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# Going Green: The Rise of Sustainability Investing in China

RECENT TIMES HAVE SEEN A SEA CHANGE IN CHINA'S APPROACH TO SUSTAINABILITY INVESTING. BUT ALTHOUGH ESG AWARENESS IS ON THE RISE IN THE COUNTRY, FUND MANAGERS STILL NEED TO DO THEIR HOMEWORK, SAYS RANDY ZHOU, HEAD OF RESEARCH AT POWER PACIFIC INVESTMENT MANAGEMENT.

**FOR INVESTORS SEEKING COMPANIES** with strong environmental, social and governance credentials, China isn't always first to come to mind. Yet widespread adoption of ESG practices among corporates in the country now goes well beyond simple box-ticking exercises.

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"There is a misconception in the West that China and ESG or sustainability are incompatible but that is not the case," says Randy Zhou, head of research at Shanghai-based Power Pacific Investment Management. "China, may still be in the early stages but ESG in the country is evolving and improving at a rapid rate."

This, in turn, is leading to long-term sustainable risk-adjusted returns, Zhou tells *Funds Europe*.

Chinese president Xi Jinping recently surprised markets when he announced stronger climate targets for China and called on countries to work towards achieving a greener global economy in the wake of the coronavirus pandemic.

Addressing the UN General Assembly in September, Xi said that China's carbon dioxide emissions would peak within the next ten years, and it would reach carbon neutrality by 2060[1]. It was the first time the world's biggest emitter of $CO_2$ had pledged to end its net contribution to climate change.

Covid-19 may have been a factor, but the pandemic has only served to accelerate trends already in place in the country, according to Zhou.

At the 19th Party Congress held in 2017, the government addressed the need to fight against climate change. Two years later, the it launched a "green finance" initiative published in the UN's 'Guidelines for Establishing a Green Financial System'.

This year, the Chinese government announced it was going to stimulate domestic economic growth by advancing the adoption of 'green' technologies, as well as upgrading urban infrastructures to mitigate the risks of pollutants and contaminants to the general public. Plans also included a budget increase for a smart grid in April, and a renewed focus on renewable energy, usage efficiencies and renewable energy storage.

China is the world's largest manufacturer and installer of solar panels. It is largely responsible for the cost reduction of PV modules used in solar panels. This has made solar power more economically viable, according to Zhou. Between 2008 and 2013, China's mass expansion of solar PV manufacturing, supported by "significant" government tax breaks and financial incentives, caused prices worldwide to drop by 80%[2].

**Striving for transparency**

Zhou notes that strides are also being made on the disclosure front, another sticking point in the country. Last year, the China Securities Regulatory Commission (CSRC) mandated the disclosure of ESG assessments for all domestically listed companies and corporate bond issuers, mirroring practices already in place to be implemented in the H-shares market.

This summer, Hong Kong Stock Exchange required all exchange-listed companies to produce a statement setting out the board's consideration of ESG risks, as well as how it determines what ESG issues are material to the business. The stock exchanges of Shanghai and Shenzhen are expected to follow suit and require all issuers to increase ESG disclosures.

On top of this regulatory pressure, Zhou points out that a new generation of entrepreneurs has emerged, taking over the reins from their parents, with a greater interest in corporate transparency and improving the flow of information. Often educated abroad, this younger generation tends to be more cosmopolitan, and more concerned with the environmental issues affecting the world.

As foreign institutional capital increases, these local companies will want to integrate ESG into their management philosophy to attract new investors, Zhou explains. Beyond obtaining a high credit rating, businesses also need to have strong ESG scores from S&P and Moody's, he adds.

There are 50 Chinese signatories on the Principles for Responsible Investment, reflecting a change in management mindset that is expected to grow exponentially in the coming years[3].

Despite an improving ESG landscape, fund managers still need to do their homework, says Zhou. Having been investing in China's public equity markets for the past 15 years (under the first Qualified Foreign Investor License to be granted to a Canadian institution), he believes Power Pacific is well placed to navigate the market.

The secret to Power Pacific's success is its robust bottom-up, high-conviction quantitative and qualitative research process that focuses solely on around 90 stocks, Zhou explains. The investment manager has specifically targeted companies which advance affordable clean energy and support climate actions. "We only invest in companies with sustainable business models that give us the freedom and room to dig deep," he says.

Through a private equity lens, the team analyses financial metrics such as cashflows, R&D spending, product development and competitive edge. Sustainability is firmly integrated into the investment decision-making, the head of research asserts.

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Power Pacific has a proprietary ESG analysis framework that includes initial screening as well as incorporating the 17 United Nations Sustainable Development Goals. Companies are then assessed for the sustainability of their business model to produce an overall rating used to determine the percentages and weights within the firm's portfolios, according to Zhou.

The process also enables the team to identify emerging trends and opportunities.

In late 2018, for example, they expected "double-faceted" solar panels to emerge as a key technology with the potential to enhance the solar conversion ratio by 3-5% at low marginal costs.

They then identified two companies who were at the forefront of this development – today these firms account for 55% of the market. Over the next three years, they are expected to capture 87% of the overall market share, Zhou says.

According to the analyst, investors will be well rewarded by selecting best-in-class companies with sustainable business models that fully take into account environmental, social and governance best practices.

From June 28, 2013 to June 28, 2019, data shows that both the MSCI China ESG Leaders Index and the ESG Universal Index beat the MSCI China Index by 4.7%, and 0.9% per annum, respectively[4]. Since the outbreak of Covid-19, ESG companies overall have proven even more resilient, outperforming the index by 3.43% in the first quarter[5]. The numbers speak for themselves, says Zhou.

1 – Financial Times
2 – VDMA Photovoltaic Equipment
3 – UN PRI
4 – Bloomberg
5 – Bloomberg