Allianz Global Investors

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The Greening of China – the unexpected flourishing of sustainability in the world's second-largest economy

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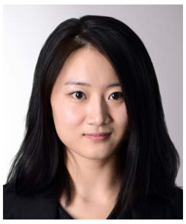

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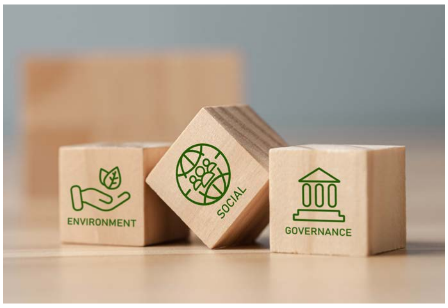
ESG (environmental, social, and governance) considerations are often perceived as a trade-off between sustainability and economic growth, especially in China where growth has been the priority for several decades. However, the landscape has changed and China's focus on green tech and manufacturing is now strategic, with this strategic perspective encompassing three broad themes: export potential, economic diversification, and sustainable growth.

In terms of seeking new overseas markets for its products, China aims to rapidly grow its shares of the renewable energy, energy storage, grid infrastructure, and new energy vehicle sectors. Given the issues surrounding the property market, this development of new industries will aid the transition to a new form of innovation-led growth. Indeed, it will lead to China's future growth being more sustainable, both in terms of the products and services coming to market, and in terms of reducing the risk of assets becoming stranded as the world moves to new models of production and exchange.

And these changes are already in full flow. For example, China customs data for 2023 shows that a third of cars exported by China were electric vehicles (EVs) – totaling 1.8 million vehicles, a year-on-year increase of over 67%. Similarly, China's output of solar modules has now ranked first in the world for 16 consecutive years, while its production of polysilicon, silicon wafers, and solar cells made up 80% of the world's total.[1] China's commitment to green manufacturing thus not only addresses environmental challenges, but is also positioning it as a global leader in sustainable technologies.

ESG risk management – a changing culture



Alongside the focus on new industries, Chinese corporates are increasingly aware of ESG risk management, especially during manufacturing processes and management of their supply chains. This change is part of a broader, global culture shift in terms of attitudes towards the integration of ESG into business processes, but also has specific drivers in the Chinese context that we believe are accelerating these changes within corporates.

For instance, China remains a manufacturing hub for many global brands, and these brands are increasingly vocal about their commitments to ESG practices. One notable US-based tech leader has pledged to achieve net zero carbon emissions across its products and supply chain by 2030 – for China to retain its place at the heart of the supply chains of companies such as this, it will need to adapt rapidly to these changing demands. On the sovereign level, institutions such as the EU will increasingly penalize imports of materials such as steel that are produced with a high carbon footprint, again forcing manufacturers to adapt.

In addition to these international pressures, China's suite of domestic ESG regulations is also growing rapidly. As well as mandatory ESG disclosures for state-controlled enterprises since 2023, China's national Emissions Trading System (ETS) is set to grow in scope, while the Shanghai and Shenzhen Stock Exchanges are now publishing guidance for sustainability disclosure, emphasizing greater transparency for listed companies.

A final key driver in this culture change are the demands of both local and international investors who are strong advocates for improved ESG management and transparency. Indeed, global investors are often leading discussions with Chinese corporates on topics such as biodiversity, supply chain management, and international ESG standards. For instance, our own systematic ESG approach, combined with local insights, fosters a two-way communication between listed companies and investors, leading to a stronger conviction in investment cases.

Integrating ESG into China equity investing

While simple quantitative ESG approaches can offer some insight, they are often highly ESG disclosure-dependent and backward looking. Large, well established Chinese companies with higher international investor bases are therefore often better rated and represented in pure quantitative ESG portfolios. This bias is more obvious in emerging markets where information disclosure is more fragmented.

In practice each company's ESG situation and journey is unique, and tailoring our approach accordingly is thus key. Our ESG analyses allow us to look beyond pure financial performance and identify share price drivers that are sometimes missed by the market. Depending on market movements, what we believe are important ESG risks and opportunities can sometimes be very different from disclosure-based ratings.

Taking electric vehicle (EV) batteries as an example, our analyses extend beyond global shipment forecasts; we also delve into, for instance, potential trade obstacles arising from labour management and carbon footprint considerations. By actively engaging in this type of research, we pinpoint companies that excel in supply chain management, demonstrate strong labour practices, and exhibit greater commitment to decarbonization. Indeed, we firmly believe these factors are critical in enhancing a company's negotiating leverage with global customers.

Another area that may lead to enhanced returns is improvements in former ESG laggards. For Chinese state-owned enterprises (SOEs), for example, we acknowledge the market's concerns regarding low

[1] https://ydyl.cctv.com/2024/01/17/ARTI4Ap7tYnOIuMtgjv74tQF240117.shtml

efficiency and low ESG ratings; however, in such cases, we firmly believe that it is crucial to focus on the direction of change. Better incentivized management can often drive changes such as reductions in related party transactions, rising dividends to enhance shareholder returns, and proactiveness in communicating with investors. Positive governance developments in many SOEs can also be an indication of improved future performance.

Going down the market cap spectrum, we also find underappreciated companies which are making a positive environmental and social impact; their role in the energy transition space may be indirect but is still essential. Examples include transformer producers that are key to a resilient grid network, cooling solution providers that improve energy efficiency at data centers, and automobile parts suppliers with rising market shares in new energy vehicles. In practice many of these companies are poorly rated by ESG rating agencies due to a lack of disclosure – not surprising given their niche size and more limited resources.

Structural shifts signal a positive trajectory for ESG practices in China, benefiting both companies and investors alike. Our deep dive research and in house sustainability methodology enables us to identify ESG opportunities and risks which go beyond disclosure-based ratings.

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