Environmental, Social & Governance Risks in China

Valentina WU, SynTao - Sustainability Solutions

July 2013

Originally published in Top Capital www.topcapital.com.cn. Republished with permission

Environmental, social, and corporate governance (ESG) is the catch-all term for the concerns that are now central to the measurement of a company's non-financial and sustainable performance. The type of investment that takes ESG issues into account is called Socially Responsible Investment (SRI). ESG integration refers to the idea that investors should aim to analyze a company's sustainability practices and performance because such indicators can have a material impact on an organization's financial success.

Responsible investors are concerned with the types of long-term ventures in which ESG issues play an important role. While responsible investments are linked to the retail financial sector, they are often made in sustainable fields, like renewable-energy and green technology, which incorporate ESG issues and criteria linked to a values-based approach. Two key trends are driving ESG integration into investment decision-making. First, asset owners like pension funds are adopting ESG integration strategies into portfolio management. Second, ESG indicators are increasingly seen as material, as they can help identify risks and opportunities that are often missed by traditional metrics. In cases when the market-value of a company can be attributed to intangible assets, mainstream investors are paying greater attention to a firm's ESG performance in order to assess its financial return potential.

The UN Principles for Responsible Investment (UNPRI), whose signatories include 269 asset owners and 742 investment managers, offers a framework for investors seeking to integrate ESG risks into their investment strategies. Research conducted by the UNEP Financial Initiative (UNEP FI) has shown that ESG issues significantly affect shareholder value in the short and long term, and 94% of UN PRI signatories have established their own sustainable investment policy. Additional studies have also shown that a company's ESG performance is positively correlated with improved risk-adjusted returns. As of December 31, 2011, the global sustainable investment market (excluding Latin America) is estimated to be valued at USD $13.6 trillion. [1] This represents 21.8% of total global assets under professional management, and the International Institute for Environment and Development (IIED) has stated that the sustainable investment market is expected to grow to one third of total invested capital by 2015.[2]

Despite the increasing number of sustainable investments made globally, the concept of SRI has only been around China for about a decade. SRI becomes popular due to growing concerns surrounding China's environmental crises and labor issues. In April 2008, AEGON-Industrial founded the first socially

---

[1] Global Sustainable Investment Review 2012, http://gsiareview2012.gsi-alliance.org

[2] IIED. Investing for sustainable development? A review of investment principles - trends and impacts. Just Economics. 2011. http://pubs.iied.org/16505IIED.html

responsible fund in China. CCB Principal Asset Management and China Universal Asset Management followed suit with their own SRI funds in 2010 and 2011 respectively. There is also an array of different funds categorized under the greater domain of responsible investment that are active in the Chinese market, such as low-carbon and environmental protection funds.

Thus, it is becoming increasingly important for mainstream investors in China to integrate ESG risk concerns into their portfolios. Undisclosed ESG risks, accounting for a great proportion of the so-called "black-swan events", can have a catastrophic impact on the companies, industries, and markets involved.

Three such events closely reflect the dramatic effect that ESG issues can have on profitability. In 2012, Guizhentang, the company responsible for producing traditional medicine from the bile of live black bears, became the most controversial firm of the year after receiving massive public opposition to its operation from celebrities and non-governmental organizations (NGOs). The company dropped its initial public offering (IPO) in June 2013 after regulators continued to scrutinize their listing, and the firm has had significant difficulty in raising capital since. In 2010, Zijin mining's pollution activities not only incurred China's highest pollution fine and a large compensation loss, but also caused unpredictable long-term damage to the company's reputation. Lastly, in an event that received worldwide attention, Foxconn's stock-prices plunged after several employee suicides convinced workers to threaten the company with protests over their allegedly slave-labor like conditions. Before the dispute was settled, many financial advisors had suggested that investors dump their stakes in the company, doubting Foxconn's ability to remain profitable in the future.

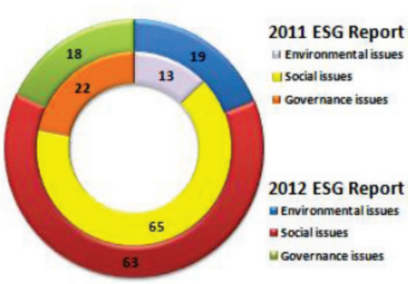
These events demonstrate that non-financial factors can have a considerable impact on the financial performance of a company. As such, companies need to pay greater attention to their own ESG performance should they want to retain or improve upon the confidence that investors place in them.

ESG risk monitoring

Negative screening (e.g. excluding the companies producing weapons) and positive screening (e.g. Best-in-Class) are the two main tools used for portfolio mix selection and ESG factor evaluation. SynTao's ESG risk reports for 2011 and 2012 discuss China's major corporate ESG challenges through negative screening, and were based on findings made from SynTao's local news monitoring system. SynTao carried out the studies in order to identify the country's most pressing ESG issues, and were assessed on both an individual and industry-wide level. When integrated into investment analysis and decision-making, the potential risk and value impact of ESG factors may provide investors with long-term performance advantages.

SynTao's news monitoring system is designed to help investors identify potential ESG risks in their portfolio and comply with international norms such as the UN Global Compact and the UNPRI. It identifies when articles released by the Chinese media that are written in Mandarin highlight particular ESG issues in the operation of Chinese companies. SynTao's studies provide an up-to-date overview and analysis of the sustainability concerns specific to the realities of the Chinese market, and encourage responsible investors to develop an ESG strategy for their investment decision-making. For further indepth reading on the topic, please refer to SynTao's "Revealing China's ESG issues 2011" and "Revealing China's ESG issues 2012".

Chart 1 Distribution of alerts per ESG issue (%)



The social category has the most pressing ESG issues

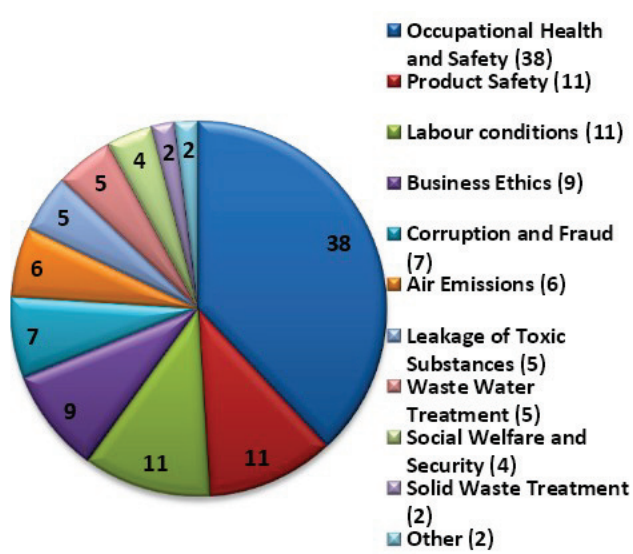
In 2011 and 2012, the most pressing ESG issues were found in the social issues category. The category covers topics such as occupational health and safety, welfare and security, labor conditions, and product safety. Overall, both occupational health and safety and product safety received the most alerts for social risks.

Social issues generated 65% of total alerts in 2011 and 63% in 2012. Environmental and governance alerts accounted for 22% and 13% respectively in 2011, and 19% and 18% respectively for 2012. (see chart 1)

Occupational health and safety

According to the overall number of generated alerts, the most pressing ESG issue in both 2011 and 2012 was occupational health and safety. The category accounted for 41 % of total generated alerts in 2011 and 38% in 2012.

Chart 2 Breakdown of ESG alerts per risk category (%)



In 2011, most of the generated alerts for occupational health and safety came from the manufacturing and mining industry, sectors that are generally characterized by unsafe and labor-intensive working environments. It is estimated that around 200 million people in China work in hazardous circumstances and are faced with the constant threat of occupational disease due to human carelessness and fatigue, unsafe working conditions, and poor prevention and workplace inspection by public authorities. According to SynTao's findings, most accidents were related to the abovementioned industries, and were mainly caused by building collapses and flammable substance leakages that caused fires and explosions. Occupational health and safety continues to be a recurring high-risk issue despite the large number of regulations present within China's Labor, Safe Production, and Occupational Diseases Laws.

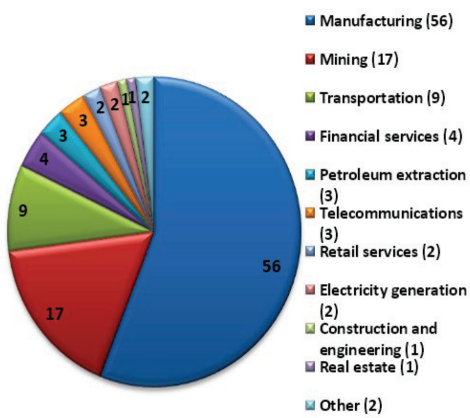
Product safety

Product safety accounted for 11% of total alerts in 2012 over 6% in 2011, highlighting one of the Chinese public's most widespread concerns. Most product safety issues apply to food contamination, and is a highly sensitive matter among domestic consumers. In recent years, China has experienced several shocking food scandals, one of the most infamous being the recall of infant formula tainted with excessive levels of mercury. The incident is reflective of much wider food safety problems in China, as the addition of non-food grade chemicals in food ingredients, illegal use of food additives, inaccurate or misleading product labeling, and the lack of proper pesticide and fertilizer management practices are common in the industry.

Industry most affected by ESG issues

Manufacturing was the industry most affected by ESG issues in 2011 and 2012. Of all the ESG alerts generated between 2011 and 2012, 56% were associated with this sector. The majority (43% of these alerts) were related to occupational health and safety issues. However, the industry is confronted by additional challenges from the following ESG sub-categories: environment and industrial hazard (18%), corruption and fraud (14%), and product safety (7%).

Chart 3 Breakdown of ESG alerts per industry (%)



The manufacturing sector can be divided into several sub-industries. Most alerts were generated for chemical and chemical product (30%), food product (7%), pharmaceutical, electrical component and board, basic iron, steel, and ferro-alloy manufacturing (5% each) in 2011.

For both 2011 and 2012, manufacturing was the most exposed industry to ESG issues, accounting for 55% and 56% of total alerts respectively. ESG exposure was highest for the pharmaceutical manufacturing sub-category, which increased from 13% to 18% between these years and accounted for almost one-fifth of all manufacturing-related alerts. Additionally, chemical and electrical component production each accounted for 17% of alerts in 2012.

The exposure of the manufacturing industry to ESG issues can be explained by the large size of the sector in relation to the overall Chinese economy. Over the years, economic growth in the country has been driven primarily by labor-intensive and export-oriented manufacturing activities. In 2010, China became the world's largest manufacturer, accounting for almost 20% of global output. By nature of its share of the world economy, ESG issues that affect one company domestically often automatically impact the entire industry. A scandal quickly spreads to the operations of other firms, generating additional questions about the integrity of the sector as a whole. Foreign companies linked to China through their supply chains are therefore highly exposed to domestic ESG challenges, as they are equally responsible for ensuring that their suppliers are properly vetted and managed.

Implications for investors

Social concerns were by far the most common type of ESG risk reported among companies in China. For two years in a row, SynTao's ESG risk reports have found that manufacturing, and in particular the pharmaceutical, chemical, and electronic component sub-categories, was the most exposed industry to social risks. The corporate sector was also especially susceptible to issues in the areas of occupational health and safety, labor conditions, product safety, business ethics, corruption, and fraud. Significantly fewer alerts were received for environmental and governance issues.

Integrating ESG factors into investment strategy considers the economic implications of quickly changing socio-economic circumstances in China, and can provide comprehensive strategic insights that may otherwise be overlooked. Companies that incorporate sustainable goals into organizational strategy make strong ESG performance a proxy of managerial competence, with implications for future cash flows for company returns and investors. Similarly, responsible investors should be able to anticipate where ESG incidents can occur, realize how a company is expected to respond, and recognize the potential economic implications of such risks.

SRI provides a great opportunity for Chinese investors to understand how ESG considerations can be integrated across a wide range of financing decisions as a way to better comprehend the long-term sustainability of a project or investment. It can help identify new opportunities, improve financial performance, increase returns, and help mitigate risk. Above all, however, the core principles behind ESG as an approach to business provides all stakeholders involved in the Chinese marketplace with a greater understanding of the underlying trends that will drive the country's long-term economic success.

SynTao *Co., Ltd. is a leading Beijing-based consultancy promoting sustainability, responsibility in the Asian region. We provide consulting, research and training services in Corporate Social Responsibility (CSR) and Socially Responsible Investment (SRI) . SynTao has developed successful partnerships with a wide range of local and overseas organizations such as international and national corporations, government agencies, NGOs, academic institutions and media groups.* *www.syntao.com*