ESG investing opportunities in China from an industry perspective

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Executive Summary

In September 2020, President Xi Jinping announced that the People's Republic of China will “aim to have CO2 emissions peak before 2030 and achieve carbon neutrality before 2060” - called the 30/60 target for short. Since the announcement, China’s government and enterprises have been working diligently towards this target, through both top-down and bottom-up approaches.

With ESG criteria being more and more explicitly reflected in China’s policies and regulations, we believe the regulatory environment in China is becoming stricter in this area and anticipate more detailed and aligned execution measures to be put in place in the near term.

Growing momentum in the investment universe and fund flows of ESG funds in Asia and China shows that technical support for this asset class remains strong, suggesting that China’s commitment and potential on the sustainable development front are well recognized by global investors.

As one of the largest countries in the world, China’s economy is driven by a complex mix of industries, each of which plays a distinct but crucial role in the transition journey to a sustainable world. The drive toward international alignment of Chinese ESG standards is progressing quickly with significant implications for cross border financing flows. In this piece, we summarize the ESG state of play of three industries, financials, industrials, and technology, media and telecom (TMT), and provide case studies of key players in these sectors.

Prevailing trend of ESG integration into China’s policy discourse

Progress on ESG in China cannot be achieved without top-down policy enforcement and implementation. In recent years ESG topics have been mentioned more and more frequently in China’s policy discourse, either in top level country-wide policy, or industry-specific guidance.

Released on October 16, 2022, the Report of the 20th National Congress of the Communist Party of China elaborated the concept of “Chinese-style Modernization”, whose development goals are highly integrated with ESG. In terms of environmental pillar, the report emphasizes the requirements of carbon peaking, carbon neutrality, climate action, and biodiversity several times. In terms of social pillar, the reiteration of “common prosperity” and “rural area revitalization” stands out. For the governance pillar, there are topics around anticorruption, equity, equality, discipline system, etc. During the 2023 National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) in March, ESG topics was also highlighted by Premier Li Keqiang in the Report On The Work Of The Government. Besides, several proposals on green buildings investing, ESG information disclosure, and infrastructure construction were heatedly discussed by the representatives and attendants to the meetings.

Aside from high level policy, several functional regulatory authorities also issued ESG-related policies in 2022. These advocate ESG concepts in different sectors and look to accelerate the process of standardizing ESG instruments, diversifying products, enforcing mandatory information disclosures, and integrating international cooperation. Taking the financial industry as an example, new policies and regulations were enacted to shift the economy towards sustainable, carbon-neutral, and green finance. More than 20 documents were issued in 2022 on sustainable financing by major regulators including the People's Bank of China (PBOC), China Securities Regulatory Commission (CSRC), China Banking and Insurance Regulatory Commission (CBIRC), etc. (Table 1). There is no doubt that market participants across various sectors are facing increasing scrutiny around ESG-related issues.

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Table 1 – China sustainable finance policy overview (2022)

Date	Issued by	Policy Title	E	S	G
1/5/2022	Ministry of Ecology and Environment, Ministry of Commerce	Guidelines for Ecological and Environmental Protection of Foreign Investment Cooperation and Construction Projects	Y	Y	Y
1/26/2022	CBIRC	Guidelines on the Digital Transformation of Banking and Insurance Industries	Y	Y	Y
2/8/2022	PBOC, CBIRC, CSRC	"14th Five-Year" Development Plan for Finance Standardization	Y	Y	Y
2/9/2022	CBIRC	Regulatory Data Standard for Banking Financial Institutions			Y
2/11/2022	CSRC	Provisions on the Regulation of the Depositary Receipt Business under the Stock Connect Scheme between Domestic and Overseas Stock Exchanges			Y
2/18/2022	PBOC, NDRC	Several Policies for Promoting the Recovery and Development of Hard-hit sub-industries in the Service Industry		Y	Y
3/4/2022	PBOC, CBIRC	Notice of Strengthening Financial Services for New Urban Residents		Y	Y
3/16/2022	NDRC, etc.	Opinions on Promoting Green Development under the Belt and Road Initiative	Y		
4/6/2022	CBIRC	Notice of Further Strengthening Financial Support for the Development of Micro and Small Enterprises in 2022		Y	Y
4/12/2022	CSRC	Announcement on Issuing Four Financial Industry Standards Including the Carbon Financial Products, etc.	Y	Y	
4/15/2022	CBIRC	Notice of Financial Support for Freight Logistics to Ensure Smoothness		Y	
4/18/2022	PBOC, SAFE	Notice of COVID-19 Containment and Strengthening Financial Services for COVID-19 Containment and Socio-Economic Development		Y	
4/26/2022	CSRC	Opinions on Accelerating the Promotion of High-Quality Development of the Industry of Publicly Offered Funds			Y
5/11/2022	CBIRC	Notice of Issuing the Insurance Industry Standardization Plan for the "14th Five-Year Plan" Period			Y
5/20/2022	CSRC	Measures for the Supervision and Administration of Managers of Publicly Offered Securities Investment Funds			Y
5/24/2022	State Council	Notice of Issuing a Package of Policies and Measures to Firmly Stabilize the Economy		Y	
5/26/2022	Ministry of Finance	Notice of Maximizing the Guiding Role of Fiscal Policies and Providing Financial Support for the Alleviation of Difficulties and Development of Market Participants		Y	
5/27/2022	State Council	Work Plan for Improving the Quality of Listed Companies Controlled by Central Enterprises			Y
6/1/2022	CBIRC	Guidelines on Green Finance for the Banking and Insurance Industries	Y		Y
6/2/2022	CBIRC	Notice of Further Effectively Providing Financial Services for Enterprises in Difficult Industries Affected by the COVID-19 Outbreak		Y	
7/28/2022	CBIRC	Provisions on the Administration of Insurance Assets Management Companies			Y
8/19/2022	PBOC, NDRC, etc.	Overall Plan for the Construction of the Chongqing Green Finance Reform and Innovation Pilot Zone	Y		Y
10/28/2022	NDRC	Opinions on Further Improving the Policy Environment and Increasing Support for the Development of Private Investment		Y	Y
11/10/2022	CBIRC	Notice of Issuing the Statistical System for Green Insurance Business	Y		Y

Source: Government publishments, White Paper on ESG Development and Innovation in China 2022, consolidated by Invesco, as of Dec 2022. May not be a full list. Note: NDRC: National Development and Reform Commission; SAFE: State Administration of Foreign Exchange.

Positive momentum in terms of investment universe and flow trends

- Growing universe of China green bonds and green loans

The sustainable bond market is expanding globally, with green bonds accounting for half the universe. According to the Climate Bonds Initiative (CBI), China (18%), US (14%), and Germany (12%) were the top three issuers of green bonds in 2022. Even though primary issuances in both the China onshore credit market and Asia offshore US dollar bond market suffered from multiple headwinds in 2022 (rate hikes, geopolitical conflict, China property crisis, etc.) and the issuance amount saw a drop for 2022, the amount of green bonds issued in China expanded by 15% year-on-year (Figure 1).The local and foreign currency green loan balance by financial institutions and its percentage of the total loan balance also grew steadily and rose by 38.5% year-on-year, surpassing CNY22 trillion (equivalent to US $3.2 trillion) as of 2022 year-end (Figure 2).

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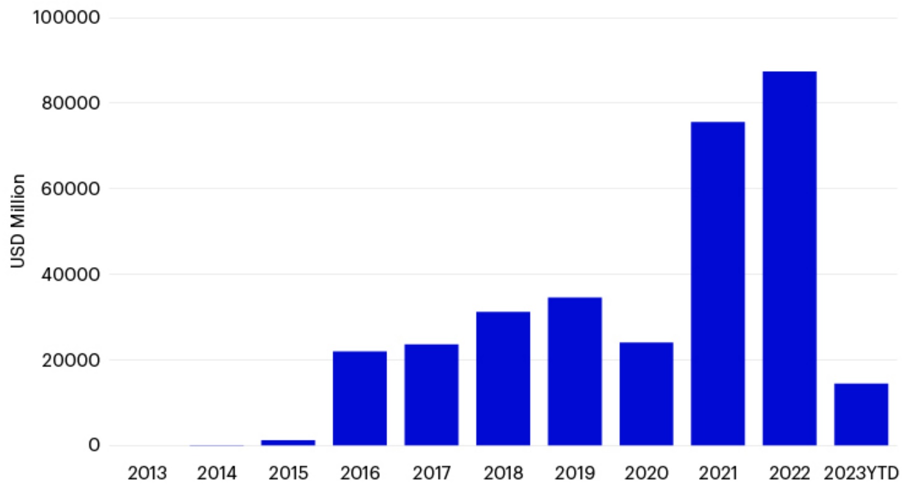
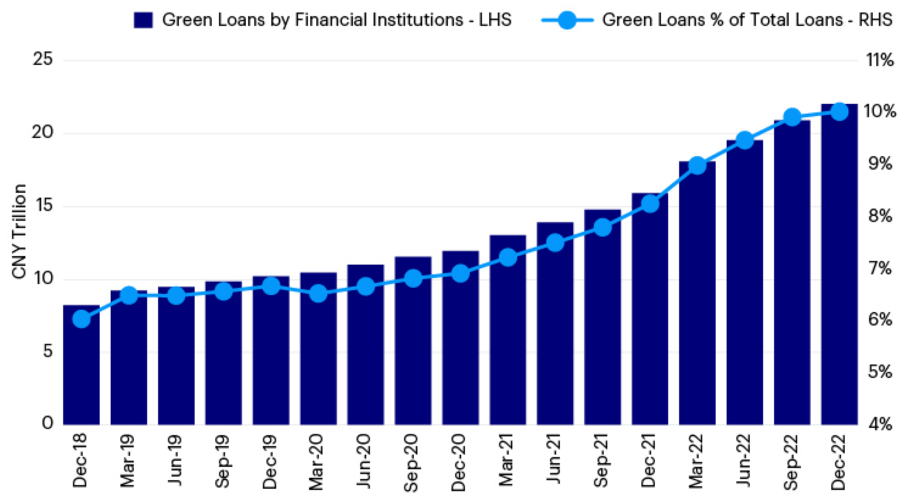
Figure 1 – China green bond issuance (USD Millions)



Source: Climate Bonds Initiative, data as of 12 April 2023.

Figure 2 - Local and foreign currency green loan balance and proportion in China



Source: Wind, data as of 31 December 2022.

- **Resilient fund flows of Asia and China ESG bond funds**

To uncover the latest flow momentum, we looked at Morningstar Asia and China bond fund peer groups[1] and filtered out funds that indicated a focus on sustainability; impact; or environmental, social, and governance factors in the fund name. We define these bond funds as ESG bond funds and found that their net flows stayed stable in 2022 despite the large outflows and AUM shrinkage of the broad bond fund universe under the bearish market environment brought on by global and regional headwinds. Furthermore, there have been noticeable inflows into ESG bond funds since November 2022, when the greater China reopening narrative started to come into play. It is apparent that ESG bond funds have experienced more resilient technical support during downside market stages and there has also been growing awareness and capital flows into ESG investing in recent years.

[1] EAA OE Asia Bond, EAA OE RMB Bond – Onshore, EAA OE Asia High Yield Bond, EAA OE Asia Bond - Local Currency, EAA OE China Bond, and EAA OE Greater China High Yield Bond.

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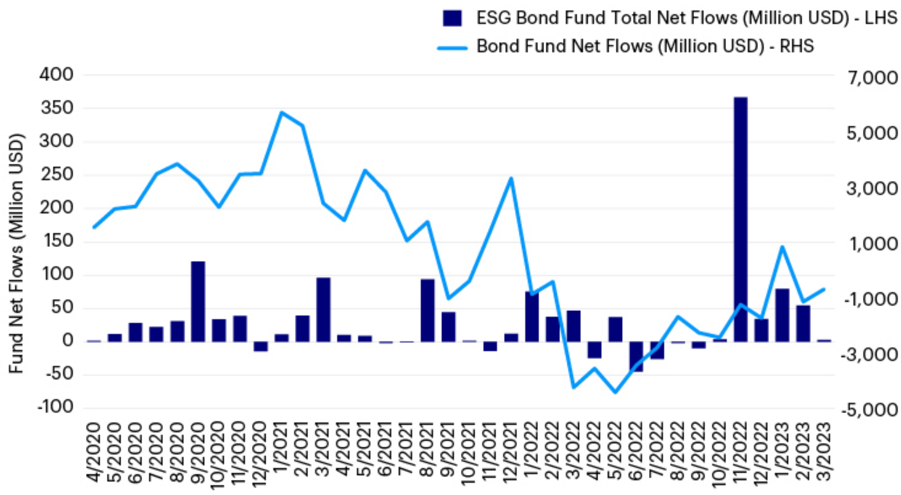
Figure 3 – Net Flow of Asia and China bond funds (ESG and total)



Source: Morningstar, Invesco, as of March 2023. Subject to data availability by Morningstar. Statistics by Invesco based on Morningstar peer group[1]. ESG bond funds are defined by the indication of the focus on sustainability; impact; or environmental, social, and governance factors in the fund name.

Why invest in financials, industrials, and TMT in China from an ESG perspective?

When investing in China's growth story in a sustainable way, a question that is frequently raised is which industries could be of greater value and potential from an ESG perspective. Investors also care about how companies in these sectors are doing in terms of their transition mission. Invesco engages with invested companies and issuers as part of its wider commitment to active ownership. Through a centralized engagement process, Invesco draws on this collective power to capture management attention and use our influence to encourage stronger sustainability-related behavior from the entities in which we invest. In this section we take a deep dive into three sectors in our investment universe, financials, industrials, and TMT, and elaborate with some case studies to showcase some key players in these sectors.

- **Financials**

The financial industry allocates capital for the functioning of the economy. As part of China's efforts to tackle the challenges of pollution after decades of rapid economic growth, the country has looked to develop a green financial system, providing support on fiscal, tax, and land policies for green industries and projects. The banking sector accounts for more than 91%[2] of the total assets within China's financial industry and plays a vital role in catalyzing and accelerating the transition to a sustainable economy by directing capital to climate-resilient and resource-efficient sectors and enterprises.

Pressure is mounting on the sector to respond to ESG concerns and reform their analysis and investment processes, as well as incorporate ESG strategies at pace. China has the largest green loan balance in the world. The key driver of China's green loan balance increase has been its mega banks, which has contributed over half of the outstanding balance. China's share of mega banks as a proportion of all banks increased from 49% in 2019 to 55% by 2021. Policy banks also played an important role in green finance in China, and the share of policy banks stood at 27% at the end of 2021, followed by joint stock banks at 12%.[3]

We recently upgraded our in-house ESG rating for one of China's mega banks given its improving track record in ESG. The bank has continued to contribute to China's 30/60 target, UN sustainable development goals (SDGs), and the Paris Climate Agreement. Aside from setting up a leading group for green finance with its chairman as the head, in 2021 the bank also released the 14th Five Year Plan for green finance. ESG has been at the forefront of firm's financial product growth. The bank's green credit stood at RMB 2.0 trillion (US $289 billion) as at end 2022, up 41% year-on-year. It has issued transition bonds, biodiversity-themed green bonds, and sustainability linked bonds, etc. globally.

[2] Source: People's Bank of China, as of 30 September 2022.

[3] Source: TABInsights.

Table 2 – Invesco's sustainability bond scorecard using a case study of a mega bank in China

	Score	Rationale	Definition
Use of proceeds (score 0-4)	4	The bank's Sustainability Series Bonds align with Sustainability Bond Guidelines 2018, Green Bond Principles 2018, and Social Bond Principles 2020 to fund new and existing projects and businesses with environment and/or social benefits. Eligible projects include but not limited to renewable energy, energy efficiency, pollution prevention and control, environmentally sustainable management of living natural resources and land use, clean transportation, sustainable water and wastewater management, green buildings, affordable basic infrastructure, access to essential services, affordable housing, and employment generation.	**Score 1:** Management does not disclose targeted projects or majority is towards refi of existing activity **Score 2:** Projects are identified and at least 50% are new but of limited green social value, possibly due to the industry **Score 3:** Projects are identified, it's new financing, and are generally aligned to SDGs even if not specific or sizeable **Score 4:** Project makes significant contribution by providing new financing and is aligned to UN SDGs.
Management of proceeds (score 0-2)	2	The bank shall record the source and allocation of proceeds in a separate ledger management system to ensure that all the net proceeds of the Sustainability Series Bonds are properly managed and used. The bank will review and update the ledger on a quarterly basis. Any proceeds allocated to projects that have amortized, been paid, sold, or otherwise become ineligible shall be reallocated to newly nominated and approved projects.	**Score 0:** Mgt of proceeds not disclosed **Score 1:** Proceeds are deposited in general funding accounts **Score 2:** Proceeds are held in escrow until invested
Reporting (score 0-2)	2	The bank will make disclosure of the allocation of the proceeds and the environmental and/or social impacts of funded eligible projects on an annual basis on its website. The bank will also publish statement on a quarterly basis to confirm that the utilization of proceeds of the Sustainability Series Green Bonds complies with the statement on the official website.	**Score 0:** Mgt does not commit to reporting **Score 1:** Mgt commits to reporting a general sustainability report **Score 2:** Mgt commits to allocation and impact reporting
External verification (score 0-2)	1	The bank will also disclose annual reports of the Sustainability Series Bonds, an attestation report for the annual report by a third party and an attestation report for the use of proceeds by a third party.	**Score 0:** No external verification **Score 1:** A single second party opinion (i.e.: CICERO, Vigeo, DNV GL, Oekom Research, EY, KPMG) **Score 2:** Verified by multiple parties (incl. e.g.: the climate bonds initiative and may have a Moody's Green Bond Assessment, S&P Green Bond Evaluation)
Result (out of 10)	9	Maximum alignment with both the UN SDGs and good overall governance framework.	

Source: Company data, Invesco, as of April 2023. The above company was selected for illustrative purposes only and is not intended to convey specific investment advice. It is illustrative of the investments the strategy would make.

Invesco has developed a proprietary framework to assess sustainability bonds against the International Capital Markets Association (ICMA) Green Bond Principles and Social Bond Principles. The alignment of invested bonds to this framework is monitored on continuous basis by credit analysts. Under the framework, we find that the mega bank's Sustainability Series Green Bonds are rated "Maximum alignment with the UN SDGs and have a good overall governance framework" (Table 2).

In mainland China, the bank helped to launch the first carbon-neutral securitized product, advised on the first local government overseas green bond issuance, and underwrote the first green personal auto loan asset-backed security (ABS). The bank also prioritizes the achievement of net zero in its operations. It has announced the tightening of its policy toward overseas coal exposure and plans to stop related new financing. In terms of disclosure, the company has joined the Task Force on Climate-Related Financial Disclosures (TCFD).

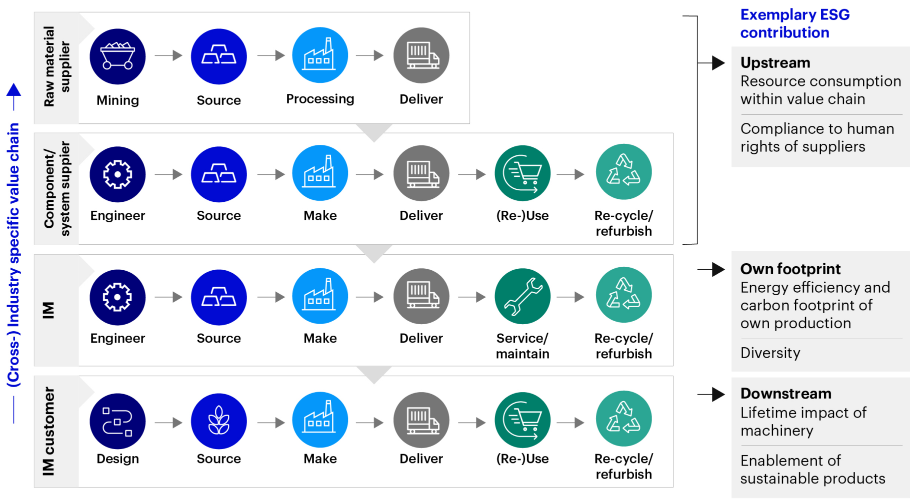
From a social perspective, the bank has continued to show improvements in the proportion of women in its workforce (57%) and employee training. It has been active in community spending and inclusive financing. The bank's agriculture-related loans also reached RMB 2 trillion in 2022, up 38% year-on-year. From a governance perspective, the bank is ahead of its peers in terms of the percentage of women on its board, the board size, the board meetings per year, and duration of board members.
This bank is a one key example of the effort Chinese banks have contributed toward sustainable development as well as the progress that has been made.

- **Industrials**

The industrial sector represented nearly 33.2% of China's GDP in 2022, among which the manufacturing sector comprised 27.7%.[4] China's manufacturing sector has been the largest in the world for the past 13 consecutive years.[5] Onshore industrial companies are answering the call to be more sustainable and embrace ESG. Numerous top firms across multiple industrial sectors have advanced their ESG efforts significantly and have established objectives and commitments to pursue ESG-conscious best practices and initiatives.

Industrial manufacturing (IM) companies need to take a holistic value chain view to understand the full ESG impact of their products and services. These companies have a significant environmental impact not only within their own value chain but even more so on that of their customers. As a result, multiple levers across value chains need to be included to improve their sustainability footprint.

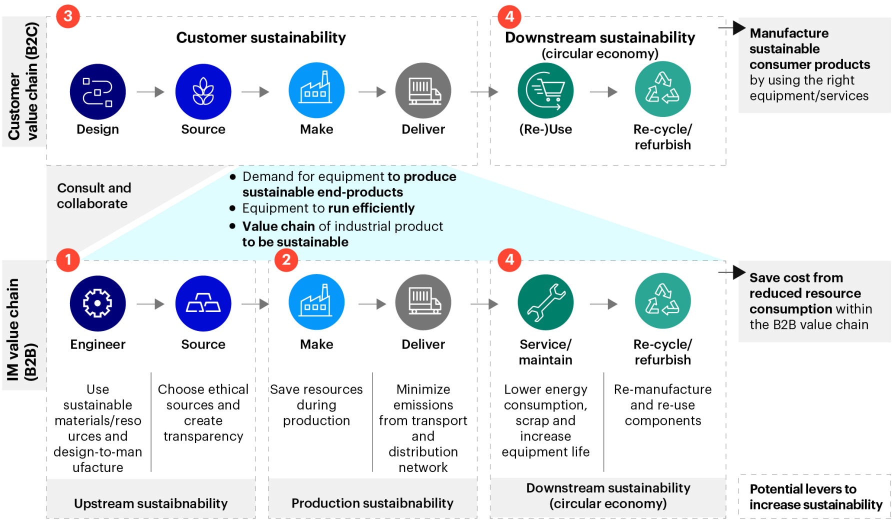
Figure 4 – Cross-industry value chain of industrial manufacturing companies



Source: Strategy &.

[4] http://www.gov.cn/xinwen/2023-03/19/ontent_5747420.htm
[5] Ibid.

Figure 5 – Industrial manufacturing companies: Multiple levers across value chains to improve sustainability footprint



Source: Strategy &.

We recently had our one-on-one engagement meeting with a cement manufacturer in China. The key discussion points included the company's net zero goal and decarbonization roadmap, the challenges of achieving net zero in China's cement industry, and the domestic carbon trading market.

Despite lack of a SBTi (Science-Based Targets initiative) net-zero target announced, the company highlighted to us that they recently released the domestic cement industry's first white paper on low-carbon development. They have also set an aggressive carbon intensity reduction target of 70% by 2030.

The focus of the company's near-term strategies are on 1) reducing the clinker factor in cement production; 2) using alternative raw materials and fuels; 3) improving energy utilization efficiency; 4) optimizing the utilization of waste heat from cement kilns and; 5) smart manufacturing technologies like China Carbon Emission Reduction (CCER) and bioenergy with carbon capture and storage (BECCS). To achieve carbon neutrality in the medium and long term, the company aims to develop carbon capture, utilization, and storage (CCUS) and BECCS technologies. To do this, the capital expense commitment during the period from 2020 to 2030 is likely to be more than RMB 10 billion.

During our engagement, the company shared their perspective on decarbonization and margin improvement. In their view, decarbonization strategies such as reducing the clinker ratio, using alternative raw materials and fuels, and improving energy utilization efficiency should also contribute to cost reduction. This can motivate China's other cement companies to follow suit and join the decarbonization journey.

Use of electricity (largely coal-based in China), combustion of coal and process chemistry account for 2-5%, 35%, and 60-65% of CO_2 emissions emanating from the cement production. However, increasing clinker substitution, alternative fuel use, and thermal energy efficiency can at most reduce 40% of CO_2 emissions of the existing production process. The company believes that the main technology group that can enable achieving the remaining required emission reduction is CCUS, owing to the relatively high concentration of CO_2 in the flue gas from these large, point-source emitters. However, CCUS technology could take time to develop and implement.

When discussing carbon trading, management sees it as an opportunity for capacity rationalization. China's cement industry still suffers from overcapacity. The development of the carbon trading market can help to phase out the less energy efficient cement production capacity. It can also encourage corporates to improve energy efficiency and develop more 'green' production processes. Nevertheless, China's carbon trading market is still at an initial stage as compared to Europe's more mature market.

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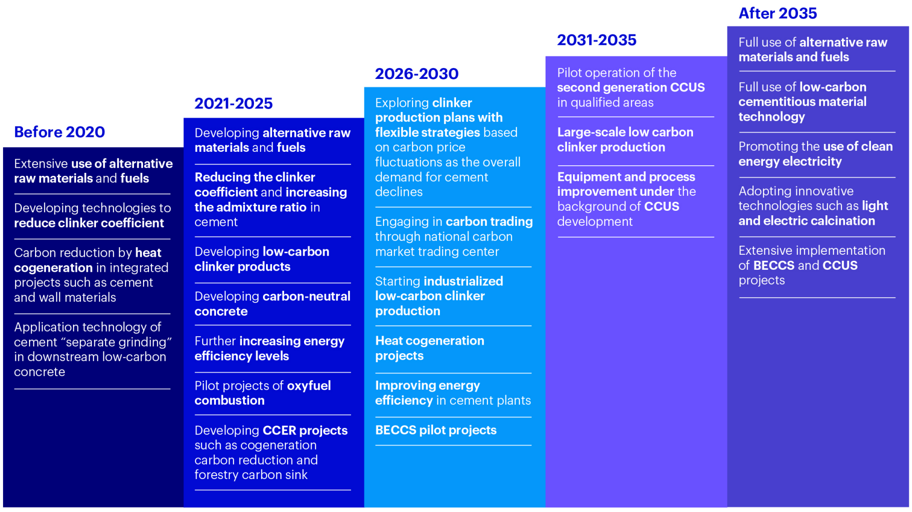
Figure 6 - Carbon emissions reduction roadmap – using a case study of a cement manufacturer in China



Source: Company report.

A similar action plan to develop alternative raw materials and fuels to reduce carbon emissions is also being applied by a large-scale diversified non-ferrous metals production group. The group and its flagship listed subsidiary aim to achieve peak carbon emissions by 2025E and reduce carbon emission by 40% by 2035E. These targets were announced in 2021 and are significant given they are five years ahead of the national 30/60 target. Carbon reduction KPIs were disclosed in the company's 2022 ESG report. Given that smelting is an energy-intensive stage of non-ferrous metal production, the company's energy plan is a key component from an environmental perspective. The company aims to reach a 60% renewable energy mix (including solar, wind, hydro, etc.) by 2030 from the level of around 40% in 2022. The company's other ESG commitments include being an early mover in the recycling business and participating in the carbon trading mechanism consultation process.

• TMT

The TMT industry covers a broad range of sectors and can be divided into multiple sub-sectors of hardware, semiconductors, software, media, and communications, etc. TMT companies typically exhibit the characteristics of a heavy reliance on R&D, a strong focus on intellectual property rights, and close connection across multiple sub-industries through the supply chain.

ESG commitment by different companies in sub-sectors under the TMT industry looks different depending on the company. For example, hi-tech manufacturers can have a direct impact on the environmental front through technological innovation and product development. According to academic research, ICT (information and communication technologies) has the potential to reduce global emissions by about 15% by 2030.[6] In contrast, for communication service providers, considerable weight is given to corporate governance, followed closely by privacy and data security, and human capital development, with only around a 5% weight given to environmental factors.[7]

One of the issuers in the sector which caught our attention is a leading global PC (personal computer) manufacturer in China, which designs, develops, manufactures, and distributes a wide range of smart devices (including personal computers, tablets, smartphones), infrastructure, solutions, and services globally. The company is a signatory of the UN Global Compact and has aligned its strategies and operations with the ten Principles regarding human rights, labor, environment, and anticorruption, as well as 14 out of the 17 SDGs in the FY 2021/2022.

[6] Source: Jens Malmodin, Pernilla Bergmark, Exploring the effect of ICT solutions on GHG emissions in 2030
[7] Source: Simons Simons, ESG practical step for TMT business.

The company has made an extensive commitment toward the environment and has taken various initiatives in this regard. Given the potential risks of climate change, the company is fully committed to reducing its carbon footprint in its operations. To this end, in June 2020, the company established science-based emissions reduction targets, which were validated by the SBTi. Its scope 1 and 2 emissions reduction targets are consistent with limiting warming to 1.5°C, the most ambitious goal of the Paris Agreement, and its scope 3 emissions reduction targets meet ambitious criteria according to the SBTi's methodology, which means they are in line with current best practices. In 2021, the company was one of 80 companies selected to test a new net-zero standard with the SBTi, the first ever science-based net-zero target standardization. In the year 2021 to 2022, the company reported a 15% reduction in scope 1 and 2 emissions, and it is increasing its focus on collaborating with suppliers to reduce scope 3 emissions intensity across the value chain.

Specific practices to reach these targets include the improvement of energy efficiency within the company, increases in renewable energy capacity (the total in operation renewable energy capacity in the worldwide locations has reached approximately 17MW at the end of FY 2021/22), recycling and reuse, waste management and separation of waste from day-to-day operations, etc. Unique to the company's role as a PC manufacturer, the firm's Product End-of-Life Management (PELM) program is an important part of its efforts to support a transition to a circular economy. The PELM program increases the beneficial reuse and recycling of products and parts and supports the elimination of end-of-life electronic products being disposed of in landfills. It includes the practice of reuse, refurbishing, de-manufacturing, dismantling, reclamation, shredding, recycling, treatment, and disposal of products, parts, and peripherals when they are taken out of service, reach end-of-life, or are scrapped. This program covers company-branded and non-branded products owned by the company or received from customers and others (including customer returns or take backs).

Investment Implications

ESG investing opportunities in China allow investors to gain exposure to industry-specific structural growth drivers that are aligned to the country's decarbonization goals. From a fixed income perspective, we believe the investment universe in the sustainable labelled bonds space will grow further. ESG fixed income investment differentiates itself from traditional portfolio management by adding in a fourth pillar in addition to the traditional three pillars - fundamentals, valuation, and technicals. With our proprietary approach, every investment needs to pass through these four pillars to be considered in the evaluation process.

ESG assessments in credit research deliver additional insights into a company's risk and performance. Higher ESG-rated issuers tend to have stronger cash flow metrics, lower levels of ex ante risk, and less-frequent severe incidents than lower ESG-rated issuers.[8] With ESG finally a mainstream concept, the power of public opinion has highlighted that flawed ESG management can cause a company's reputation to plunge overnight, while companies that put more weight on ESG demonstrate commitment to a stronger credit profile in the long run. We believe applying an ESG lens does not imply a lower return but instead provides stronger risk management and can lead to higher risk-adjusted return in the long run.

[8] MSCI, 2021.

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Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

When investing in less developed countries, you should be prepared to accept significantly large fluctuations in value.

Investment in certain securities listed in China can involve significant regulatory constraints that may affect liquidity and/or investment performance.

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