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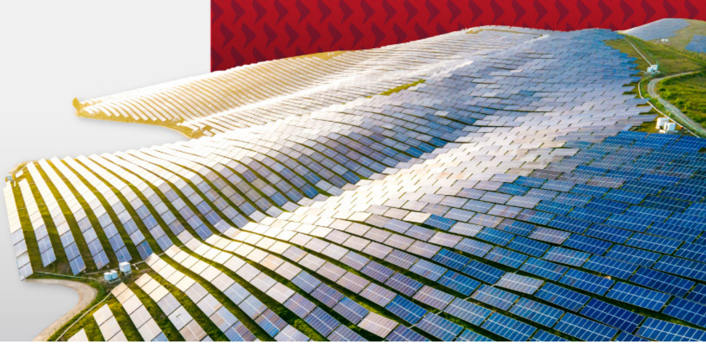
Understanding ESG in China



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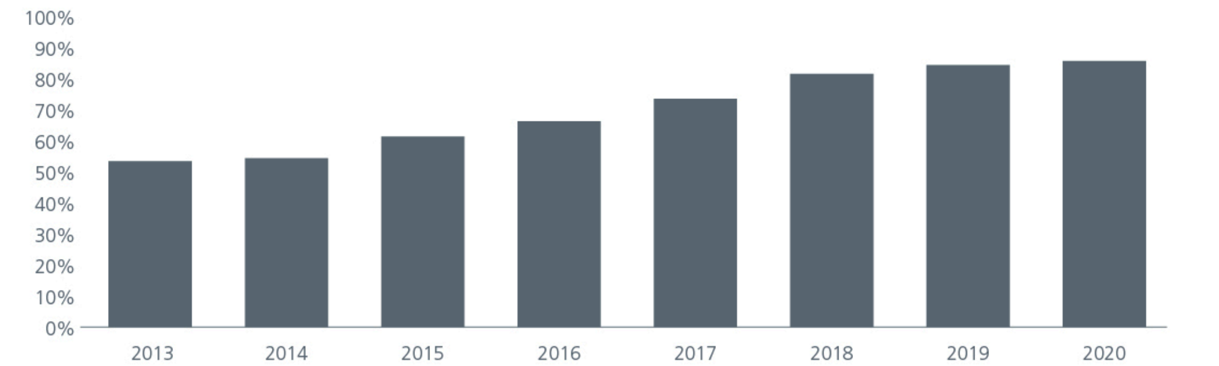
There will be long-term value creation as companies in China improve their sustainability reporting and practices. At the same time, China's successful solar panel and Electric Vehicle supply chains show that it can develop world-class companies that contribute significantly to the global effort to combat climate change.

China's first ESG disclosure guidelines came into effect on 1 June 2022. The voluntary Guidance, developed by China's biggest companies and government-backed think tanks, aim to provide ESG guidelines that are more aligned with China's operating environment. By specifying disclosure principles, requirements, responsibilities and supervision for different industries, the Guidance can help companies evaluate their progress in ESG practices, as well as investors in their company assessment.

As in many markets, it is the larger capitalised companies in China that have devoted more resources to ESG governance and reporting - 86% of A-shares companies in the CSI 300 Index issued ESG reports in 2020 compared to 27% of all A-shares companies[1]. While this is still below most developed market standards, the trend is encouraging – only 54% of CSI 300 constituents had issued ESG reports in 2013. Fig. 1.

Fig. 1. % of CSI 300 companies with ESG reports



Source: World Economic Forum.

[1]SynTao Green Finance. As of 15 June 2020; includes reports labelled as "sustainability", "CSR" etc.

WHY GLOBAL ESG FRAMEWORKS MAY NOT WORK

Global ESG frameworks may not be fully applicable within the China context. This could be due to the different development stages of China's industries, shareholding structures, policy priorities and other local nuances. For example, while material risks for the gaming sector in the developed markets centre around data privacy, employee engagement and energy consumption, key policy priorities for China's gaming sector include preventing gaming addiction among adolescents and using the gaming platform to raise awareness of Chinese culture etc[2]. Companies that are not able to meet these policy priorities could experience reputational risks and regulatory backlash.

Likewise, global ESG frameworks may penalise China state-owned enterprises (SOEs) as management tends to be seen as insufficiently motivated to maximise shareholder benefits, given their low share ownership. On this front we note that the China government believes that ownership diversity is key in helping SOEs become world class enterprises and has been promoting mixed ownership in SOEs as part of its reform program. Hence, investors may need to focus more on the progress, rather than the current state of play.

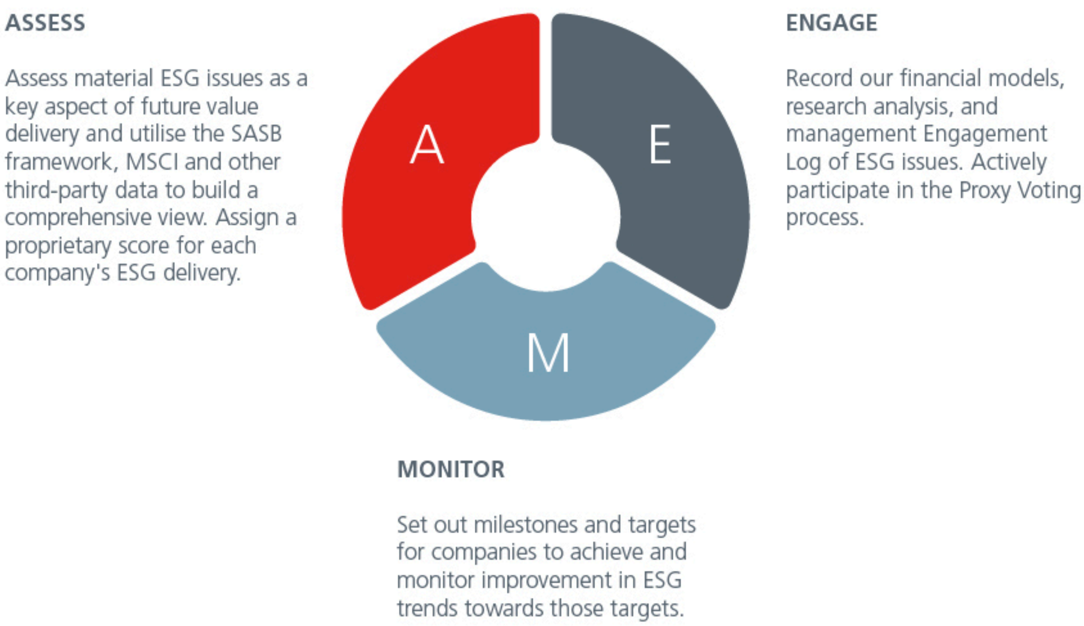
Local knowledge and understanding of macro policies, sectors as well as companies are key in assessing material ESG risks in China. This is especially so in instances when reported ESG data is limited or incomplete. Investors need to be aware of how robust and comparable the data is and adjust their analysis accordingly. We undertake our own ESG analysis as part of our Assess-Engage-Monitor framework. Fig. 2. Besides using third party ESG reports, we analyse publicly available government data, company annual reports as well as engage with company management and industry experts.

HOW TO ACCELERATE ESG PROGRESS

A number of factors will continue to accelerate ESG consideration among China companies. Research suggests that policy and mandatory disclosure requirements are more impactful than voluntary guidelines when it comes to ESG reporting. Mandatory disclosures help codify terminology and bring about greater consistency and market efficiency. Mandatory regulation also helps to level the playing field with regard to disclosure practices and reward companies that have robust ESG reporting and sound sustainable practices[3].

In China, regulation has been a key driver in encouraging ESG information disclosures by public companies.

Fig. 2. Assess-Engage-Monitor framework



Source: Eastspring Investments. September 2022. For illustration purposes only.

[2]Cheung Kong Graduate School of Business. Professor Zhu Rui. [3]CFA Institute. ESG integration in china: Guidance and case studies.

- June 2021: The CSRC required companies to dedicate a section to environmental and social responsibility in their annual reports.
- Jan 2022: The Shanghai and Shenzhen stock exchanges included CSR requirements in their listing rules for the first time.
- April 2022: The CSRC included ESG-related information into the Investor Relation Guidelines.

The above measures follow steps taken by China's regulators since 2018 to provide a basic framework of ESG disclosure. China's own goal to achieve net zero neutrality by 2060 is also expected to spur more companies to provide detailed decarbonsiation plans and targets.

Investors, particularly institutional investors, have helped accelerate ESG integration in China. The inclusion of China A-shares market in the MSCI Emerging Market Index improved data coverage and encouraged companies to develop databases on ESG information. Stakeholder engagement has helped companies in China avoid ESG controversies. A recent study shows that companies which engaged with stakeholders on supply chain management, labour practices and environmental protection issues have on average experienced fewer negative ESG issues in the last 2-3 years, compared to their peers[4].

Sustainable business practices also make good business sense. Companies that are able to demonstrate sound sustainable practices tend to attract more capital and enjoy easier access to financing. Consumers in China are also calling on businesses to become more sustainable. Incorporating ESG considerations into the business may drive innovation and lead to new products and services. An increasing awareness of the potential benefits of taking ESG seriously and conversely the costs of not doing so, is gradually encouraging greater adoption of sustainable business practices in China. We will probably also see a snowball effect where companies will strive to improve their ESG practices and reporting since their competitors are doing likewise.

SEIZING ESG OPPORTUNITIES IN CHINA

We believe that an active approach is needed to construct a sustainable portfolio in China. Investor engagement is key to driving change and more sustainable business practices.

A recent study using natural language processing which was conducted on 150 companies in China found some degree of misrepresentation in their data disclosures relating to environmental practice, labour management, anti-corruption and product quality and safety[5]. Fig. 3. As such, a dynamic approach is needed to navigate greenwashing risks and companies that are not committed to reducing their material ESG risks.

Long term investors will be able to benefit from the value creation generated as more companies in China adopt sustainable practices and better ESG disclosures over time.

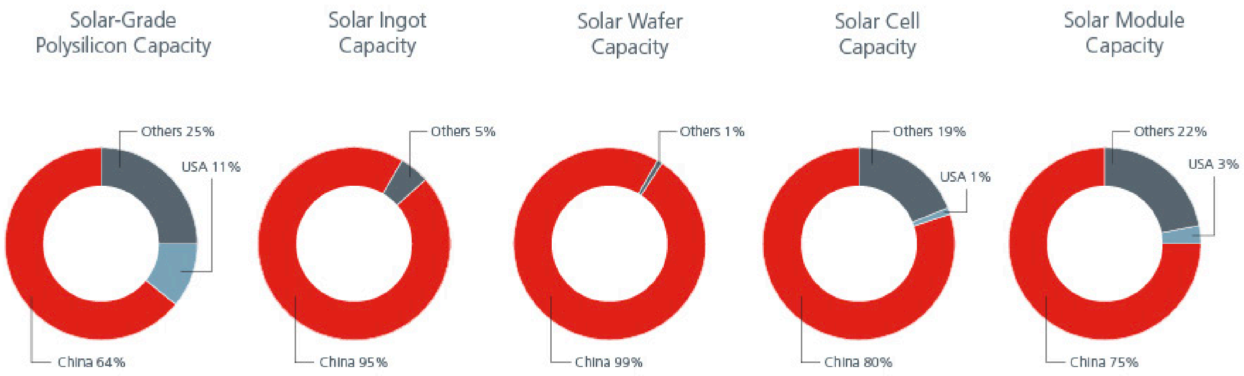
Fig. 3. Greenwashing occurrences by sector (2019 – 2020)

Sector	Share of total greenwashing cases
Financials	16%
Consumer Discretionary	16%
Energy	13%
Health Care	13%
Consumer Staples	10%
Real Estate	10%
Industrials	10%
Materials	6%
Information Technology	6%

Source: Mio Tech, J.P. Morgan, public information.

[4]J.P. Morgan. China ESG Data Analytics. Part III: Identifying greenwashing risks. 28 September 2021. [5]C.P. Morgan. China ESG Data Analytics. Part III: Identifying greenwashing risks. 28 September 2021.

Fig.4. China has a near monopoly on most solar manufacturing



Source: REC Silicon ASA.

The voluntary guidelines released in June suggest that we are one step closer to mandatory disclosures in China.

In addition, there are opportunities to invest directly in China's green sectors. With energy and climate being a priority for policymakers, the China government is expected to commit significant resources to support these sectors. Investors tend to be more familiar with China's solar power and Electric Vehicle (EV) companies. China is a world leader in solar manufacturing (See Fig. 4) and dominates the world's EV supply chain.

There are also opportunities in other green sectors in China. For example, China's power grids are adopting digital technologies and automation in order to optimise power dispatch on the back of a rapid increase in renewable capacity. Domestic companies that provide grid automation equipment or software for power grids' customer service platforms are potential beneficiaries of rising digital grid spending and the reforms taking place in China's power market. China's gas utility companies are also developing carbon management technology. Some of these utilities offer low-carbon/zero-carbon integrated energy solutions using renewable energy sources as well as integrated energy storage systems. Meanwhile, hydrogen is likely to play a key role in China's de-carbonisation efforts. Companies that construct hydrogen equipment for fuelling stations and storage tanks also present interesting opportunities. China's successful EV and renewable energy companies suggest it is able to develop world-class companies that contribute significantly to the global effort to combat climate change. We continue to assess and capture these emerging opportunities for our clients.

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