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China's exciting ESG evolution

Growing appreciation of ESG investing in China's A-share market comes with considerable upside potential for investors.

Awareness of environment, social and governance (ESG) concerns has been a growing global trend among governments and societies more broadly over the past few years.

We have lost count of the number of times we've been asked to explain ESG. In reality, it means different things to different people, so we should start by outlining what ESG means to us.

In ESG, the 'E' deals with how companies interact with the environment – what they consume, discharge, dig up or leave behind.

The 'S' deals with the way companies interact with employees, government, society and vendors; and the 'G' refers to the governance of a firm, or how well it is managed.

There is a degree of overlap between the three elements. Our view is that 'G' is the most important, because it determines the 'E' and the 'S'.

As a fund house we integrate ESG analysis into our investment process, which means we consider risks and opportunities surrounding ESG factors when we do due diligence on companies.

For example, a company may look cheap, but if it is polluting rivers regularly it will likely be subject to a government fine, could suffer reputational damage and even be shut down.

Similarly a firm might be very profitable, but if it is a poor employer – working staff 16 hours a day or withholding pay, for instance – we would doubt its ability to retain its workforce.

Factoring ESG into company analysis means incorporating the full spectrum of information available to us as an investor. It is about trying to assess the sustainability of a company's business model and its ability to adapt, survive and thrive in a changing business environment.

It helps us to learn how a business operates and assesses risk. As such it allows us to develop a more rounded understanding of a company and its management. This puts us in a better position to understand whether the risk of investing is priced appropriately or not.

Ultimately, we believe selecting companies with strong ESG standards improves our chances of investing in long-term winners and avoiding loss-making corporate failures and scandals.

Active engagement

For years, global investors seeking access to China's economic growth had to buy stocks listed in Hong Kong because the A-share market was accessible only to domestic investors.

But gradually China has opened its exchanges to overseas parties, initially through the Qualified Foreign Institutional Investor (QFII) scheme in 2003. Subsequently authorities introduced an RMB-denominated QFII extension in 2011 and Stock Connect initiatives in 2014 and 2016. Today we are seeing incremental inclusion of A-shares in mainstream benchmarks.

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These deregulations have facilitated our journey from observer to investor.

China's A-share market is far deeper and more liquid than its Hong Kong counterpart and its range of companies and sectors more varied.

Our challenge in this market, as in any other, has been to identify firms that meet our strict quality criteria. We define a quality company as one with a strong balance sheet, sustainable earnings growth, progressive management and good governance.

We researched the universe for more than a decade before we made our first investment in 2011. From our earliest forays we learned that China's legal system needed to develop in terms of protecting the interests of minority shareholders.

Share ownership in China can be as concentrated as it is complicated, involving partnership structures and cross shareholdings where firms hold shares in companies that hold shares in them – which raises questions about potential conflicts of interest.

Certainly China lacked a supportive domestic eco-system – such as a formal regulatory framework – to guide investors and institutions on the practicalities of ESG issues.

Even today, some firms regard ESG reporting as a box-ticking exercise. They have little appreciation of how it can add meaningfully to risk management due diligence or contribute to improvements in corporate performance over the long term.

Since our entry in 2011 we have carried out innumerable company meetings and engaged with hundreds of management teams. It is important to question managers constructively.

Active engagement is what we do as owners of companies after we have bought them. The aim is to ensure that good companies remain good companies.

During this period we have campaigned for improved capital allocation, disclosures and corporate practices. Well-run companies with good capital management make better investments over time, in our experience.

Our process always starts with the controlling shareholder. We want to be sure their interests align with ours as a minority shareholder.

We check their backgrounds to understand where they have worked, how they have progressed through the ranks and whether they have been involved in any corporate scandals.

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We look to understand what connections they retain to privately held vehicles and scrutinise for related-party transactions. We look at the board and management team and assess their competence, character and commitment.

After we have invested we strive to foster a close working relationship with the management and their internal team through visits and regular communications.

We view ourselves as equity partners, not just shareholders. Ultimately we want to build rapport and a sense of trust with the managers themselves. Being close to the decision-makers helps us to engage with them more effectively.

It also helps us to evaluate which management teams are of the highest quality. These interactions either alleviate our concerns or raise awareness about additional risks.

Environmental opportunity

One area where we can source data consistently in China is on the environment. Chinese companies – especially large ones – are conscious about their carbon footprint.

Environmental degradation is a constraint on China's economic growth and a threat to national health and social cohesion.

Reducing reliance on coal for power generation has become a government priority. It explains why disclosures relating to the environment are relatively robust in this market.

As an investor we see risks and opportunities in segments such as energy consumption, waste disposal, land development, carbon emissions, renewable energy and clean technology.

Given that environmental awareness is relatively high, we find ourselves engaging on opportunities more than risks. Implementing sustainable practices can improve brand perception and customer loyalty and guard against catastrophes that could have legal ramifications.

Strategically, the government is fully behind increased use of renewable energy. China is by some distance the world's top investor in renewable energy and electrification of road transport.

We have seen growth in companies that provide solar power or deal in electric vehicles. We see further investment potential around component manufacturers, utility companies and transmission and energy storage companies.

Social side

In contrast, guidance on social factors such as how companies interact with employees, vendors and society more broadly is less developed in China. This can cause concern because social issues create business risks. Again, we see both ESG risks and opportunities.

We engage companies on building and maintaining corporate values. Supporting employee well-being and adhering to fair labour principles can lead to a more productive workforce, which will create value in the long run. Labour policies are closely tied to corporate strategy.

Above all we engage management teams on hiring policies. There is a race for IT expertise in China as companies move into advanced technological industries and digitalisation. We explore how they are working to attract and retain this talent.

Other social issues include supply chain management and establishing a code of conduct for suppliers. We also examine health and safety policies to understand what protections companies have in place to prevent loss of productivity.

As China opens its markets more fully, regulations will increasingly need to cater for this wider audience and provide stronger guidance on corporate practices. We engage companies on the issues, mindful of potential changes in future.

Positive progress

Encouragingly, we are starting to see signs of change. The China Securities Regulatory Commission has tightened rules on dividends, information disclosure and protections for minority shareholders and introduced more formalised roles for boards of directors.

We have witnessed improvements in corporate governance, such as enhanced board and management composition; formal dividend payout policies where there were none previously; improved transparency in reporting; and moves to diversify share ownership.

More companies have introduced employee stock ownership schemes, which better align the interests of management and minority shareholders.

Hundreds of Chinese firms now publish corporate sustainability reports (CSR), where they outline their thinking on sustainability, their aspirations to reduce their carbon footprint and the frameworks they have in place to negate ESG-related risks.

As an investor, we would like to see even more granular disclosures on sustainability issues – such as data on emissions as well as targets and a strategy for reducing them – above and beyond a simple CSR report.

But companies have become more willing to engage and listen to our interests as a minority shareholder. In response to our requests for information, one personal financial service group staged an investor day to grant us insights into its operations and access to decision-makers.

Our interactions gave us a better understanding of how it manages human capital, cyber security and anti-corruption and bribery risks. We gained an appreciation of how its products and services span socio-economic groups. We engaged on succession planning, and were heartened it has since put measures in place.

We have also engaged a leading property developer focused on tier 1 and tier 2 cities. We discussed ways it could capture opportunities in environmentally friendly building design. Now it is paying more attention to its green certification processes.

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Exciting potential

That A-share companies are more open to listen to us today is testament to the positive market progress we have seen since we made our first investment nearly a decade ago.

We have witnessed a growing appreciation that we are not in China for the short term, and this is helping to improve the dialogues we are having with our investee companies.

For example, we recently approached a company that interested us to assuage our concerns about a related-party transaction.

Initially we dealt with investor relations, but slow progress encouraged us to engage with management directly. We arranged to meet the chairman for tea in a Beijing hotel lobby one Sunday afternoon.

We had to come up with a game plan in advance. After all, we couldn’t simplistically say to the chairman: “We think related-party transactions are bad.” As company founder, he is primarily interested in growing the company, increasing its share price and making money.

We had to consider the best way to discuss how related-party transactions could impact on his company’s growth and how minimising them could benefit his firm.

In other words, we had to think like a business owner ourselves. That is how ESG is evolving for us. It is about doing things differently in an effort to generate sustainable alpha.

We spent two hours with the chairman in the lobby. We presented him with a long-term picture and explained that we wanted to work with his him as an equity partner.

He bought into our suggestions and said he would communicate internally to see how we could work together. He did not say he would change everything, only that we had made some valid points and that he would try to reform his business.

If the dialogue had failed, we would not have invested. While that would have meant we wouldn’t lose any money, it would have meant we wouldn’t have made any money, either.

In equity investing there is a need to take some risk. It is the growing awareness of ESG in the A-share marketplace that we think is exciting.

A lot of Chinese companies are beginning to appreciate the potential significance of ESG. Access to companies has improved to the point that some companies are approaching us for advice.

From our earliest investments to where we are today we have witnessed the A-share market’s evolution. It has come a long way, and has further room for development as well.

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