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ESG in Action: China

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With China's increasing importance in the global economy, the country is at an inflection point in its broad adoption of ESG principles and stewardship activities. This quarter, we returned to China for the second time in 2018 to meet with portfolio companies. We also attended the Asian Corporate Governance Association (ACGA) annual conference. Through meetings with companies, regulators, and local institutional investors, we gauged key driving forces behind the recent ESG momentum in China, identified challenges, and areas where active investors could play a role to further develop the ESG ecosystem.

Momentum in Corporate Governance and ESG Disclosure

ESG adoption in China is still mostly driven by regulations and consumer demands, less so by investors. In our meeting with Shanghai Stock Exchange (SHEX), we discussed progress towards higher corporate governance (CG) standards and the promotion of ESG disclosure. In September 2018, China released amendments to its CG codes, the first since 2002. Key changes include strengthening the protection of retail investors, encouraging responsible investment and participation by institutional investors, and emphasizing the role of independent board members. In addition, listing requirements now include a mandatory audit committee.

The new CG code also incorporates ESG disclosure although what will be required is not certain as guidance will be rolled out at a later stage. Compared to Hong Kong Stock Exchange (HKEX), where a majority of our China holdings are traded, ESG reporting is still in its early stage for the mainland A-share market. **Since 2016, HKEX has required list firms to disclose their ESG policies including a Global Reporting Initiative (GRI) Index and state whether they are compliant with regulations on 'comply or explain' basis.** In mainland China, CSR reports are still voluntary and mainly focus on environmental information. The number of CSR reports by listed firms increased from 69 in 2008 to 845 in 2016, although this has plateaued in recent years. Regulators committed to make environmental disclosure mandatory for all listed firms by the end of 2020—a significant positive step.

In addition to government regulations, surging consumer demand is another key factor behind the recent ESG momentum in China. As more and more people become aware of environmental issues, environmental risk can easily damage companies' brand image and competitive positioning.

Challenging Headwinds

While positive changes are underway, we also see significant challenges. **There is a lack of a long-term oriented institutional investor base.** Investor Stewardship development in China is still behind and there is little participation from local institutional investors, who tend to have a short investment horizon with high trading frequency. However, a few leading asset managers became UNPRI signatories over the past two years. In addition, MSCI's inclusion of A-share this year could be a positive catalyst for increased focus on ESG issues from foreign investors.

In Brief

- ESG adoption in China is primarily driven by regulations, less so by investors
- First significant updates to Corporate Governance (CG) Code in sixteen years
- ESG Disclosure is still voluntary in mainland China, but environmental disclosure will be required by 2020 for all listed companies
- There is a lack of strategic integration of ESG issues at C-Suite level management discussions, and ESG efforts are primarily compliance-driven
- ESG data is exponentially expanding, but quality is mixed; independent judgement is key
- Party Committees, required under the new CG Code for State-Owned Enterprises, raise concerns about companies' decision-making processes
- Active investors need to engage with regulators and companies to share best practices to further build out the ESG ecosystem in China

Environmental Reform and Clean Energy

'Beautiful China' has been a key policy driver behind the rapid developments on clean energy and green finance in recent years. Replacing coal with natural gas is an important component of China's commitment to the goals of the Paris Accord and a shift to a cleaner energy mix. Winter heating using coal is a major source of pollution. During our trip, we visited a rural village in Handan, a city in northern China known for its pollution. Gas heating penetration is now 90% in the village, from all coal-based heating in 2015. The government has set a target of clean heating penetration in Northern China from 34% in 2016 to 70% by 2020. Green finance is also gaining momentum. In 2017, both green-certificate and carbon-trading schemes were established in China. AMAC, the Asset Management Association of China, recently published Green Investment Guidelines to promote Green Finance. Often the progress of these programs needs to be understood in the context of the overall energy sector reform in China, which will take time.

There is a lack of corporate culture to integrate ESG reporting into business operations and strategic decisions. The attitude towards ESG is still primarily compliance-driven. Most companies do not have the awareness and process to include ESG issues at C-Suite level management discussions. **Regulators see current CG rules and enforcement as sufficient to prevent companies to 'do no evil', yet find it difficult to provide incentives for companies to 'do good'.**

One controversial area of the new CG code is the requirement for State-Owned-Enterprises (SOEs) to incorporate Party Committees (PC) into their Articles of Association. Party Committees are a unique aspect of corporate governance in China especially for SOE firms. Despite a long history in practice, there is a lack of understanding of PC's role and existence. The new CG code has established PC's role in the collective decision process for SOEs. However, it did not specify the relationship between PCs and the Board of Directors, nor does it require disclosure of PCs activities. **Historically Boston Common has not invested in companies that are majority-owned by the State due to corporate governance and human rights concerns.** Meetings with our portfolio companies have not raised any concerns, but we continue to monitor and engage with them.

Active Judgement of ESG Data is Key

Through our discussions with local investors and stakeholders, we noticed the exponential growth in the volume of ESG data, thanks to surging demands and proliferation of third-party data providers. However, there is a general dissatisfaction with the quality and comparability of these data. ESG scores from the major data vendors have very low correlation with each other. Investors struggle to incorporate this data while corporates are confused about reporting on ESG factors. **At Boston Common, we use raw ESG data from multiple data vendors and triangulate them through our own data sources. We believe investors should take an active approach in integrating ESG data; while the science is in the data, the art is in integration and active engagement.**

The most dynamic growth areas in today's Emerging Markets also happen to be in sectors where better ESG practices can build superior performance.

For example, one of our portfolio companies in China, Beijing Enterprises Water, reached out to us to provide feedback on how they can take the next step in ESG reporting. The company already provides disclosure according to the HKEX requirements. The company also asked us which were the most relevant disclosure frameworks and what metrics did we find most material. We shared with them best practices from relevant industry leaders across the globe and encouraged them to take the next step including responding to the CDP on water. More encouragingly, we believe our dialogue will lead to better understanding by the company of materiality issues and investors expectation.

We believe active investors, including Boston Common, can help to promote corporate best practices through Active, Engaged Ownership and Sustained Dialogue. **As ESG gains momentum in China, there is a clear role for active investors to share perspectives with regulators and companies about the best practices to help further build out the ESG ecosystem.**