratings which are produced by third parties – similarly as credit ratings for credit worthiness, these provide the investors with a deeper insight into the company's ESG profile. Looking into the **Bloomberg's ESG disclosure scores** being compiled out of multiple standard and non-standard ESG related elements in companies' public disclosures, stocks included in the Adria region's blue chip indexes show a mixed picture, with **most companies reporting on ESG elements coming from Slovenia and Croatia**, while the rest of the region falls behind. Implementation of the Bloomberg's ESG environmental score (a more direct indicator for the financial materiality of the company's ESG compliance) is on a weaker position, with only 2 companies out of the whole list of Adria region's blue chips getting such ratings, while the rest are non-rated. For both ESG score levels (disclosure and environmental), the conclusions are similar when looking in the rest of the Europe, with Eastern Europe peers displaying similar ESG reporting implementation level as Slovenia and Croatia, however all fall behind the most developed markets – almost all companies in the German DAX index are carrying ESG scores.

Index name	Country	Total # of stocks in index	# of stocks with Bloomberg's ESG disclosure score	# of stocks with Bloomberg's ESG Environmental score
SBI TOP	Slovenia	10	9	1
CRO10	Croatia	10	9	1
BELEX15	Serbia	10	1	0
SASX10	B&H	10	1	0
BIRS	B&H	20	0	0
MBI10	N. Macedonia	10	1	0
BET	Romania	20	15	3
BUX	Hungary	15	10	3
PX	Czechia	10	8	5
WIG20	Poland	20	17	16
DAX	Germany	40	37	38

source: Bloomberg

In terms of financial reporting and resultantly ESG score completeness, for the EU countries we expect a sizeable **improvement to take place with the CSRD** reporting requirement for stock listed companies for the financial year 2024 (first reports to be published in 2025), where standardized ESG disclosures will provide investors with access to the information they need to assess investment risks. The rest of Adria region i.e. the non-EU countries will not see the same regulatory pressure unless companies are consolidated into the EU-based countries. However, we expect a gradual ESG reporting improvements to take place therein as well as capital flows and pricing will push the companies to adapt.

Outlook

In **2023**, **we do not expect major downside pressures on ESG assets as seen in the biggest part of 2022**, however we also do not see a potential for a major re-acceleration in new ESG debt issuance nor material increase in the value of ESG-dedicated stock indexes. **Our view is rather for an ongoing volatility in the capital markets**, with the main driving forces being:

- further rise in interest rates alongside the ongoing need to stabilize the mid-term inflation expectations – this will create a volatile environment as investors are searching for the central banks' terminal rate levels and the time how long rates will be maintained elevated before a new round of rate cuts;
- shaky economic growth prospects weighing on general outlook for corporate earnings.

Outlook is more positive looking into the mid-to-long term perspective. Firstly, the **EU** is looking into an ambitious **plan to reach 40-45% energy usage out of renewables by 2030** (the final target still discussed by the EU bodies). This will fuel sizeable investments into the renewable energy infrastructure in the upcoming years and we expect investors focus to be on a sizeable financial support. In other words, financing of such projects will be an important pillar for the overall economy and capital market flows in the years to come.

Secondly, **regulatory reporting framework** will likewise **support capital flows** towards the ESG leading companies. Starting with FY 2024 reports, the **EU's CSRD reporting regulation** will increase the number and quality of companies' reporting on their sustainability strategies and principles. Presenting more transparency towards the investors' community on companies' working with sustainability will not only force the companies to improve any failures to contribute to the overall sustainability movement, but this will also drive investors' focus onto companies which were potentially disregarded by now. The overall capital movement will be also supported by the **SFDR regulation** – which requires asset managers to classify and disclose the characteristics and level of sustainability of funds under their management into categories Article 6, 8 and 9 (the latter being highly sustainable) – this will fuel the demand for sustainable investments i.e. asset allocations under the Article 9 category.

Another case we see as **important** for the overall **financial flows** is the strategical **functioning of the banking systems under the growing regulatory needs**. The EU regulatory bodies are increasing the ESG-related requirements for the banks' own capital management. There are two specific elements which banks need to bear in mind – one requires banks within their own organizational and operational setup to work on sustainability e.g. ensure high gender diversity, increase energy efficiency etc. The other element concerns banks' business exposures, where **financing ESG laggard companies** (e.g. which fail to improve environmental influences and similarly) is **demotivated by the regulators** asking from banks to set aside more own capital for exposures towards ESG laggards than for companies with good ESG ratings. In essence, this means that banks' profitability potential is trimmed if they are providing funds towards firms which are not contributing (enough) towards the general sustainability. The regulators are doing this in two ways - one is by asking the banks to implement the ESG-related strategy and operational rules in banks' regular business, and the other one is by conducting standardized stress tests under the unified rules for a large set of the EU banks. Under the latter, the EU regulators are defining negative scenarios which simulate the distortion in business environment and then test how the banks' capital adequacy is behaving in such situation. Those banks with poorer results are then receiving additional regulatory requirements which limit their profitability potential going forward. **Bottom line** is that in the future we see **more financing - or at least financing under a comparatively better price - being directed towards companies with good sustainability profile**, while the ESG laggards would be receiving less capital and/or paying more for it.

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Bloomberg Adria Team Analytics

Andrej Knez, Chief Markets Analyst
andrej.knez@bloombergadria.com

Ivan Odrcic, Lead Financial Markets Analyst
ivan.odrcic@bloombergadria.com

Marina Petrov, Senior Markets Analyst
marina.petrov@bloombergadria.com

Jelena Zindovic, Senior Corporate Finance Analyst
jelena.zindovic@bloombergadria.com

Matteo Mosnja, Corporate Finance Analyst
matteo.mosnja@bloombergadria.com

Ilija Nesic, Corporate Finance Analyst
ilija.nesic@bloombergadria.com

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