Investment Managers

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An evolving process: Understanding ESG challenges and opportunities in Asian credit

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Home to some of the world's pre-eminent economic growth engines, Asia's credit market is gaining increasing traction from global investors - as is its addressing of environmental, social and governance (ESG) issues. The ESG focus in Asia has received a huge boost in recent years and market players are incorporating more Asian names into their proprietary investing frameworks. As of June 2020, APAC-based ESG funds totaled US$61.75bn and ESG ETFs for APAC rose to US$7.01bn in first quarter this year, increased by 3.5 times in two years.[1] With this we believe it is vital to adopt both a holistic and case-by-case approach when evaluating these risks in an Asian context.

The rise of social and governance risks amid COVID-19

Climate change has put the spotlight on the "E" of ESG over recent years, while the pandemic has subsequently brought "S" and "G" into the frame. Amid the growing ESG influence in credit ratings, one major trend as a result of COVID-19 is a heightened focus on social risks, including healthcare and inequality. While the environmental factor can be assessed by a firm's carbon footprint, it can be more difficult to quantify social and governance risks.

Zooming in: US/China sanctions

Alongside the pandemic, investors are also facing a series of elevated macroeconomic uncertainties. The US/China geopolitical tension that gained further traction due to the approaching of the US Presidential Election, has caused an increase in sanction headlines and triggered plenty of market consternation. The issue and the risks implied are worth investors' vigilance, yet we think the ultimate impact of sanctions on different companies may be overstated due to their narrow focus and low likelihood of broad implementation.

For example, in late August 2020, the US Department of Defense (DoD) added 11 more "Chinese military-backed companies", including China Communications Construction Company, Three Gorges, ChemChina, SinoChem, and China State Construction Group, to the list they are required to keep under the International Emergency Economic Powers Act ('IEEPA').[2]

While being on the DoD list is an escalation, it appears to be measured and would not necessarily pose any issues until a listed company is contracting with defense-related US government entities.

Sources:

[1] https://www.ubs.com/global/en/investment-bank/in-focus/covid-19/2020/sustainable-investing-apac.html

[2] https://www.scmp.com/news/china/diplomacy/article/3099380/us-adds-sinochem-and-10-others-list-chinese-military-backed

[3] https://www.morningstar.com/insights/2020/05/11/sustainability-atlas-measuring-esg-practices

[4] https://www.moodys.com/research/Moodys-assigns-Baa2-to-JDcoms-proposed-senior-notes-outlook-positive--PR_414060

Even then, there seem to be various stipulations and further considerations before any business dealings would be impacted. From what we have evaluated, the greatest significance of the list, is it appears to make it easier for the US President to authorize sanctions under the IEEPA, as sanctions would not require the declaration of a national emergency as is otherwise required.

Coincidentally, at around almost the same time in late August, the US administration added 24 Chinese companies (some of whom are also on the DoD list) to the Commerce Department's more restrictive Entity List that bans them from buying specified American products deemed sensitive to US national security. After closer evaluation, we think the lists are serving as more of a public relations tool to effect geopolitical negotiations as the direct business impact is quite limited due to a high degree of conditionality. The most consequential ban would occur under the US Treasury's Office of Foreign Assets Control, which could limit or prohibit a sanctioned entity from access to the US financial system globally. We believe it is significant and, so far, encouraging that this has only been applied on very limited and exceptional basis. Despite a fair amount of heated rhetoric, sanctions appear to be a measurable and, therefore, manageable investment risk that is part of a broader emerging and diverse Chinese ESG landscape.

Evaluating Chinese names through the ESG lens

Chinese firms tend to score poorly on their sustainability profiles in global standards. A Morningstar study shows that China lands in the third quintile in a global scale.[3] In this context, some Chinese companies could be easily denied their investment potential, as they are subject to lower-than-standard ESG scores. That isn't always the case, however, and there could be more to consider behind a score calculated by proprietary methodologies.

Case 1:

JD.com is the largest e-commerce retailer in China in terms of revenue, offering a wide selection of products and an online marketplace for third parties via its website and mobile applications.

The company's ownership structure has long been under question. Richard Liu - founder and CEO - holds 15.2% direct interest in the company and 16.2% through other holding companies, and controls 78.5% of the voting rights in JD (as of March 2020). The high concentration of voting power makes JD.com subject to low score in governance risk terms.

However, we think there are several factors that can mitigate such risks. For example, JD.com has a balanced board, as most members are independent non-executive directors. Other than the company's long track record as a listed and regulated entity, it has also established a prudent financial policy and solid net cash position.[4]

The COVID-19 health crisis also warrants a look at how companies manage their supply chains. JD.com was better placed than its competitors in China to cope with the effects of COVID-19, due to a mix of factors such as its low dependence on physical stores and an efficient distribution network covering the whole country. Its vast range of products across and adoption of intelligent sorting systems made the retailer well equipped to absorb the surged demand and the shock of sudden change in purchasing.

Sources:

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Overall, we think the trend and evolution of JD.com's ESG profile is positive, even though it might be not be the case now in some proprietary ESG frameworks.

Case 2:

Metallurgical Corporation of China Ltd is a state-owned engineering and construction company, with 88% of revenue from E&C projects, including metallurgical, building and transportation infrastructure construction.

The company is bound to score poorly in E and S respectively as its resource development business is facing risks including pollution from mining and smelting, management of soil, water and waste, and a series of natural and man-made disasters.

However, such risks are mitigated by the limited scale of MCC's mining businesses and its track record of environmental protection and complying with regulations.

We also find MCC subject to relatively low governance risks. Dual-listed in Shanghai and Hong Kong, MCC is required to provide adequate information transparency to the public. Moreover, the company's ultimate ownership indicates it is monitored and supervised by the central government. The above-mentioned companies do not constitute any investment recommendation or investment advice. It is for illustrative purpose only.

Looking ahead

Over the near and medium term, the US/China stand-off, COVID-19 and other macro-level uncertainties will all naturally challenge investors' risk management, but particularly through the lens of ESG. While the rigour is helpful, the aim will be showing that such judgements can be consistently useful for investors.

New social and governance risks will arise as we slowly recover from the pandemic. To stay ahead of the curve regarding ESG investing in Asia, more case-by-case qualitative analysis – not just number-crunching - will be required.

Although ESG risks in Asia are still broadly greater than they are in the developed world, people are becoming more aware of sustainability issues. China, for example, is catching up on ESG standards by excluding so-called clean coal from a draft list of projects eligible for green bonds. In addition, it is now aiming to become carbon neutral by 2060. The country's President Xi Jinping surprised the United Nations General Assembly, stating that China is expected to hit a peak in carbon emissions before 2030 and would adopt "more vigorous policies" to achieve the new target.

ESG integration can help us make better-informed investment decisions and potentially optimise long-term risk-adjusted returns. For Asian fixed income investors, other than a structured approach, we think the key is to focus on material factors that have the greatest impact on bond valuations. With a structured approach and dedicated active credit analysis, we believe ESG investing will present tremendous opportunities for Asian investors.

Sources:

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Sources:

[1] https://www.ubs.com/global/en/investment-bank/in-focus/covid-19/2020/sustainable-investing-apac.html

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