Navigating ESG in China

“拨云见日”
“Dispel the clouds to see the sun”

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Introduction

Arisaig Partners has been investing in China since 1996. Back then, the country’s GDP was less than USD900 billion, or roughly the equivalent to the Netherlands today. We have since witnessed a period of economic success of unparalleled scale as the country became the ‘factory of the world’ following its inclusion into the WTO in 2001. GDP has compounded at a rate of almost 13% in dollar terms (to almost USD15 trillion).

Despite this, China has and continues to be a tricky place to invest, particularly for international investors. It is a market that has required an unusual amount of discretion from investors who wish to capture this underlying growth, with the index a poor reflection of the underlying opportunity – for example, the MSCI China Index, which perhaps best mirrors the investable universe of Chinese stocks for foreign investors, has delivered less than 5% annualized returns since 1996, around half the rate of the S&P 500 and less than half the rate of GDP growth.

Going forward, we believe this will continue to be the case. One key reason for this is the continued deepening of ESG into the economic agenda of the Chinese Communist Party, and ultimately into the capital markets and its various actors. Navigating this dynamic space requires deep discipline and an integrated ESG research and stewardship approach that goes beyond the passive indices and the reported data that underpins them.

In this piece we draw from our own experiences over the past two-plus decades as well as the views of a range of local ESG academics and practitioners. We outline the role that ESG has played within China’s equity markets, what ESG has largely entailed to date, and where we believe it is likely to head over the next decade. These learnings have helped to refine our own distinctive investment approach in China.
Executive Summary

- The Chinese equity market offers investors a compelling cocktail of attractive prospective returns and differentiation versus the broader global equity universe. Furthermore, the wide skewing of investment opportunities within the market creates rich pickings for active investors.

- Despite this, global investor allocation to China remains very low relative to its contribution to the global economy. With the barriers to entry for foreign capital declining in recent years, there is every reason to believe this gap will close.

- ESG in its Western guise remains a nascent concept in China. Nevertheless, there are signs that companies that score well on global ESG metrics have been able to outperform their peers. This coincides with a range of top-down policies from financial market regulators which have encouraged greater transparency and accountability for ESG amongst corporates.

- To date, governance (the ‘G’) has been the overarching concern amongst foreign investors looking into China. Issues have included the dominant and privileged position of inefficient state-owned enterprises (SOEs), legal doubts over the overseas investment structures that underpin many of the largest foreign-listed companies, accounting standards, and black-box regulation. While all of these concerns persist, there is reason to believe they have become a lot more manageable.

- Looking ahead, there is evidence to suggest that the pace of change of ESG adoption will accelerate significantly in the next decade and extend much deeper into the environmental (‘E’) and social (‘S’) pillars.

- Everything starts with the consumers in China. Not only do they shape an ever-larger stake in the domestic economy, but they also seed the future policy direction of the Chinese Government. We show that they have long been amongst the most-conscientious consumers globally but suggest that only now is this starting to manifest in the purchasing decisions they are making. This could have profound consequences on the nature of shopping baskets in the future.

- The policy priority of the Chinese Government is now evolving from brute-force economic expansion towards more inclusive and environmentally sustainable growth. The latest Five-Year Plan – announced in March 2021 - places social welfare and green development at its core. Given the power of the state to translate these wishes into actions, we see heightened risk and opportunity for all companies.

- Domestic investors are still grappling with this transition and how they should position themselves. We suspect that a recent migration of capital from retail to institutional investors will be an important ingredient for improving the sophistication and long-term mindedness of the capital markets.

- To conclude, we flag several learnings when it comes to adapting an ESG approach to China. These include prioritizing political risk, localizing frameworks and building up local networks.

June 2021
The attraction of China’s equity market

**Diversification benefits and the opportunity for active investment**

Chinese equities have offered investors attractive and differentiated returns in recent years compared with other national and regional markets.

![Sustainable Growth and Correlation of Major MSCI Indices](source: “China and the future equity allocations” by MSCI ESG research, 2019)

Meanwhile, the returns to active investors in China have been even stronger. The median China A-Share active manager delivered over 4% annualized alpha over the last decade. This is well ahead of emerging market peers, which in turn lead those in the developed world.

<table>
<thead>
<tr>
<th>China A Share active fund managers versus CSI 300 Index (Dec 31(^{st}) 2019)</th>
<th>Emerging Market active fund managers versus MSCI EM Index (Dec 31(^{st}) 2019)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3 years (pa)</td>
</tr>
<tr>
<td>5th percentile</td>
<td>16.2</td>
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<tr>
<td>25th percentile</td>
<td>8.5</td>
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<td>50th percentile</td>
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<td>95th percentile</td>
<td>-2.2</td>
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<tr>
<td># observation</td>
<td>50</td>
</tr>
</tbody>
</table>

\(^1\) Sustainable growth is approximated by the average of long-term sustainable reinvestment growth (sustainable ROE times earnings retention ratio) and earnings per share growth

\(^2\) The merits of a standalone equity allocation in China, Wills Towers Watson, 2020, retrieved from link

June 2021
A huge market which remains under-represented in global portfolios

Simply put, China is a market that no global investor can ignore. The world’s second largest economy accounts for 18% of world’s population and contributes almost one third of global GDP growth (more than twice the level of the USA). Over the past decade, discussions on investing in China have gradually shifted from “should we invest in China?” to “how do we invest in China”.

Nevertheless, global asset managers remain heavily underweight in China. According to a 2019 survey prepared by Greenwich Associates, the average China exposure amongst global institutional investors was only 4.6% of total assets, while only 14% of asset managers globally have any dedicated exposure to China’s equity markets.

Investment Gap: The Size of China’s Economy versus International Equity Weighting

Limited market access used to be the key factor that impeded global asset managers from exploring investment opportunities in China. This is now changing and over the past 5 years much progress has been made to open up the Chinese financial markets to overseas investors. This improvement in market access and transparency encouraged global index providers to elevate the weighting of Chinese equities, which as of February 2021, accounted for 40% of the flagship MSCI Emerging Market Index, up from only 17% in December 2010.

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3 China has replaced US as locomotive of global economy, Reuters, 2019, retrieved from [link](#).
4 Crafting the Optimal China Allocation Strategy - The Asset Owner’s Perspective, Greenwich Associates, 2020, retrieved from [link](#).

June 2021
The role of ESG as a returns’ driver in China

With the opportunity for investment in China clear, the question turns to ‘how’. The evidence here to date suggests quite convincingly that integrating ESG factors into the portfolio construction process has at least correlated with superior returns. For example, the MSCI China ESG Leaders index – which invests in the top ESG performing companies across each sector – has significantly outperformed the wider index in China (see table below). Of course, this is a highly simplistic and backward-looking view of ESG, but it does create a signal for the potential in active investment.

<table>
<thead>
<tr>
<th>MSCI Core versus ESG Indices (June 2013 – June 2019)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Emerging Markets</strong></td>
</tr>
<tr>
<td>MSCI Emerging Market Index</td>
</tr>
<tr>
<td>Return (%)</td>
</tr>
<tr>
<td>Risk (%)</td>
</tr>
<tr>
<td>Sharpe ratio</td>
</tr>
</tbody>
</table>

Data source: MSCI. All risk and return figures are annualized, based on gross daily index total returns in USD.

This outperformance of ESG coincides with a structural long-term trend towards more ESG-alignment within the Chinese capital markets. We outline the four key areas:

a) ESG related policies and guidelines:
Unlike in more democratic Western markets, regulators have been the early driving force in building awareness of ESG in China. ESG integrated investment is now a key area for research and discussion in China, supported by multiple policy reforms and government guidelines over recent years.

b) **ESG disclosure:**
ESG information is gradually becoming more transparent and available for investors as more listed companies are providing regular ESG disclosure. Taking the onshore A-share market as an example, as of June 2020, 1,021 A share listed companies (or 27% of total listed companies) have published some form of ESG report, up from only 371 companies in 2009.

c) **Corporate governance and stewardship:**
The gradual decline in ownership concentration has opened the door for non-controlling shareholders to play a more active role in the governance of listed Chinese companies. The average controlling interest as a percentage of total shareholding across all A-shares declined to ~34% in 2020 (vs. ~46% in 2000). In addition, institutional shareholders are beginning to get more actively involved in major corporate actions. Voting turnout has been slowly but steadily rising in China and more shareholders are casting votes against resolutions they dislike, instead of swallowing them in silence.  


d) **ESG ratings:**
The ESG ratings of Chinese listed companies in large indexes improved significantly over the past two years. Five years ago, most domestically listed Chinese stocks were not even covered by any ESG rating organizations. However, as of May 2020, almost all the 704 China stocks in the MSCI index had been assigned ESG ratings by MSCI. What is more, the performance on these ratings suggests a gradual improvement over the past two years, albeit to a level that is still well below both emerging and developed market peers.

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5 China Stewardship Report 2020, Fidelity International, 2020, retrieved from [link](#)

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Despite all of this progress, it is worth noting that the overall adoption of ESG amongst investors in China remains nascent. We spoke with several local asset managers while researching this, and although some have been developing inhouse ESG research capabilities, at national levels the figures are still very poor – for example, there are only 14 UN PRI signatories in China and only 47 ESG mutual funds and ETFs with combined AUM of just USD7.3 billion\(^6\). As such, the opportunity for growth here remains huge.

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\(^6\) ESG investing gaining ground in China, The Asset, 2020, retrieved from [link](#)
China ESG 1.0: All about the ‘G’

ESG in China has historically been centered around the ‘G’\(^7\) and the idiosyncrasies thrown up by a state-directed economy adapting to the breakneck speed of its expansion in recent decades. These issues have shaped the perspectives of international investors looking into the market. Below we run through some of the highest profile China-specific governance issues and the deepening nuance that surrounds them.

1. State-Owned Enterprises (SOEs) and the Misalignment of Interests

*The role of SOEs*

State-owned enterprises (SOEs) are well known as being linchpins of the Chinese economy. Today SOEs still play an important role in strategic sectors where the government oversight is essential - specifically in sectors such as defense, energy, telecom, aviation and railway – and collectively account for around a quarter of China’s GDP and almost 40% of the A-share market\(^8\). In 2020, SOEs occupied 91 of China’s 124 spots on the Fortune Global 500 list of the world’s largest corporations by revenue in 2020\(^9\).

![SOE Representation in the China A-share (by Market Capitalisation)](source)

*Source: Zhongtai Securities Institute for Financial Studies*

*The SOE legacy of capital misallocation*

Historically, the concern with SOEs is that their objectives are typically tied to socio-economic outcomes, which may be quite distinct from shareholder profits. As such, investors – and in particular foreign investors – come low down on the list of priorities for the Chinese Communist Party (CCP) representatives that run these organisations.

\(^7\) Awakening governance: the evolution of corporate governance in China 2020, ACGA, retrieved from [link]

\(^8\) How Much Do State-Owned Enterprises Contribute to China’s GDP and Employment?, World Bank, 2019, retrieved from [link]

\(^9\) The Biggest But Not the Strongest: China’s Place in the Fortune Global 500, Center for strategic and international studies, 2020, retrieved from [link]
This misalignment of interests with equity investors has been reflected in productivity and profitability – on average, listed SOEs are one-third less productive and enjoy half the return on assets of listed private companies\(^\text{10}\).

**SOE transformation in recent years**

To address these governance issues, the Chinese government started to push a new round of SOE reforms since 2013 to better align the interests of three core stakeholders (the state, private investors and SOE itself) and advance the incentivisation, productivity, and competitiveness of SOEs. These reforms aim to reduce state intervention in SOEs through the following method:

1. Shifting the role of government from direct control of state enterprises to high-level allocation of state capital\(^\text{11}\)
2. Introducing mixed ownership across public and private entities
3. Hiring external professionals to the management teams
4. Establishing a Board and Supervisory Committee in each SOE and authorizing them influence in business decision-making process

These efforts have achieved positive results in terms of financial performance and profitability. For example, despite the COVID-19 pandemic effect, net profits of China’s 97 central SOEs expanded 2.1 percent year on year in 2020, with around 80 percent of central SOEs reporting rising profits and falling debt-to-asset ratios\(^\text{12}\).

Although the reforms cannot solve all the issues, the improvements may give investors some confidence in the investment opportunities ahead for some of China’s SOEs. Companies such as Kweichow Moutai, Anhui Conch Cement and Shanghai International Airport, which have consistently delivered compounded earnings and returns to shareholders, offer some proof that not all the SOEs are bad investment targets.

\(^{10}\) Resource misallocation among listed firms in China: the evolving role of state-owned enterprises, IMF, 2021, retrieved from link

\(^{11}\) This reform suggests the government to provide high-level state capital allocation towards national priorities or strategic industries without participating in the day-to-day operations

\(^{12}\) Economic Watch: China's central SOEs report rising profits in 2020 amid reforms, Xinhua Net, 2021, retrieved from link
Total Shareholder Return of Three SOEs vs MSCI China Index (December 2016 – December 2020)

It is also important to note that the lines between SOEs and private companies is increasingly blurred, particularly since President Xi’s re-prioritisation of the party’s leadership in 2012. Now, most large companies in China are equipped with a Party unit regardless of their ownership, requiring investors to think more deeply about the level of political impact on each business, and ultimately the company’s impact on its broader stakeholders.

Source: Bloomberg, Arisaig Partners
2. Overseas Investment Structures and The Variable Interest Entity (VIE)

What is a VIE?

Source: Arisaig Partners

13 Party Committees in the private sector: rising presence, moderate prevalence, Macropolo, 2020, retrieved from link

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VIE stands for “variable interest entity” and has become the most common structure for investors to access companies in sectors which are restricted by China’s foreign investment policies. A VIE structure entails a listed foreign entity that controls a Chinese onshore company through a series of contractual arrangements (so called “agreement-based control”) to circumvent China’s restriction and regulation on foreign investment.

**Examples of Large VIE Companies in China**

<table>
<thead>
<tr>
<th>Technology</th>
<th>Consumer services</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alibaba Group</td>
<td>新东方</td>
<td>DAQO NEW ENERGY</td>
</tr>
<tr>
<td>Tencent</td>
<td>唯品会</td>
<td>中通快递</td>
</tr>
<tr>
<td>Baidu</td>
<td>好未来</td>
<td>ZTO EXPRESS</td>
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</tbody>
</table>

Source: Publicly available news

**The key concern over VIEs**
To date, the validity of the VIE structure has never been formally confirmed under local Chinese law. As such, investors are relying on the future judgement of the government over their legality. This could in theory make these contracts worthless in an extreme case.

**What gives investors the confidence to back these?**
The VIE structure has brought a huge amount of economic benefit to China in terms of jobs, taxes, innovation and global soft power. Over the past 20 years, the VIE structure has allowed more than 900 Chinese companies to raise capital from overseas markets. Within the MSCI China Index alone there are more than 100 VIE companies representing about USD4 trillion of market capitalization. The confidence placed in these structures is based on two fundamental reasons:

- **Economic perspective**: Many of these VIE companies, particularly in technology and consumer services sectors, have become sector leaders or national champions. They are not only key players in China’s race to be seen as a global technology leader, but also vital contributors to reach the 14th Five Year Plan via job creation and the revitalization of the rural economy.

- **Political perspective**: The VIE structure still provides the Chinese government with the necessary influence over the company’s actions via its onshore entity. For example, it can crack down on local representatives of the company if it deems activities to be against its interests.

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14 Legally ambiguous ‘VIE’ structure means foreign investors don’t technically own overseas-listed Chinese stocks – and that could spell disaster, South China Morning Post, 2020, retrieved from link

15 More details in the second section ESG 2.0, the central role of government in Chinese society.

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We believe the VIE should therefore support the broader national objective of opening up the financial markets gradually and reducing restrictions and prohibitions on foreign investments. There is little obvious incentive for the Chinese government to radically overhaul this current system, and the several attempts to regulate VIEs in recent years have generally been constructive rather than prohibitive.

3. Fraudulent Accounting

The scars of poor accounting controls

Distrust in accounting standards is another often-mentioned factor that has disturbed global investors. The unfamiliar Chinese accounting standards, different reporting requirements and all the well-publicized “China Hustle” cases (involving mass fraud amongst US-listed Chinese companies) have brought concerns about the accounting and financial reporting quality in China. Although accounting fraud is a global issue, China’s business environment and low costs of violations may potentially present higher risk.

The Chinese technology sector has been the latest hot-bed for accounting shenanigans, with companies using inflated revenue and engagement figures to distract investors from their lack of profits. Luckin Coffee was a recent high-profile example of this, with the erstwhile darling of the Chinese tech scene declaring bankruptcy – wiping USD14bn of market cap away – following the revelation of an accounting fraud.

<table>
<thead>
<tr>
<th>Contrast Between Securities Law Infringements in the US and China</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>China</strong></td>
</tr>
<tr>
<td>Example case: Kangmei Pharmaceutical Co. (600518 SH) was filed on 2019 for accounting fraud in results from 2016 to 2018, leading to an overstatement of cash holding by RMB 88.7 billion (USD 13.7 billion).</td>
</tr>
<tr>
<td><strong>Penalties (as of April 2021)</strong>:</td>
</tr>
<tr>
<td>✖ The company was fined at RMB 600,000 (USD 92,700)</td>
</tr>
<tr>
<td>✔ 21 key persons were fined ranging from RMB 100,000 to 900,000 (USD 15,540 – 139,860)</td>
</tr>
<tr>
<td>✔ 6 major responsible persons were banned from securities market from 10 years to lifetime</td>
</tr>
<tr>
<td>✔ Former Chairman MA Xingtian was taken into police custody on suspicion of crime</td>
</tr>
</tbody>
</table>

| **US** |
| Example case: Enron Corporations was filed in 2001 for a series of financial crime including inflating income levels by USD 586 million. While the executives were pocketing the money from investors, the funds were used for personal use, which led to the final bankruptcy. |
| **A selection of penalties**: |
| ✖ The company was fined USD 500 million |
| ✔ Key responsible persons were fined between USD 12 – 23.8 million and sentenced 6 years in prison |
| ✔ Former CEO was fined USD 45 million and 24 years in prison |

This case in China was applied with the most severe penalty under the old Securities Law, suggesting the low cost of violation. The new law effective in March 2021 has increased the penalties, which should be able to tighten market behavior. For example, the highest penalty for information disclosure-related misconduct were raised from RMB 600,000 to RMB 10 million.

Source: CSRC website, Caixin Global, Wikipedia

16 The China position report, EIU & Invesco, 2019, retrieved from link. Lack of trusted financial intermediaries is ranked as the fourth biggest challenges to invest in China by 35% of surveyed investors who have no dedicated investment exposure to China only.

17 See the 2017 documentary film, ‘The China Hustle’

18 Luckin Coffee files for bankruptcy seven months after Nasdaq delisting, Forbes, 2021, retrieved from link

19 Scandal-Plagued Kangmei Hit With Bankruptcy Restructuring Suit, Caixin Global, 2020, retrieved from link

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What can be done to build confidence?

First of all, regulators in China have now woken up to the threat this poses to its capital market – and in turn the hundreds of millions of retail investors active within it - and are now taking more serious action. One key regulation passed in July 2020 gives the China Securities Investor Service Centre (CSISC), a government-affiliated body, the powers to sue companies on behalf of all individual investors in a company under the new class-action mechanism. This will significantly increase the power of the large army of retail investors to punish any wrong-doing and create a stronger disincentive to act illegally.

In addition, investors can take active measures to mitigate these risks when investing in China. Comprehensive due diligence must go beyond a review of financial statements and consider issues such as the complexity of the operating company and the background of the senior executives and Board Members. Some examples of techniques that can be used here include:

a) Site visits to the company to see the operations firsthand
b) Background checks on the key individuals in the company
c) Interviews with ex-employees

We have used these techniques and met with success, yet all require a patient and thorough research process.

4. Black Box Regulation

Historic concerns with the black box of Chinese state regulation

Regulatory risks have consistently been front of mind for global investors looking at China. The top-down bureaucratic government structure, complicated regulatory frameworks, opaque decision-making process, and unpredictable nature of policy changes have made it very difficult for investors to identify and quantify the regulatory risks when evaluating investments opportunities in China.

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20 The China position report, EIU & Invesco, 2019, retrieved from link. The lack of transparency in financial system and concerns about legal protections are the top two concerns to drive investors away from investing in China.

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Recent examples that caught the market by surprise include the crackdown on video game licensing in 2018 (sending Tencent’s shares down over 40%) and the sudden suspension of Ant Group IPO in November 2020 due to an unforeseen change in the regulation of fintech companies in the country\textsuperscript{21}.

\textit{‘The water that bears the boat is the same that swallows it up’}

An old Chinese proverb neatly describes the relationship between the public and governors: “\textit{the water that bears the boat is the same that swallows it up}”. Chinese regulators are acutely aware of this need to align to the desires of broader society in order to maintain the legitimacy of its ruling power\textsuperscript{22}.

Considering this, it becomes more obvious of what the government’s broader intentions are and where future regulation might fall. In the case of technology businesses in the country, while they were left to flourish unimpeded under the previous government objective of economic growth, a shift of focus to safeguarding the stability and fairness of society naturally drew many of these companies into the regulatory cross-hairs\textsuperscript{23}.

\textsuperscript{21}China raises scrutiny of financial holding groups ahead of Ant IPO, Financial Times, 2020, retrieved from link
\textsuperscript{22}Is the Chinese communist regime legitimate?, Harvard University, retrieved from link
\textsuperscript{23}More detail analysis on the future direction in the next section: ESG 2.0

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In short, once looked at in context, there is a growing consistency between the desires of the public, the government’s policy objectives and ultimately the regulatory actions in China. The best way for investors to navigate this is to consider if a company’s business model is helping to support the government’s political objectives in some way (i.e. delivering sustainable growth and positive social impact), and if not, how are they managing this risk of future intervention. This should be a key feature of all ESG integration efforts in China.
China ESG 2.0: The emergence of the ‘E’ and ‘S’ and the evolving ‘G’

Having covered the current state of ESG in China, we now turn to where we see this heading over the next decade or so. We split this between the roles of the Chinese consumer, the government and the domestic investor. What we find suggests a significant further step-change in ESG adoption amongst stakeholders in the country, although we note that the path China takes may not map exactly to what we have seen before in the developed world.

Consumers: Converting Conscience into Action

Domestic demand is the fundamental driver of Chinese market, as the contribution of exports in GDP dropped from 26% in 2010 to 18% in 2020. Focusing on Chinese consumers, there is strong evidence to suggest that they are paying increasing attention to sustainability as a general concept.

- **Increase in ‘green’ consumption:** Research from JD.com shows the consumption growth of “green products” in 2019 is 18% higher than the average. Similar rapid growth is also echoed by data from Alibaba - over 16% of the total Alibaba users are “green consumers” in 2016, up 14 times over four years.

- **Rising willingness to pay a premium for sustainable products:** Research from a local sustainability research group Syntao found that the percentage of consumers who are willing to pay sustainability premiums grew from 54% in 2016 to 75% in 2020.

- **Higher sustainability conscientiousness than international counterparts:** As early as 2015, a GfK study found that Chinese consumers are ahead of most developed countries in terms of their environmental awareness.

Despite this stated intention and the increasing purchasing power amongst consumers, there remains much scepticism over the extent to which this flows through to their wallets. Our findings suggest that the transition to sustainable consumption is taking place, but not in the same way as we observed in the West.

**Who are the proactive sustainable consumers?**

A Syntao survey of self-claimed ‘sustainable consumers’ found that they were more likely to live in second- and third-tier cities, were young (aged between 21 and 40 years old) and have a mid-level salary (~USD18-35k/year). This contravenes the conventional wisdom of the correlation between conscientious consumerism and wealth.

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24 “Green consumption” in both JD and Alibaba’s research includes a broad range of products, including consumption of energy efficient, environment friendly or healthy products. China Green Consumption Report, JD Big Data Research Institute, 2019, retrieved from link

25 Report on Green consumption in China, Ali Research, 2016, retrieved from link

26 China Sustainable Consumption Report 2017, Syntao, retrieved from link

27 China Sustainable Consumption Report 2020, Syntao, retrieved from link

28 The 2015 study shows 70% respondents (7th highest among the 23 countries studied) stated environment-negative consumptions will make them feel guilty. Retrieved from link

29 Only 48% of first-tier city respondents claim to be proactive sustainable consumers, compared to 98% and 70% in second and third-tier cities respondents. China Sustainable Consumption Report 2020, Syntao, retrieved from link

June 2021
This has important implications for the future shape of consumption in China. Young consumers living in Tier 2 and lower-tier cities contributed almost 60% of total spending growth in 2018, and they are likely to drive the domestic economy in the next decades\(^{30}\).

### Consumption Confidence Index – 2016 vs. 2018

![Consumption Confidence Index](chart)

**Consumption Growth in Urban and Rural Areas**

![Consumption Growth in Urban and Rural Areas](chart)

*Source: Analysys\(^{31}\), Arisaig Partners*

**What issues are front of mind for Chinese consumers?**

Although there are a range of sustainability concerns on the minds of Chinese consumers, there are two that stand out from global peers.

- **Food safety remains the top priority**

Throughout the cross-agency, cross-temporal research, pursuing safer food is consistently ranked as the top priority among Chinese consumers\(^{32}\). The reason of such high attention on food safety is because most Chinese connect healthiness with safe eating, rather than simply nutrition\(^{33}\).

Despite the rise of China’s prosperity in recent years, food safety incidents still often make front-page news\(^{34}\), reinforcing longstanding worries from consumers\(^{35}\). While the government has been strengthening food safety regulation since 2010, the food production sector in China is simply too fragmented to be fully controlled\(^{36}\). While the regulatory environment is improving, consumers must rely on companies’ voluntary compliance. In a context like this, brands that can win consumers’ trust will stand out. Haidilao, a leading hot pot chain in China, created a business model that addressed this head on with impressive results (see box insert).

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\(^{30}\) [Chinese Consumer Report 2020, Mckinsey, retrieved from link](https://www.mckinsey.com)

\(^{31}\) [Lower tier city consumption report 2019, Analysys, retrieved from link](https://www.analysys.com)

\(^{32}\) [McK, Tetra Pak and KPMG consumption report](https://www.tetrapak.com)

\(^{33}\) [Tetra Pak Index 2020, Tetra Pak, retrieved from link](https://www.tetrapak.com)

\(^{34}\) A recent one revealed at the annual ‘Consumer Rights Day’ is about sheep farmers using a banned growth enhancer, see more from Bloomberg’s report in the link

\(^{35}\) [Food Safety Issues In China: A Case Study of The Dairy Sector, retrieved from link](https://www.finebalance.org)

\(^{36}\) The country has 500,000 food processing companies, among which 70% have fewer than 10 employees. Information retrieved from CNN’s report [here](https://www.cnn.com)

**June 2021**
Food safety in China driving new standards within companies: Case Study of Haidilao

Haidilao, the largest hot pot restaurant chain in China, developed an advanced and innovative food safety management system (e.g. they publicly disclose the food inspection results at its stores) and has brought in an independent Board Director with experience in this area. Further reinforcing this is the incentive structure they have designed for all store managers - each is rated purely against food safety and customer satisfaction. The result is very strong customer perception around the quality and standard of the food served (customer reviews frequently highlight this aspect).

Consumers’ attention to product quality manifests in careful examination, with 60% of those in large cities checking ingredient labels when buying\(^\text{37}\). In return, food producers with high trust are able to charge a premium, with surveys from Syntao between 2017 and 2020 showing that ‘sustainable food’\(^\text{38}\) is the product category with the highest price acceptance\(^\text{39}\).

- **Sustainable online shopping**

Online shopping has become a routine part of Chinese daily life. In 2020, over 83 billion parcels were delivered domestically, equivalent to 60 parcels per individual citizen, 40% higher than the UK\(^\text{40}\). While Chinese consumers embrace the convenience of digitalisation and express delivery, they are more concerned than international consumers about over-packaging - 71% of them will avoid overpackaged products\(^\text{41}\). Such consumer concern has been the driving force behind the green packaging initiatives launched by the two largest e-commerce platforms in the country: JD.com and Alibaba.

The public interest in this area sparked a government response. From March 2021, the National Posting Bureau will strictly control the material content of parcel packages, which will increase the cost of each packaging box by 50%\(^\text{42}\). With no change in delivery prices, this will have an immediate impact on the e-commerce value chain.

In fact, many studies have found e-commerce could be much more sustainable than in-store shopping when run at high scale and with a low impact model (see chart below)\(^\text{43}\). Building up a more sustainable online shopping experience could serve as a great opportunity to fundamentally meet the public’s desire of enjoying convenience without sacrificing the environment. In a future with increasing demand for retail, tighter regulations on environmental efficiency and higher cost of natural resources, more sustainable e-commerce models will have a growing competitive advantage.

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37 China Consumer Report 2021, Mckinsey; Tetra Pak Index 2020, Tetra Pak
38 Sustainable food are defined as those organic, non-addictive products
39 Food is selected by 70% consumers with over 10% premium and 31% for over 20% premium; home appliances got 65%, seconded to food. China Sustainable Consumption Report (mandarin) 2017, 2018, 2019 and 2020, Syntao
40 Xinhuanet News, retrieved from link
41 71% consumers in China state they are likely to avoid overpackaged products, followed by India at 60% and UK at 59%. Global average is at 57%. Tetra Pak Index 2020, Tetra Pak, retrieved from link
42 Will delivery fee increase with greener packaging? China.com, retrieved from link
43 Logistics Real Estate and E-commerce Lower the Carbon Footprint of Retail, Prologis Research and MIT, 2021, retrieved from link; The Carbon Footprint of Retail, Generation IM, 2020, retrieved from link
Public demand inspired e-commerce giant to launch green initiatives early: Case Study of JD Logistics

JD Logistics is the distribution arm of Chinese e-commerce giant JD.com. Driven by perceived regulatory risk and customer feedback, JD Logistics launched a ‘Green Stream Initiative’ in 2017, including the deployment of electric delivery fleets, recyclable delivery boxes and thinner strips of packaging tape. Acknowledging the need to go further, in 2021 JD Logistics signed up to the Science Based Target initiative – the premier corporate climate target framework - and committed to half its full-scope GHG emissions by 2030. This should ensure it stays ahead of regulation and customer expectations.

What ESG issues do we see dominating the next five years?

Based on what we have seen evolving over the past two decades of investing in China and interviews with a range of local academics and sustainability consultants, we believe there are three further issues that will shape the business and economic agenda in the country over the coming decade.

- **Climate change awareness**

While melting glaciers, global warming and natural disasters have always been discussed, climate change has never been ranked as a top issue in China. This is not due to a lack of knowledge about climate change. In fact, Chinese respondents were found to be more knowledgeable about the causes of global warming than those in other more developed countries.44,45

Policy support from the Chinese government might just be the key catalyst here. “Carbon neutrality” was a buzzword of 2020 in the country following the announcement of a national climate target in September – search

44 Politics & Global Warming, retrieved from [link](#).
45 China ESG: China’s Reality Research: Sustainable Impacts. CLSA.
queries for “carbon neutrality” increased 125 times on the country’s leading search engine, Baidu. However, this may still take some time to manifest in actions – for example, search queries for more responsive terms such as “lower carbon” or “low carbon life” remained steady, implying that netizens are still in the formative stages of understanding what this means for them.

The impact of the rising attention on climate could be profound for both portfolios and wallets:

a) **Portfolios** - Baidu data found that “carbon neutrality leading stocks” was the most popular related search to “carbon neutrality”, indicating potential latent demand in climate-friendly companies from retail investors.

b) **Wallets** - We also see a correlation between consumers’ demand of healthy and safe food, and a climate-friendly diet. For example, “being healthier” was found to be the driving factor of artificial meat consumption in China (in contrast to Americans who choose it mainly for better taste). But there is a caveat that Chinese also associate moderate amount of meat consumption to healthy diet, suggesting a continuous offering of meat and plant-based consumption in parallel. Meanwhile, demand for plant-based milk on Tmall, the largest ecommerce marketplace in China, surged 900% in 2020. As such, we see a confluence of factors potentially driving a more climate-friendly diet in the years to come, which could reshape food baskets and ultimately the entire wallet.

46 Baidu Search Index of “碳中和”, meaning Carbon Neutrality, on 21st September were at 202. With the announcement of the China Carbon Neutrality goal on 22nd Sept, the Search Index boomed on 23rd at 1837 and peaked on 15th March at 25,245. Data can be publicly retrieved from 百度指数 (baidu.com).

47 Baidu index methodology: Based on the data of Internet users’ search volume on Baidu, the index calculated a weighted search frequency of each key word.

48 Market insight on artificial meat in China, IPSOS, retrieved from link

49 Market trend for plant-based dairy beverage, Tmall Innovation Center, retrieved from link

June 2021
Characteristics of Winners in a Lower Carbon Future

Chinese consumers might prefer ...

<table>
<thead>
<tr>
<th>Food and beverages</th>
<th>Home and personal products</th>
<th>Transport and energy</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Agricultural products that are sustainably farmed</td>
<td>• Energy efficient home appliances</td>
<td>• Home-installed solar PV</td>
</tr>
<tr>
<td>• Healthier options that are lower in sugar and higher in nutrition</td>
<td>• Plant or Natural materials-based personal products</td>
<td>• Domestic energy management system</td>
</tr>
<tr>
<td>• Manufacturers that provide high transparency in supply chain</td>
<td>• Innovative re-generated artificial materials</td>
<td>• Electric bikes and private cars</td>
</tr>
<tr>
<td>• Retailers that build clear connections with local production communities</td>
<td>• Re-useable design</td>
<td>• E-platforms for sharing-economy</td>
</tr>
</tbody>
</table>
• Bio-degradable or recyclable packaging

Source: Arisaig Partners

• Gender equality is slowly moving into the mainstream

While initiatives like ‘Me Too’ received some attention domestically in China, an incident during COVID-19 brought gender equality concerns to record highs. In Wuhan, the epicentre of the virus, female health workers were forced to forgo sanitary supplies as they were not deemed ‘critical’. As this was revealed online, it sparked a national outcry. It unveiled the longstanding ignorance of women’s need in a professional environment, even within an industry so reliant upon female workers.

The health care sector is a microcosm of Chinese society. On one hand, thanks to the national advocacy of women’s role according to communist theory\textsuperscript{50,51}, on average Chinese women attend tertiary education and participate in professional technical work just like their male peers\textsuperscript{52}. However, little progress beyond that has been made in the past 15 years, making China’s rank on World Gender Inequality Index down for 11 years to 106\textsuperscript{th} position in 2020. The gender gap is particularly notable in leadership positions across political and economic society.

\textsuperscript{50} Women and communist China under Mao Zedong: seeds of gender equality, retrieved from link

\textsuperscript{51} Communism and women, Oxford Handbooks, retrieved from link

\textsuperscript{52} Global gender gap report 2020, World Economic Forum, retrieved from link

June 2021
Gender Gap in Leadership - China and UK Comparison


The rising dissatisfaction with gender inequality presents a great risk (and equal opportunity) to companies in the next decade.

- Well-educated, independent Chinese female employees will seek companies that provide a more female-friendly environment, causing talent risk. The visible pressure on working mothers means that 50% of women attribute the lack of gender equality to the lack of support provided by companies, indicating a gap that needs to be closed in the years ahead.

- Increasingly important female consumers will punish companies that mistreat women. In a recent incident Bilibili, a Chinese video platform, allowed misogynistic comments and content on the platform. Female users, who represented 43% of the total, urged a boycott from several local brands through the termination of cooperation.

- Businesses should prepare for labour cost increases due to stricter protection of female employees’ benefits. Maternity leave is a protected right in China but a recent survey shows that almost half of respondents did not benefit from this. Regulators are paying increasing attention on protecting women employees, setting ‘equal pay’ as one key long-term target. In the near term, stricter protection of pregnant employees will probably be the first to come, partially benefiting from the national strategy of increasing the childbirth rate.

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53 UK higher education student stats, China higher education graduates survey, retrieved from link and link
54 White paper on professional environment for Chinese women in 2021, Zhaopin.com, 2021, retrieved from link and link
55 Bilibili vows to clean up content following boycott call over ‘misogynist’ amine, Global Times, 2021, Retrieved from link
56 White paper on professional environment for Chinese women in 2021, Zhaopin.com, 2021, retrieved from link and link
57 In the official guidance released by All-China Federation of Trade Unions in 2019, “equal pay” is listed as a key target. Retrieved from link.
58 The latest working paper from PBOC further emphasizes the importance of providing women-supportive working environment, under the context of encouraging childbirth. Retrieved from here.
• Deeper social responsibility is required

Lastly, we found that Chinese consumers expect companies to go beyond rudimentary charitable giving. A survey conducted during the pandemic found that Chinese consumers place a higher value on a company that provides social solutions based on its core expertise or products59 - for example, respondents lauded a personal product company that donated sanitary products to women health workers, as well as an online health consultation platform that created a free virus-mapping tool.

This opens up the concept of a company’s broader impact on society and how it can create greater value across multiple stakeholders. Although ‘stakeholder capitalism’ is a still-nascent concept in China, it could become significantly more prominent in the years ahead.

The Role of Government: ESG With Chinese Characteristics

As mentioned previously, policy makers in China generally hold a positive view on ESG and responsible investment. This is not surprising as “the goal of ESG investment is highly aligned with central government’s goal of maintaining economy stability and improving business operation quality”, says SHI Yichen, a professor from Central University for Finance and Economics.

Actions from National Council of Social Security Fund (NCSSF)60 reconfirms the government’s direction. In 2020, the council for the first time included ‘responsible investing’ for active equity mandate for its reserve pension fund61, indicating a high-level recognition of the value of responsible investment.

How will China’s ESG path compare with Europe?

Even among democratic countries, ESG investment has clear differences showing significant cultural markers. For example, European investors are more in favour of government regulation enforcing ESG disclosure while North American ones are less keen. As a result, the UK pension regulator has introduced ESG requirements for trustees but the American ones rely on the market mechanism.

The cultural and social differences are even larger when it comes to China. Widely agreed as an authoritarian regime, by definition, Chinese government is much more involved in the business and industry development through tighter regulation and closer monitoring. In addition, ‘planning’ is another key feature of Chinese society, with ‘obedience’ being a ‘must have’ quality. Since the first five-year plan in 1953, the government is ruling the economy with the expectation that all entities will mobilise around the priorities set by the central government.

On the positive side, the in-depth participation of regulators will accelerate the development of the ESG market in China – globally speaking, ESG investment remained a niche strategy in the past decades until the recent nudges

59 Sustainable consumption report for 2020, First Finance, retrieved from link.
60 NCSSF runs China’s National Social Security Fund since 2000, essentially providing a reserve of funds for China’s social security system. According to the annual report, the fund held RMB2.629 trillion in assets (USD403 billion) at the end of 2019.
61 NCSSF invites bids for landmark overseas equity mandates, Asian Investor, retrieved from link
from regulators on the clarification of fiduciary duty, standardisation of data collection and reporting, as well as the effort on strengthen investor awareness. Therefore, with stronger support from regulators, we might see more rapid growth of ESG investing in China than anywhere else.

In addition, while the government is likely to follow the European path on leading the knowledge building work and market education, some differences could be observed in the following:

a) The responsibility of the State versus the Corporate

Unlike the well-established European policy system, China is still putting its own frameworks into place. This creates various grey areas in terms of ultimate responsibility for social and environmental issues, which tends to default back to the government to resolve. Examples here include the social security protection for part-time labour (see insert box below).

Example: Social security protection for delivery companies’ riders
China started to build the social security system only in the late 90s, around 15 years later than EU. Until today, the system is still far from satisfactory. More specifically, the ‘work-related injury insurance’, which is one of the five subsets of social security system, only covers workforce in formal full-time employment contract.
As a consequence, although the death of a rider (“快递小哥” or “外卖小哥”) for Eleme, a Chinese food delivery company, sparked heated discussion on the treatment of workers in gig economy era, the public concluded that it was the government’s responsibility to improve the basic social insurance coverage before companies could take further action. This is the opposite to what happened in Europe, where the public points the finger at corporates for this mistreatment.

b) Intersection of state-level economic, social and environmental objectives

Unlike democracies where sustainability issues rise organically through the governing system, Chinese companies must focus on aligning their stance to the stated direction the national government. This goes beyond simply complying with regulation and instead aligning with the objectives of the CCP. Chinese companies’ attacks on international brands that claimed human rights abuses in Xinjiang is an ongoing example of this.

As international investors, we need to be aware that these national priorities might not always map consistently with the bottom-up material issues affecting each industry and company.

The latest set of major economic objectives can be seen in the diagram below, with ‘market competition’ a notable addition relevant to the monopolistic technology sector. We have already seen the bite of this new national priority, with Alibaba on the receiving end of a major investigation and subsequent USD2.8 billion fine for its anti-competitive practices. Other companies are likely to follow here in due course.

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62 This was seen as being caused by the recalcitrance shown in a speech by its founder Jack Ma, but was in fact in motion for at least a year prior to this
Evolution of Priorities from 10th to 14th Five-year Plan (FYP)

10th FYP 2001-05
- Rural economy restructuring and reform
- Optimization and upgrading of industrial structure
- Regional development focusing on the western China
- Science and education strategy
- Opening reform
- Social security
- Sustainability development
- Uplift the spirit and morality of the people
- Democratic legal system

11th FYP 2006-10
- Economic Development
- Economy restructuring
- Education and innovation
- Energy conservation and environment protection
- Social security
- Economic reform
- Anti-corruption

12th FYP 2011-15
- Economic development
- Innovation
- Regional economy balance
- Opening reform and market competition
- Green development
- Common prosperity
- National security (econ, agri, finance, energy)

13th FYP 2016-20
- Economic development
- Innovation
- Urbanisation and rural modernisation
- Green manufacturing
- Belt and road
- Common prosperity

14th FYP 2021-25
- New socialism rural development
- Economy restructuring
- Regional economy balance
- Innovation
- Opening reform
- Social Security

Source: Government Working Reports from 2001 – 2021, Arisaig Partners

Alibaba Share Price Following Announcement of Government Investigation into Anti-Competitive Practices

The government announced draft laws to combat anti-competitive tactics by internet companies

The State Administration for Market Regulation (SAMR) announced investigation into Alibaba

Source: Bloomberg, Arisaig Partners
c) **ESG framework with Chinese characteristics**

The idea of creating an ESG framework with Chinese characteristics was raised at the ‘two sessions’ in 2020 by TU Guangshao, a former vice chairman of the China Securities Regulatory Commission (CSRC). This is not the first time China has sought to develop a domestic system in parallel to an international standard. For example, Chinese Green Bond Endorsed Project Catalogue, released in 2015, was a domestic alternative to an international green bond standard, creating a list of approved green projects.

As such, we expect to continue to see values-based differences between the Chinese and international ESG rating frameworks to better align with the aforementioned national-level objectives. These distinctive indicators are likely to include poverty alleviation, disaster relief, Party building and other SOE-related governance factors.

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**China-specific ESG Indicators**

- Poverty Alleviation Performance
- Disaster Relief Contribution
- Internal Party Building Ability
- Other governance indicators more suitable for SOEs

*Source: Arisaig Partners*

We understand that the Chinese Central Bank (the PBOC) and its affiliated Working Group on Green Finance Standard are already developing an official ESG disclosure requirement and ESG rating framework that would reflect this.

**What environmental and social issues are on the political agenda?**

a) **Climate change and broader environmental indicators**

There is no doubt about the significance of the Environmental pillar among E, S and G in the next decade of ESG development in China. The national pledge of carbon neutrality has now been enshrined into the 14th Five-Year Plan, a policy blueprint for the economic and social development through to 2025. Included within this Five-Year Plan was a strategy piece outlining the long-term environmental objectives (the “Vision 2035 Plan”), which gives a clearer direction of where future policies are headed.
Selected Policy Directions in the ‘Vision 2035’ Plan

**Re-pricing natural resources in a market-based way**

Considered as a public good, natural resources have always been under-priced in China, often subsidized heavily by the government. The 2035 plan however reveals the government’s intention to **marketize the price forming mechanism for water, wastewater, energy and other natural resources**. Beyond carbon emission trading, the strategy also mentions potentials in energy or water conservation trading and pollutant emissions trading.

**Keeping enhancing energy efficiency requirements**

Energy efficiency has always been a policy focus in the past. It is in this strategy that ‘**mandatory energy consumption cap**’ was mentioned as a potential approach to regulate new industries like data centres and 5G service providers. In addition, home appliance is another target for facilitating consumer behaviour change, which will be applied with a **more harmonised green product standard**.

**Tightening water usage regulations**

Beyond pricing mechanism, water consumption cap is also mentioned in the strategy, with an expectation to **reduce water usage intensity by 16% on average by 2035**.

**Rising expectations for manufacturers’ responsibility**

With future improvement in supply chain tracking, the 2035 plan expects **upstream producers to own extended responsibility for end-product recycling**, which aligns to the international best practice of value-chain responsibility. As an existing effort, delivery package is again highlighted as a key priority for reduction, standardisation and circulation.

Source: China’s official Vision 2035 Plan, Arisaig Partners

It is also worth noting that the manufacturing industry – which continues to be largest contributor to the job market in China – is becoming increasingly beholden to the environmental demands of international customers. The solar industry in Europe – a major customer of Chinese solar exports - is an example of this, recently requiring all photovoltaic (PV) panel manufacturers to provide low-carbon certificates in order to be eligible for procurement contracts. This is placing greater emphasis on greening the manufacturing industry in China and aligning the policies on wealth creation and green development.

**b) Improvement of labour conditions linked to ‘common prosperity’**

“Common prosperity is the essence of socialism” preached Deng Xiaoping, the former Chairman of China from 1978 to 1989. Although poverty alleviation and rural revitalization have been at the top of the policy agenda for years, the 14th Five-Year Plan is the first time that the government plans to “develop an action plan to accelerate common prosperity”.

Although it is likely that the government will do the heavy-lifting – e.g. enhancing public services and social welfare benefits to rural residents and migrant workers- corporates will also be required to play their part in achieving this goal.

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63 French regulator proposes tightening up controversial carbon footprint rules, pv magazine International, retrieved from [link](#)
An example of this in action is the recent announcement that companies employing part-time workers – such as food delivery platforms Meituan and Eleme – might be required to cover work injury insurance in the future, adding up to 2% to labour costs\textsuperscript{64}.

### Delivery Riders in Chinese Social Security System

<table>
<thead>
<tr>
<th>Social insurance categories</th>
<th>Employer contribution for formally contracted employees (% of salary)</th>
<th>Employee contribution (% of salary)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work injury insurance</td>
<td>0.5% - 2%</td>
<td>N/A</td>
</tr>
<tr>
<td>Maternity insurance</td>
<td>0.5% - 1%</td>
<td>N/A</td>
</tr>
<tr>
<td>Pension insurance</td>
<td>~20%</td>
<td>~8%</td>
</tr>
<tr>
<td>Medical insurance</td>
<td>5% - 12%</td>
<td>~2%</td>
</tr>
<tr>
<td>Unemployment insurance</td>
<td>0.5% - 1%</td>
<td>0.2% - 0.5%</td>
</tr>
</tbody>
</table>

*With recent improvements, gig workers can participate in the three insurances via direct payment to the government.*

### Increasing litigation risk related to data protection

China has the largest internet (and in turn data) market globally, and as a matter of national interest, the government has been turning its attention to how this is managed and controlled. Since 2018, a series of guidelines around cyber security, data security, personal and children’s information protection have been drafted and implemented. This was seen as leading practice within Asia in terms of its alignment with international standards\textsuperscript{66}.

A Personal Information Protection Law was drafted in the late 2020, which outlined potential fines up to RMB50m (c. USD8m) or 5% of revenue for companies in the case of significant violations. We expect to see more legislation and law enforcement effort in the next couple of years which will place greater requirements and costs on companies for monitoring its access to sensitive data.

### Domestic Investors: Narrowing Gap Between Interest and Uptake Of ESG

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\textsuperscript{64} Challenges in providing support to gig workers, China.com, retrieved from link

\textsuperscript{65} China’s Social Security System: An Explainer, China Briefing News, retrieved from link

\textsuperscript{66} China emerges as Asia’s surprise leader on data protection, Financial Times, retrieved from link
ESG investing is still a relatively nascent concept in China, with limited data and lack of consensus over what form it should take limiting the spread of more enhanced practices. Nevertheless, based on our conversations with local players, we believe there could be a step-change in the coming years.

a) Lack of ESG data leading to a lack of action

ESG investing is receiving more interest but the general level of understanding is still quite low. Interest in the annual ESG Survey by the Asset Management Association of China (AMAC) saw record interest in 2020, although responses showed limited capacity. The same survey found that risk mitigation is seen as the primary driver for ESG integration, with very few citing it as a driver of alpha. This seems to be due to a lack of data available within the market to measure company’s ESG performance, something that was reiterated in our conversation with Ciguan Qiu, a professor in Jiaotong University focusing on China’s ESG development.

b) ESG products are emerging but remain light touch

Despite of the rapid growth of ESG products in China in 2020, it remains a niche segment of the market. Funds that cite ESG or sustainability integration account for only around 2% of the market in China versus 21% in Europe.

There is clearly a need for establishing clearer guidance on what an “ESG product” is. Professor Qiu’s study shows only 15 out of over a hundred so-called ESG funds have disclosed their strategy and objectives around integrating ESG practices.

Currently, screening (both positive and negative) is the most common form of ESG strategy amongst Chinese domestic investors. This is similar to how sustainable investing began in the US and Europe, perhaps suggesting that more comprehensive ESG integration and engagement approach might come next.

Chinese investors we spoke to are aware that more ESG data is needed to support more sophisticated ESG analysis. As a temporary solution, they are collaborating with local start-ups and research institutes to dig for data from media or government portals. However, for the next wave of ESG integration to emerge, we suspect that we will need to see improved ESG disclosure and the arrival of a stewardship code for investors.

c) Rise of long-term institutional investors to support the growth of ESG investment in China

Although historically dominated by short-termist retail investors, the investor makeup of the Chinese market is evolving significantly, with a growing presence of more long-term minded and sophisticated institutional investors.

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67 ESG Investment Survey on Asset Managers, AMAC, 2020, retrieved from link
68 ESG Funds Annual Report, Sino-securities Index, 2021, retrieved from link
69 21% of total European funds under most stringent SFDR rules, Investment Week, 2021, retrieved from link
70 The definition of ESG product and expectations on ESG-alpha, Ciguan Qiu, 2021, retrieved from link
71 ESG Investment Survey on Asset Managers, AMAC, 2020, retrieved from link
I. Pension funds
Due to the aging population, the Chinese government has launched pension reforms, including an increase in pension assets investment and promoting commercial pension insurance. This could increase pension assets fourfold by 2025 according to BCG\(^2\).

II. Foreign investors
Recent financial reform has opened a door to overseas wealth and asset managers, leading to an increase in foreign investment inflows. This should bring with it a range of global responsible investment and engagement practices, which should in turn encourage local competitors to catch up on this front.

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\(^2\) How Global Asset Managers Can Step In as China Opens Up, BCG, 2019, retrieved from link
\(^3\) China Development Report 2020, China Development Research Foundation, 2020, retrieved from link

June 2021
III. Mutual funds

In recent years, retail investors have returned back to mutual funds, lifting them to record high assets of RMB2.5 trillion (USD400bn). Having said that, it is worth flagging that 45.4% of these fund investors hold their funds for less than one year, suggesting many are still focused on short-term outcomes. 

Source: Gfund, Arisaig Partners

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74 Full picture of A-share investors, Gfund Strategy, 2019, retrieved from link
75 National Survey on Investors of Public Funds, AMAC, 2021, retrieved from link
76 Outlook 2020 of Public Funds in China, Deloitte, 2020, retrieved from link
How should investors adapt their ESG and engagement approach when investing in China?

Based on the findings shared in this whitepaper, we believe there are several steps that investors could take to adapt their ESG and engagement process in order to increase their chances of success in China.

1. **Integrate dedicated due diligence on political risk**: research on all companies (including SOEs and non-SOE) in China should consider the alignment of interests with the CCP and its stated objectives.

2. **Patiently build long-term relationships with local companies**: business in China is based on a trust system which takes time and effort to build up. For foreign investors to be able to fully understand the inner workings of a company and/or to engage with them, they must apply the necessary resources to build up local relationships. In practice, this is supportive of a deep due diligence process, long holding periods, and a constructive (i.e. engagement-centric) stewardship process.

3. **Reflect local interests and norms into ESG research and engagement process**: applying global norms to ESG expectations and engagement strategies often creates false signals or stalls the process. It is important to consider the bottom-up materiality of ESG issues in China (e.g. food safety, single-use plastics) and adapt frameworks accordingly (e.g. we re-weight the issues in our Sustainability Risk Management framework to reflect our views on their relative importance at the local level). On the engagement side, it is important to come across in a supportive manner (which often begin with private one-on-one conversations) and to focus on the positive outcomes of a more sustainable and transparent business approach.

4. **Do not rely on passive indices and indicators for future outperformance**: although it can be tempting to lean into third-party indices such as the MSCI China ESG Leaders, this has several shortcomings in China. Not only is the quality of the reported data on which these are built still poor, but they tend to be inherently backward looking. For example, the top 3 positions in the MSCI China ESG Leaders index are Tencent, Alibaba and Meituan (accounting for c.44% of the index), all of whom are now facing scrutiny under the Government’s anti-competition investigation. As such, any use of such third-party frameworks must be combined with in-house research.

5. **Dedicate resources to ESG capacity building through engagement**: our experience to date suggests that there is a lot of latent interest from companies in China around ESG, but many are seeking the support and advice of stakeholders, including investors. This process of capacity building can be resource intensive, but the rewards from impact and relationship building perspectives are amongst the highest in the world.

6. **Build up local networks**: in pursuit of the capacity building mentioned above, it is helpful to establish a network of local practitioners, government-affiliated research institutes and like-minded investors. This helps to both improve understanding of local trends in the market, and also increase the weight and potential impact of future engagements. Our experiences thus far suggests that there is a growing network of people willing to share perspectives in this area.

7. **Conduct financial reporting quality screening**: introduce third-party and/or internally developed financial and fraud risk analysis systems and tools to ensure prospective investments are not in a high-risk category.

8. **Diversify VIE regulatory risk**: although the likelihood of materially negative regulatory intervention in VIEs is low, it is prudent not to be overly exposed to this structure. The growth of technology companies listed onshore presents a great opportunity to achieve this.

June 2021
Appendix: Contributor List

We would like to thank experts listed below who shared their thoughts and contributed to our thinking on this report. The views in this report do not necessarily reflect the views of the acknowledged individuals or their organizations, and Arisaig authors take full responsibility for any errors in this report.

<table>
<thead>
<tr>
<th>Experts</th>
<th>Institutions</th>
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</thead>
<tbody>
<tr>
<td>Ms. LANG Hua, Ms. LI Shaoxin</td>
<td>Main authors of Syntao China Sustainable Report 2020, Syntao Sustainability Consultancy</td>
</tr>
<tr>
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<td>Researcher at National Strategy Institute, Tsinghua University</td>
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<tr>
<td>Ms. LI Zhanyu</td>
<td>Deputy General Manager at ESG Rating Department, Zhong Cheng Xin</td>
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<td>Professor at Shanghai School of Advanced Finance, Shanghai Jiaotong University</td>
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<tr>
<td>Mr. SHI Yichen</td>
<td>Vice president and professor at the International Research Institute of Green Finance of the Central University of Finance and Economics and president of the Yangtze River Delta Green Value Investment Research Institute</td>
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