ESG IN CHINA: **CHALLENGES AND OPPORTUNITIES**

Investor interest in China has surged in recent years. The Chinese government welcomes foreign capital, and the country's rising middle class, as well as its leadership in emerging technologies such as solar and batteries for BEVs, offer interesting opportunities for investors.

China's growth potential is undeniable, but recent reforms highlight how challenging it is to invest sustainably in the country. This article details the recent demographic shifts in China and government regulations that strongly impact Chinese companies. As sustainable investors, we also explore the main environmental and social risks to consider when analysing a Chinese company.

We purposely do not draft a clear conclusion to this article, as views on the credibility and success of sustainable investing in Chinese companies may diverge according to the reader and will undoubtedly evolve over time. Navigating the complex national context to invest in China with an ESG angle requires a profound knowledge of the country.

INVESTOR INTEREST IN CHINA

In 75 years, China has risen from a famine-stricken nation ravaged by imperialism and war to become the world's economic powerhouse. Progress has by no means been linear, but lifting more than 770 million people out of poverty is undeniably impressive and explains, in part, the Party's support. Today, we stand at a juncture as big government attempts to assert its position in the daily lives of citizens and corporates. If Deng Xiaoping let the capitalist genie out of the bottle, leading to an unprecedented rise in economic growth and inequality, Xi Jinping is reaching for the stopper.

Common prosperity, centralisation of power, and corporate control are not new concepts. Party influence has increased steadily under Xi, exploding into the limelight through fines and regulatory reforms impacting education, real estate, and all-encompassing internet platforms. The environment has calmed, but it is not yet clear the extent to which golden shares will impact corporate growth and returns on capital. As a result, it is vital, more than ever, to analyse companies holistically and align investments with favourable long-term trends and policy tailwinds.

While the Party may appear monolithic, it is extremely difficult to generalise a population of 1.4 billion and the thousands of companies which have helped build China's leadership in industries ranging from solar power to electric vehicles. While an enlarged state may depress sector returns, it is worth highlighting the government's success in rationalizing unproductive capacity in industries such as steel. Strategic policy decisions made over decades are helping China transition from basic manufacturing into services and higher value products, for example, in pharmaceuticals. In the current economic environment, with elevated financial leverage, such a transition is vital and paves the way for further growth and socioeconomic development.

With rising state influence comes an even greater need for investors to ensure their companies are growing responsibly and aligned with policy objectives. Where policy conflicts with global norms, we have a responsibility to hold management to higher standards and engage where there are doubts around compliance. Growth may have slowed, but China's GDP per capita is still less than a quarter of that in the US. **A renewed focus on environment and social equality is no bad thing. This increases the complexity and challenge of investing in China but makes it no less attractive in the longer term.**

YOU, ME AND XI: SHARING CUSTODY OF ACTIVE COMPANIES IN CHINA

Since 2009, the Communist Party of China (CPC) has increasingly followed a path of authoritarianism, characterised by increasing centralisation of decision-making and ever-increasing party-state control over different aspects of life. The 20th party congress reinforced this, seeing amendments to the Constitution which raise the status of Xi Jinping at the core of the CPC. This chapter highlights the current methods and laws that the government uses to influence companies active in China.

Alignment of the Party's interest and economic activities in China

Xi has promoted and strengthened the role of state-owned enterprises (SOEs) in certain industries to the detriment of the private sector. Since coming to power, a significant consolidation among SOEs has taken place to strengthen their impact. The total number of SOEs have declined by around half, while the assets of individual SOEs have increased fivefold. This consolidation is demonstrated by the Fortune 500 list of the world's largest corporations, where Chinese companies (135) outnumber those from the US (122). While the consolidation of SOEs is considered positive to counter significant inefficiencies from the past, the expansion of SOEs into other industries may crowd out private companies. The importance of SOEs is so far-reaching that some estimates suggest that up to 45% of China's economy is controlled by SOEs, with a significant number of industries being excluded for private companies.

SOEs are an important tool for the CPC, providing public goods and performing social, economic and political functions. The close relationship between senior SOE management and top party officials is evidence of the multifaceted agendas of these companies. While China's SOEs are organised in corporate form with all or most of the attributes of standard corporate governance, they are controlled mainly by the CPC. The figure below illustrates the four pillars of this political governance structure. State ownership provides legitimacy, the Party cadre management system ensures alignment of the Party's and SOEs' goals, the Party's participation in corporate decision-making serves as process control, and intra-Party supervision is the monitoring mechanism.

Figure 1: Political governance in China's SEOs

Source: China journal of Accounting Research, 2023

The Party's influence over private companies has also increased significantly since Xi Jinping took power in 2012. The Communist Party of China (CPC) has achieved this through two different bodies. The Organisation Department is an agency that acts as the 'human resource department' of the Party Central Committee and manages the positions of approximately 70 million Party members across the country. The United Front Work Department (UFWD) is an umbrella organisation tasked with increasing the CPC's control and influence in China and abroad.

In September 2018, the China Securities Regulatory Commission announced a Code of Corporate Governance for Listed Companies. Under this code, domestically listed private firms must establish a party cell or organisation and provide the "necessary conditions" for CPC activities. The Party has demanded that both SOEs and private sector enterprises not only declare their loyalty to the CPC but also affirm the pivotal role of grassroots CPC cells and branches in business operations and decision-making.
The Organisation Department of the CPC has played a crucial role in this expansion. People's Republic of China official statistics state that in 1998, approximately 0.9% of private enterprises had what the CPC's theoretical journal Qiushi described as "connections" with the Party. By 2008, the figure was 16%, and by the end of 2014, the latest year for which data is available, 53.1% of private enterprises (1.58 million firms) had established such connections. This rose to over 95% among large private sector enterprises. An additional dimension has been added to the party-state's oversight role with key municipalities, as well as the State-owned Assets Supervision and Administration Commission (SASAC), assigning government officials to new offices in private firms. These include some of the biggest enterprises in China, such as Geely and Alibaba. In 2003, only 6% of the significant private firms had Party cells. That increased to 21% in 2010 and to 73% by 2017, according to data provided by the CPC in 2018.

The government is also obtaining so-called "golden shares" in companies operating critical information infrastructure and holding large amounts of data. One golden share can provide majority control or include special powers, such as a veto over changing the company's charter and the power to restrict or block the number of shares that other shareholders can hold. Earlier this year, the CPC acquired golden shares in Tencent, Bytedance, and Alibaba, extending its influence over the country's star tech firms and its most powerful and wealthy businesspeople.

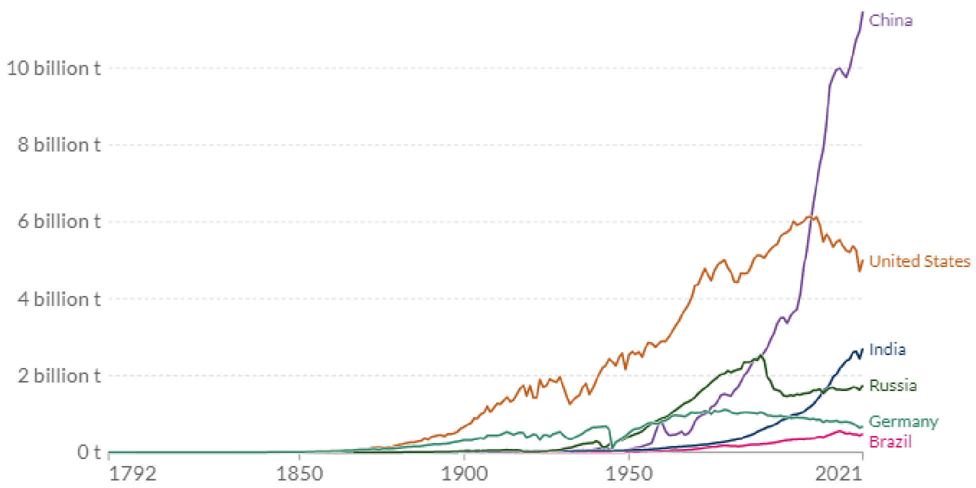
The creeping influence described above goes hand in hand with the top-down crackdown that the government initiated through heavy fines imposed on Alibaba after its founder criticised Chinese regulators. A wave of sanctions was passed in other industries, from internet and gaming companies to real estate and education, leading to a collapse in stock prices.

Given the government's focus on SOEs to deliver CPC ambitions, the installation of party cells in private companies, crackdowns on dissident companies and extensive influence through golden shares, a convergence between SOEs and private companies becomes apparent.

THE ENVIRONMENTAL CONSIDERATIONS: A COMPLEX PUZZLE

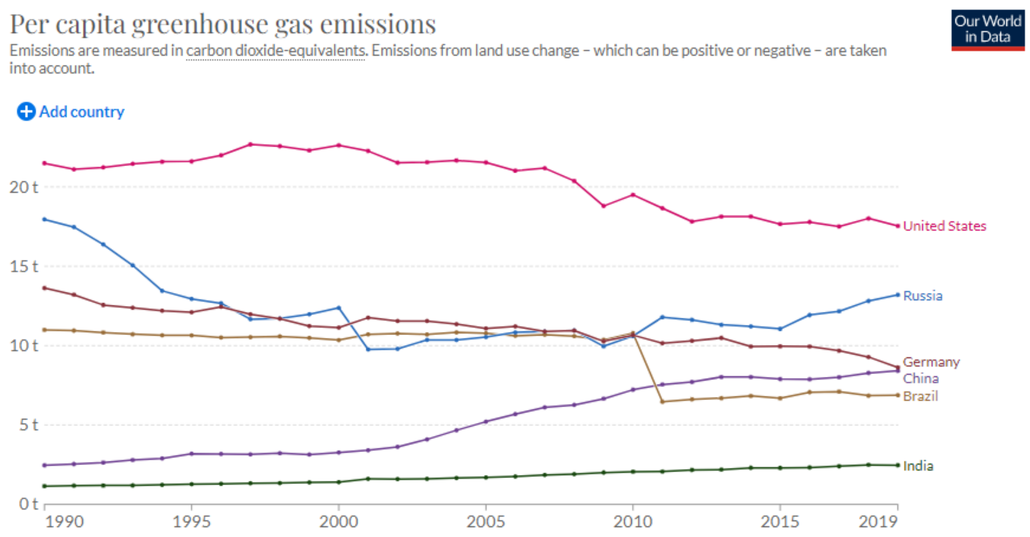
Traditional news coverage often portrays China's policies and ambitions concerning climate change in a negative light. The country is still the largest contributor to global CO2 emissions, as shown in the figure below.

Figure 2: CO^2 & Greenhouse Gas Emissions



Source: Our World in Data, 2022

Figure 3: Per Capita Greenhouse Gas Emissions



Source: Our World in Data, 2022

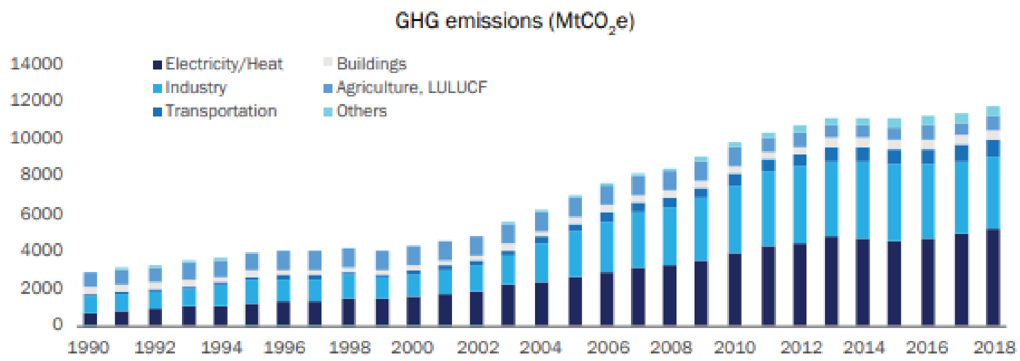
Considering the size of the country and its population, we observe that China's GHG emissions per capita are actually similar to those of Germany.

Another mitigating factor is the outsourced emissions of developed countries that consider China the world's factory. Therefore, some GHG emissions should be attributed to countries that buy products manufactured in China. Figures dating back to 2015, have enumerated that around 13% of GHG emissions of China originates from production meant for other countries.

Unfortunately, mother nature cares neither about per capita emissions nor production figures, and the consequences of climate change will continue to be felt as the absolute level of emissions rise.

Data from the IEA and calculations carried out by the World Bank show that the biggest drivers of emissions in China are the country' power (45%) and industrial (33%) sectors, followed by the transport sector (8%) and buildings (5%).

Figure 4: China's emissions profile is dominated by the coal-dependent power sector and heavy industry



Source: World Bank, 2023

The CPC is acutely aware of the negative impact of these emissions on its population's health and has enacted legislation to reduce emissions in specific industries while bolstering the production of renewables. Nevertheless, provincial plans released by China suggest that 100-150 million tonnes of coal could be added to production in 2023, according to Fengkuang Coal Logistics, which represents an increase of up to 3% compared to 2022. Last year, China's National Bureau of Statistics declared that the country had produced 4.6 billion tonnes of coal, an increase in production of 9% compared to 2021. This two-pronged approach undermines the government's efforts to mitigate climate change.

Subjected to environmental regulations

Over the years, the Chinese government has implemented significant steps to diminish the negative impact of companies on the environment. Companies that breach regulations may face fines or lose their license to operate. In key regions, targets were launched to reduce fine particulate matter in an air pollution prevention and control action plan.

More recently, China's emissions trading scheme was put into practice after long delays. This trading system currently includes about 2,000 enterprises in the power sector, which emit close to 4.5 billion tonnes of carbon dioxide annually, accounting for 40% of the country's total. However, at the end of 2021, China's Environment Ministry slammed firms for falsifying carbon data. The inaccuracy of ESG data relating to Chinese companies is a challenge that will be addressed later in this article.

During the CPC's 20th Party Congress, Xi Jinping's speech emphasised a key objective to reduce GHG emissions. This objective should be reached through efficiency gains, the modernisation of the country's energy systems, and only using coal as a backstop for energy security.

Therefore, it is crucial for companies operating in China to have proper environmental management systems to properly track pollutants and limit contamination on the environment. Failing to do so may result in fines from increasingly active regulators. In the context of the new national ETS, fines will be levied if an entity fails to report on its data, reports false information, or if the entities are unable to keep their allowances below the emissions allowances.

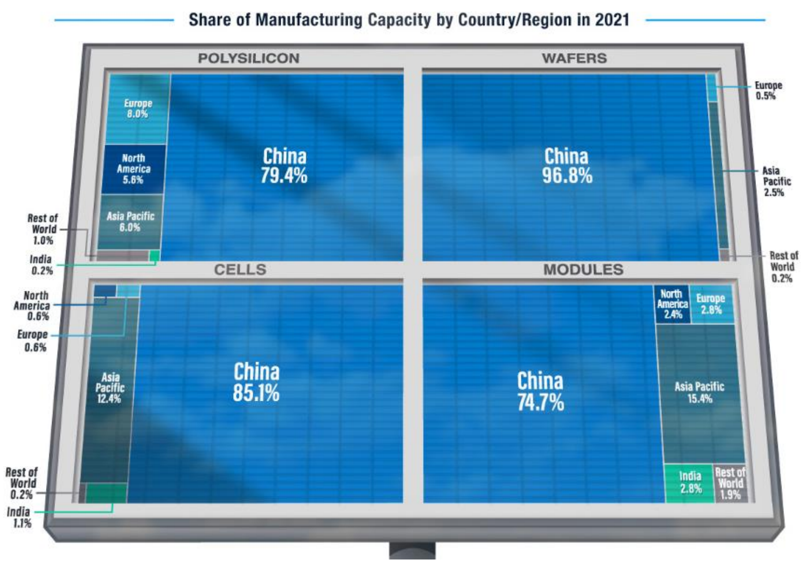
A focus on renewable production

The Asia Europe Clean Energy Advisory Co revealed that China's polysilicon capacity should increase from approximately 530,000 tonnes at the end of 2021 to up to 1.2 million tonnes in 2022, jumping to 2.5 million tonnes in 2023 and up to 4 million tonnes in 2024. However, this figure may be on the higher side of the spectrum as Bloomberg New Energy Finance suggests the total polysilicon capacity worldwide to be 1.5 million tonnes by the end of 2023.

At the Climate Ambition Summit in 2020, Xi Jinping announced that China plans to have 1,200 GW of solar and wind energy capacity installed by 2030. This goal will be necessary considering the rising electricity demand due to i) an increase in energy demand due to poverty alleviation, ii) the switch from fossil fuels to renewables, and iii) the electrification of the economy.

The country is well-positioned to achieve these impressive targets, having developed expertise in the production of renewables over the past decades. Heavy subsidies and the concentration of polysilicon in China were the foundations for the country's flourishing solar panel manufacturing industry. As depicted in the figure below, the country is already the frontrunner in the production of various solar panel components. Due to geopolitical tensions, this role may diminish, but given China's legacy and know-how, it won't happen overnight.

Figure 5: Share of Manufacturing Capacity by Country/region in 2021



Source: Visual Capitalist, 2023

THE SOCIAL **CONSIDERATIONS**

It is challenging to discuss the social risks that companies operating in China face without touching on infringements made possible by national legislation. allows. This article focuses on two specific elements: digital rights and the prosecution of Uyghurs in the Xinjiang region.

When it comes to protecting user information from the Chinese government, companies have limited options. The government has unbridled access to customers' data through a range of regulations, which can be used to monitor, track, and prosecute political dissidents or citizens critical of the government.

It is often challenging to distinguish between organisations actively procuring data for the government and those simply following regulation. Clearer ethical question marks are raised by companies such as Hikvision, which has played a more active role in identifying minority groups subject to government persecution. Their surveillance products have been found in so-called vocational education and training centres in Western China and were used to identify people during recent COVID mass protests. This active facilitation of human rights infringements is different from the passive involvement through data sharing enforced by national laws. It is challenging to identify the level of involvement, especially given companies' reluctance to discuss the impact of government regulation on their activities.

Categorising the government's legal instruments controlling data management is difficult as they are vague and far-reaching. The Great Firewall, a collection of laws and technologies used to enforce China's digital censorship, blocks foreign content and companies from the Chinese market. It also influences the development of China's internal internet economy by nurturing domestic companies and reducing the effectiveness of products from foreign internet companies. Various Cyber Security Laws determine how companies must collect and share data with the State. The wording of the law is deliberately vague, allowing the government to use and interpret it flexibly while denying any contention. The Data Security Laws prohibit data stored within China from being provided to foreign legal or enforcement authorities without approval from competent Chinese authorities. This restriction on transfer and production of data appears to apply to all types of data and is not limited to "important data", which is already subject to restrictions from the Cybersecurity Law. Organisations are restricted from reporting on what data is shared with the government, making it difficult to have a proper view of the collaboration between organisations and the government on authoritarian or non-democratic crackdowns.

In addition to the role some businesses play in infringing digital rights, the prosecution of the Uyghur is another key issue. Over one million people are estimated to have been processed in re-education camps in Xinjiang and are forced to support companies operating in the area. In response, the US Uyghur Forced Labor Prevention Act (UFLPA) came into effect in 2022. It prohibits the importation into the US of all goods wholly or partially produced in the Uyghur Region, on the presumption that forced labour is involved. This presumption also applies to goods made in or shipped through other countries (including China) that include inputs made in the Uyghur Region. Similar legislative proposals are being discussed in Europe, with the European Parliament adopting a resolution in June of last year condemning crimes against humanity against the Uyghurs in China and calling for a ban on the import of products made by forced labour. Following the resolution, the EU Commission published a proposed regulation on prohibiting products made with forced labour on the Union Market, empowering EU member states to detain, seize, or order the withdrawal of such products from the EU market.

It is alleged that Uyghur labour is being used in a wide variety of sectors, from IT to textile, solar panel, and wind turbine manufacturing. Increased scrutiny of western companies' supply chains will provide a more complete picture and increase attention on companies operating in the Xinjiang region.

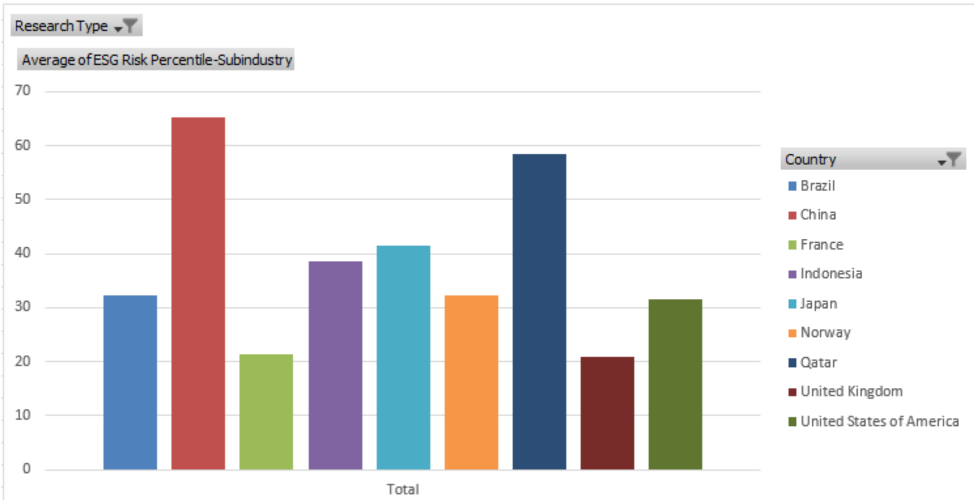
Of course, China is not the only country where companies face severe human rights abuses. Nevertheless, China stands out given significant government involvement in Chinese corporate activity and the link between alleged human right abuses and government labour programmes.

WORKING (TOGETHER) WITH DATA PROVIDERS TO IDENTIFY ESG RISKS

Working with ESG data providers helps assess the ESG risks of investee companies. It can provide useful signposting around which further ESG analysis can be carried out.

Analysing data that is currently available from one provider we can see that ESG risks are perceived to be significantly higher in China. Even after adjusting for subindustry biases between regions, the average ESG risk percentile of a Chinese company is dramatically higher than for companies in developed countries or even other developing nations.

Figure 6: Average of ESG Risk Percentile-Subsidiary



Source: Sustainalytics, 2023

There are some elements that explain this discrepancy between the geographical scope:

- The coverage rate of companies tends to be lower in emerging markets, China in particular. Much of the analyses carried out by data-providers use a multi-factor assessment model based on Machine Learning. Significant biases can be observed as a result.
- There remains a bias towards good ESG practices based on a western point of view, as extra-financial rating agencies remain conditioned by a western view of environmental, social and good governance issues, to the detriment of companies from emerging economies, particularly Asian ones. This can really be unearthed when looking at corporate governance aspects, where different market practices can be observed between western companies on the one hand and Chinese or Japanese companies on the other.
- ESG disclosure is significantly lower for Chinese companies compared to other companies across the globe. However, this lack in disclosure does not always lead to lagging ESG practices. For example, it may be that the company has put in place best practices for its workers, but fails to report on it to investors, as investors' requests are less frequent with Chinese investors.

There is some hope that with increased shareholder pressure, Chinese companies might improve their ESG reporting. This is already the case for some Chinese large cap companies, such as Tencent or Alibaba.

Unfortunately, in 2021, China passed a law that restricts the sharing of corporate data with non-Chinese authorities. This also demonstrates the limited ability of companies to share data about their supply chains with those outside of China. This is especially relevant for the ESG issues that can be linked back to the government.

INVESTORS SHOULD TREAD CAREFULLY BEFORE MARRYING CHINA'S ESG CHALLENGES WITH INVESTMENT OPPORTUNITIES

The incredible economic catch-up of the Chinese economy with developed markets over the last 75 years has led to a significant surge in social emancipation for its population. Fueling this trend through investments can be the key to continuing to alleviate poverty among the Chinese people and providing them with access to decent healthcare, proper education, and economic emancipation.

Investing in China does come with some ESG challenges. A proper understanding of these challenges is necessary to avoid investing in companies that may be in the regulatory line of fire of Western or Chinese government sanctions. Simply relying on the ESG scores of Chinese companies is insufficient to properly assess the ESG risks they face. In-depth knowledge of sector-specific risks and geopolitical challenges must be integrated as well. Sectors, industries and themes should never be capitalised, unless they are at the start of a sentence.

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