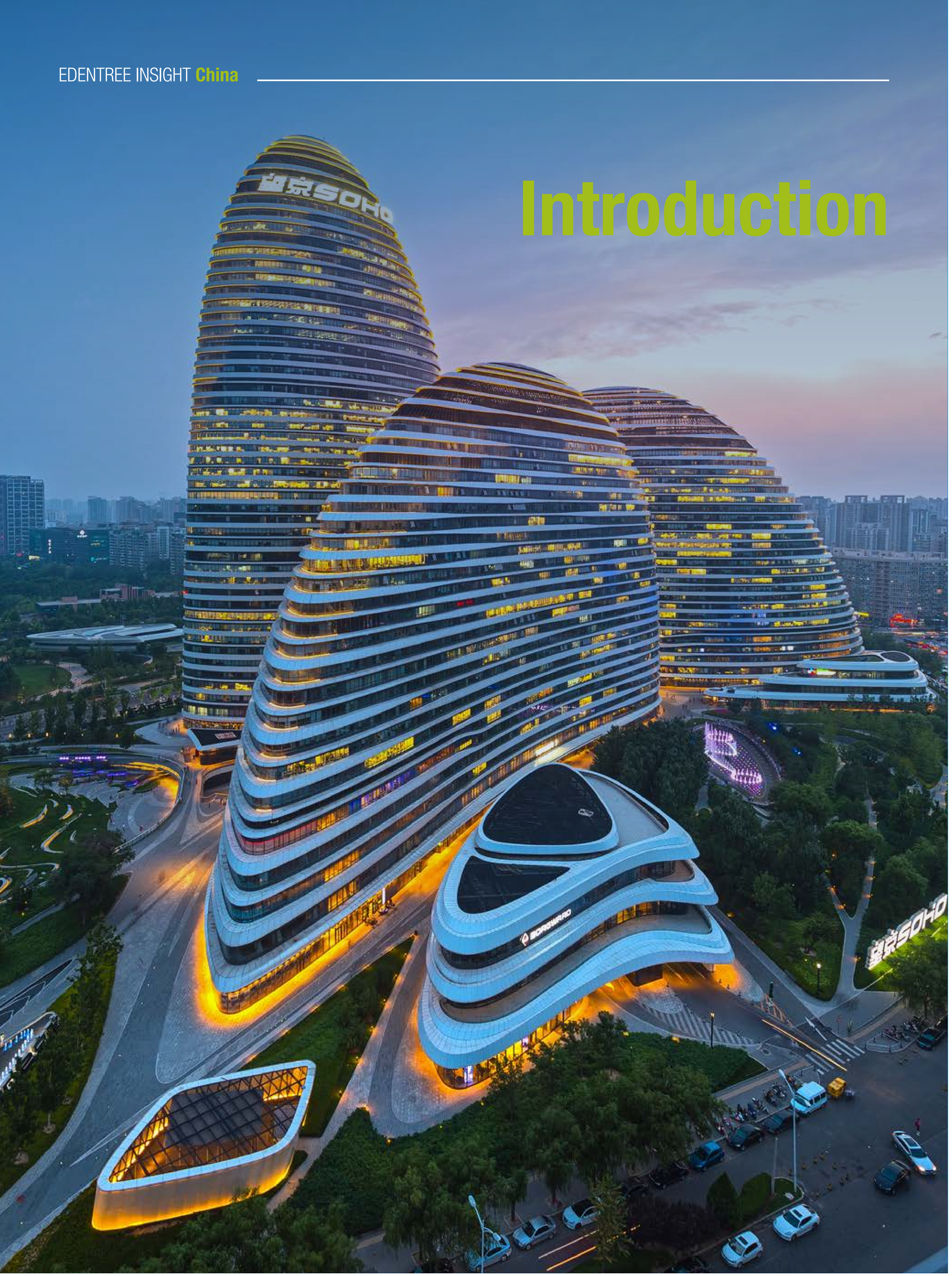
EDENTREE INSIGHT **China**

China on the world stage:

What it means for responsible investors



Introduction

On 1 October 1949 Mao Zedong took to the stage on Tiananmen Square in Beijing and declared the creation of the People's Republic of China, marking the start of the one party state that we still know today. In the last 70 years, China has seen enormous change and has risen on the world stage from an agricultural economy closed off from the world, to a global superpower. China's transformation, under the close supervision of the Communist Party of China, has been spectacular.

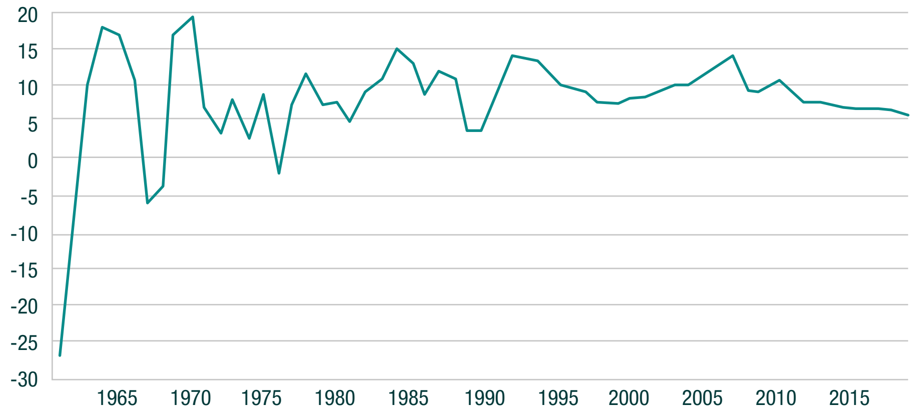
Such a rapid pace of development and economic change has also brought environmental and social consequences. We first explored this in an Amity Insight on China back in 2009. Then we asked the question whether it was possible to invest responsibly in China. That question is still relevant today and probably even more pressing than when we released our first publication. As China's role in the global economy continues to grow, it means companies worldwide are almost certain to have some relation with China, either through direct operations, vast supply chains or when they are trying to sell into the growing Chinese market of over a billion consumers. This means global investment portfolios will have direct or indirect exposure to China too, and for responsible investors this raises several challenges.

In this Insight we will explore China's transformation and its place in the world, as well as the environmental, social and governance issues responsible investors should be aware of. We will also summarise EdenTree's views and how we ensure we invest responsibly and sustainably in a world where China is at the heart of 21st century capitalism and geopolitical debates.

China's economic development

Until 1978, the Chinese economy was closed off from the world and was mostly agricultural in outlook. Plans under Mao to industrialise the countryside under the second five year plan also called the *Great leap forward* had failed, and the so-called leap forward which aimed to increase farming yields led to mass starvation instead. Only under reforms led by Deng Xiaoping, after he took power in 1978, did China open up to the western world and began to establish relations with the US in particular.

China Annual GDP growth (%) 1961-2019



Source: World Bank.

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China saw GDP growth reportedly averaging almost 10% a year between 1978 and 2010 [i], and whilst critics have raised reservations about the veracity of the reported figures, China has undoubtedly seen spectacular economic development.

Economic development also led to a reduction in poverty. GNI per capital significantly increased after 1990 and whilst in absolute numbers the population living in extreme poverty remains high, the population living under the international poverty line of USD 1.9 (in purchasing power parity) a day has been reduced to 1%. China's development has not only brought economic gains; China has also seen progress on a number of social indicators. Reforms to health and education systems have led to big improvements in literacy rates and a reduction in the number of patients who have no access to care when needed [ii].

China is however a country of contrasts and economic growth has also been accompanied by an increase in economic inequality. China counts amongst the largest number of billionaires in the world and has also seen an increase in GINI coefficients (a metric measuring income inequality), even higher than Britain or the US [iii].

China's economic development is in large part linked to its manufacturing capabilities and 'Made in China' has become a global symbol of China's rise and industrial dominance. An abundance of lower-wage workers and the creation of a vast ecosystem of suppliers and distributors turned China into the manufacturing centre of the world. In addition to technology, China's leading manufacturing position also prevails in garments, automobile parts, electrical machinery, furniture and bags & accessories. Made in China is how the rest of the world sees China, however that is set to change. Under its Made in China 2025 strategy, the country wants to develop its manufacturing sector further, but moving away from cheap low-tech goods and expanding in high-value manufacturing and services. It will also encourage more domestic consumption and reduce reliance on foreign exports. China's economic development is also visible when seen through the lens of the largest companies globally. Twenty years ago there were only 10 Chinese companies in the Fortune 500 list. By 2020, there were 124, and for the first time there were more Chinese companies on the list than US companies[iv]. However a substantial part of the economy remains controlled by the State and only a minority of Chinese companies in the Fortune 500 list are privately owned.

In addition to its global role in manufacturing, China also represents an attractive consumer market. With approximately 1.4 billion people or just under 20% of the world's consumers live in China. As China develops and people get richer, consumption is set to increase further, presenting huge opportunities for businesses seeking to take advantage of the growing Chinese market. Spending patterns are already changing: for instance, spending allocated to food has decreased from 68% in 1990 to 25% in 2017 [v].

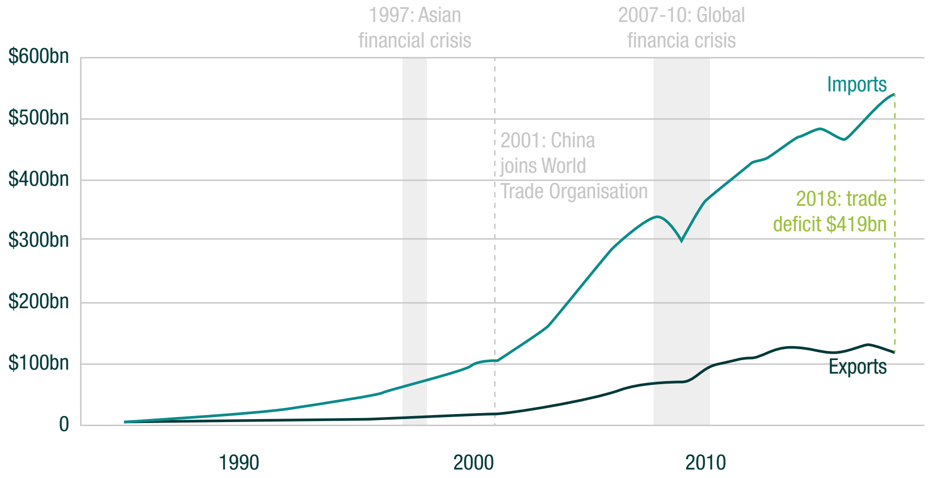
This Insight would not be complete without mentioning China's relationships with its key economic counterparts: the US and the EU. China and Europe trade on average over € 1 billion a day and both Europe and America have large trade deficits with China; we have already witnessed this deficit being one of the starting points of the ongoing US-China trade war in the last two years. Trade tariffs imposed by both parties have done more harm than good and relations continue to be tense at the time of writing.

China's remarkable progress in reducing extreme poverty has significantly contributed to the decline in global poverty.

Hoon S. Soh, World Bank Program Leader for economic policies for China

US trade with China

US trade deficit with China has soared since 1985



Source: US Census, BBC

Supported by its economic development, China's influence on the global stage has significantly changed in the last 20 years, however it is not just economic. It uses its soft power to build relationships by hosting large international events such as the 2008 Beijing Olympics and the 2010 World Expo in Shanghai and uses 'Panda' diplomacy - the practice of sending Pandas on long term loans to other countries – to build international relationships. China's foreign investments have also seen rapid development, especially through the so called 'Belt and Road' Initiative: a spectacular plan along the "21st century silk road" covering 71 countries in Asia and Africa. Its rising military presence is also noteworthy, with China arguably succeeding Russia as the only other military superpower alongside the United States. China visibly demonstrates this potential with activity in the South China Sea and in areas of 'influence' such as in Hong Kong.

The rapid changes seen over recent decades makes it difficult to predict what China will look like by the mid-century when it celebrates the 100th anniversary of the founding of the People's Republic of China; surely China's development won't stop here. As it continues to develop and further its influence, the topic of responsible investment in a world dominated by China becomes even more relevant.

Issues for responsible investors

China's position as a world leader means what happens in China affects the rest of the world, this is especially true for environmental, social and governance standards. These issues are relevant when investing directly in China, in companies with operations or supply chains in China, and/or those seeking to access the growing Chinese consumer market.

Many of the social and governance issues are directly linked to companies operating there, whilst many of the environmental issues pose global challenges at a macro level. China's position on the world stage means its environmental efforts can, for instance, make or break the Paris Agreement. Given investor focus on climate change, we believe China's moves should be watched closely.

The environment: an unambitious start, but China is getting greener

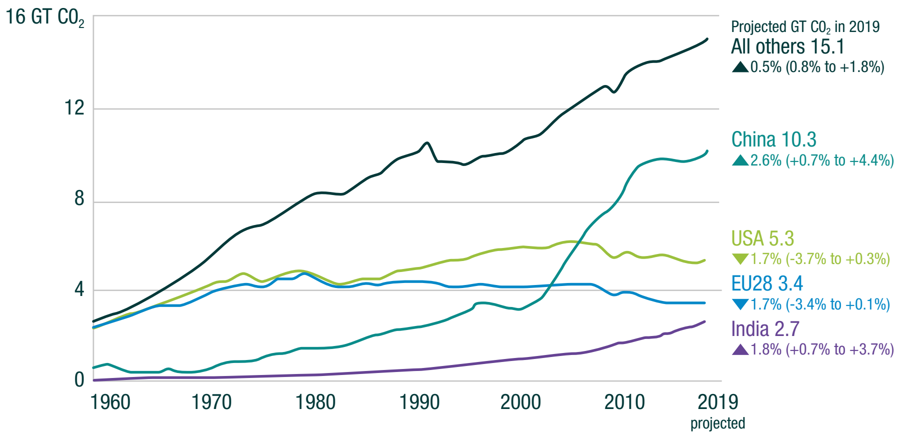
China's economic development has long been supported by unsustainable exploitation of natural resources and significant greenhouse gas emissions. A damning report by the US Department of State draws a dirty picture of the country's environmental problems:

> "the world's largest emitter of greenhouse gases; the largest source of marine debris; the worst perpetrators of illegal, unreported, and unregulated (IUU) fishing; and the world's largest consumer of trafficked wildlife and timber products."[vi]

Poor environmental practices have an impact not just in China, but on the rest of the world too, and present a challenge for responsible investors.

Today China is responsible for roughly 29% of global GHG emissions; particularly after the turn of the millennium, emissions increased exponentially [vii].

Annual Fossil CO_2 Emissions and 2019 Projections



Source: Global Carbon Project. Data: CDIAC/GCP/UNFCCC/BP/USGS.

China has been the world's largest emitter of greenhouse gas emissions since 2006 – although arguably, China is not to blame for all of this , as a lot of external production, and thus emissions, are effectively outsourced to the country – as a result of which, its emissions continue to rise. Of course having the largest population of any country in the world, contributes to those emissions, but it is worth noting that emissions per capita are higher in other countries including the US, Canada and Japan.

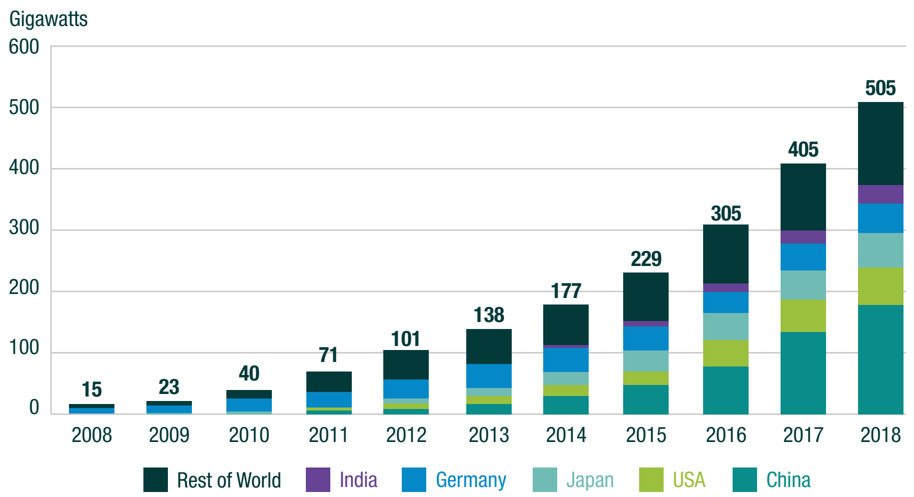
Another factor to take into account when assessing China's contribution to global emissions is its dependency on coal; however it is worth remembering that the development of western economies was also powered by coal. In 2019, coal represented 52% of the country's generating capacity and its coal fleet is significant. Between 2000 and 2019 China's coal fleet grew five-fold and almost half of the world's coal capacity is in China. China is also where we are seeing the largest expansion in capacity with many new plants being planned and built [viii].

China's polluting and unsustainable environmental record is not limited to greenhouse gas emissions; its manufacturing leadership includes sectors with high environmental impacts including pesticides use, water consumption, energy use or air pollution. China is responsible for 27% of the world's cotton production, 39% of the world's paper manufacturing, 48% of the world's coal, 50% of the world's steel and 65% of global chemical and synthetic fibres[ix]. A staggering 99% of heavy rare earths – a critical raw material for smartphones, batteries and many other modern technologies - come from China.

Whilst China is often associated with negative environmental impacts, there are encouraging signs that this is changing. Beijing is increasingly aware of its role as a superpower and the need to play its part in combating climate change and demonstrating wider environmental stewardship.

Whilst being the number one carbon emitter, it is also number one in renewable energy production, and a leading manufacturer of renewable energy technology, especially solar panels. Whilst coal represents the majority of the country's energy mix, renewables are on the rise and represented 28% of the mix at the end of Q1 2020 [x] - the majority comes from hydropower, but solar PV is seeing rapid growth. Three of the world's 10 largest dams are in China, The Three Gorges Dam being the largest of all, with a capacity of 22,500MW.

Solar PV Global Capacity, by Country and Region, 2008-2018



Source: The Renewables Global Status Report by the Renewable Energy Policy Network for the 21st Century (REN21)

Other promising signs of progress include the announced ban on imports of foreign waste and its flourishing green bond market. The biggest surprise came when Xi Jinping announced China's pledge to achieve carbon neutrality before 2060. The announcement also included a commitment to peak emissions before 2030 and raises the bar for other countries ahead of COP26 next year.

Many questions remain about China's green path though. Whilst the recent announcements and investments in renewables are welcome and much needed, the country's addiction to coal and the expanding fleet need to be addressed. In addition, abroad, through the 'Belt and Road' Initiative, China also exports its low environmental standards and funds major infrastructure projects that are alleged to have significant negative environmental impacts.

Social issues: a long list of concerns difficult to navigate

Censorship, oppression, human rights violations, working conditions, health and safety, freedom of association…. The list of areas of concern for responsible investors doesn't stop at the environment. The tight control of the Communist Party of China on the economy extends to its people. Many human rights organisations including Freedom House and Amnesty International have flagged a lack of fundamental freedoms, and a crackdown on dissent. As a result China is classified by EdenTree under our oppressive regimes screen as an 'oppressive regime', resulting in restrictions on investment where companies are also potentially involved in activities related to human rights violations in oppressive regimes.

Many of the countries on our oppressive regimes list are authoritarian or totalitarian, this is also the case for China and the CPC is at the heart of many of the issues. The Chinese Communist Party has a tight control over the state bureaucracy, the media, online speech, religious groups, universities, businesses, and civil society associations. Media and internet censorship is widespread and controlled by the CPC. Independent rule of law is non-existent/very limited. The CPC dominates the judicial system, with courts at all levels supervised by party political-legal committees that have influence over the appointment of judges, court operations, and verdicts and sentences. The CPC interferes and controls religious activities, including naming religious leaders and prosecuting Tibetan Buddhists, Uighur Muslims and proponents of Falun Gong.

The CPC has been in continuous power since 1949. Activists and lawyers who support a democratic transition are detained, abused, executed or mysteriously disappear. Political freedom as well as freedom of speech are not tolerated. Following amendments to China's constitution abolishing the two-term limit for the state presidency and vice presidency, this is unlikely to change; President Xi Jinping has been given (or given himself) unlimited terms in power, effectively for life.

The disapproval of democratic thoughts and ideologies that are different from the CPC are also a key factor in many of the tensions between Beijing and some of its autonomous regions and special administrative regions. Whilst tensions with Tibet have been ongoing since the 1950s, oppression has significantly increased in the 21st century, with tighter surveillance as well as suppression of the Tibetan culture. In Xinjiang province, campaigns against "religious extremism" have led to severe human rights violations and indoctrination in so called "re-education camps". Since Hong Kong was handed back to China in 1997, control from China has only tightened and freedom has significantly been reduced further, following the recent imposition of the National Security Law.

Whilst a lack of freedom and the presence of an authoritarian regime is a concern, as an investor this becomes especially material when companies become complicit in violations. As explained in the first part of this Insight, given China's size and role, many companies will have some exposure to operations or suppliers in China or might be trying to sell their products and services in the Chinese market. As responsible investors we watch out for possible involvement in human rights issues.

China's surveillance ecosystem is one of the issues that concerns us. The Skynet project is a vast network of security cameras deployed in public spaces across the country, it is the world's largest surveillance network. According to the Chinese Ministry of Public Security, China is anticipated to have 626m CCTV cameras in use in 2020 [xi]. The Great Firewall is the largest and most sophisticated online censorship operation in the world. Beijing has curbed the internet from the beginning, and online activities are closely monitored to avoid "hurting national security or the interests of the state". VPNs - Virtual Private Networks used to circumvent the firewall - have largely been blocked since 2015. This vast surveillance and censorship ecosystem would not be possible without the cooperation and participation of businesses. Manufacturers of cameras used by the regime, telecoms operating censored networks, or online services having to comply with China's surveillance regime should make a western investor cringe. These issues do not just appear when trying to invest in the likes of Huawei or Baidu; given the size of the Chinese market global companies sell their technology in China too. Companies ranging from Microsoft and Apple, to Cisco and Ericsson have discovered the challenges of a delicate balancing act between the ambition to operate in China and the risks of handing over sensitive user data to Beijing.

China's role as the manufacturing centre of the world also means that investors will no doubt have exposure to supply chains in China and the country's labour practices. Whilst labour rights such as freedom of association and health & safety in the workplace legislation exist, in practice it is not always respected or enforced. For instance, trade union representation has been allowed since the 1990s, however similar to the political sphere, there is not much choice. Whilst workers have the right to join or form a union, they are expected to join the CPC approved All-China Federation of Trade Unions (ACFTU). In practice, new unions are not tolerated and considered as political threats.

Health and safety, working conditions and forced labour also regularly feature in NGO reports on factory conditions in Chinese supply chains. China Labour Watch reported that over 200 million employees are exposed to a variety of occupational risks that impact their health, and about 12 million enterprises provide working environments that increase risks of developing occupational diseases. Electronics supply chains as well as the garment industry have both been shown to endanger employee health due to exposure to chemicals and dyes. The working conditions at supplier Foxconn have exposed many of the issues in China's factories. In addition, China's economic development has been powered by mass migration from rural China to the east coast where a lot of the manufacturing jobs are. As a result workers will often live on factory grounds, with poor living conditions in factory dorms [xii].

Forced labour can take many forms: over the past two decades there have been reports of children being kidnapped to work in brick kilns or cotton fields and forced internships whereby university students are threatened not to be able to graduate if they refuse to take on manufacturing internships – often not related to their degrees - on electronics or automobile production lines. Despite the Ministry of Human Resources and Social Security announcing that the practice of withheld wages will be eradicated by 2020, this still prevails, and similarly the charging of recruitment fees creates significant debt preventing employees from changing jobs. A new form of forced labour emerged in the last few years in Xinjiang province, and many international brands have been accused of benefiting from forced labour in re-education/labour camps managed by the CPC. Resulting from this is there is mounting pressure on apparel retailers to 'manage' where their suppliers source cotton given that 20% of global supply emanates from Xinjiang and is likely to be affected by forced labour issues.

Alibaba

ByteDance 字节跳动

Baidu 百度

sina 新浪网

Tencent 腾讯

weibo

Many well-known Western players of the digital era have a Chinese equivalent, which strictly adheres to CPC censorship rules. Companies like Alphabet, Amazon or Facebook have faced difficulties gaining access to the Chinese market for this reason.

Governance and business ethics

Investing directly in China is still relatively new for foreign investors. The start of the privatisation of the economy and the acceptance of foreign investment in the eighties made it an attractive market given the opportunities. Foreign investment really took off only in the twenty-first century following the creation of the Qualified Foreign Institutional Investor scheme. However as with so many aspects of its economy, Beijing keeps a tight control over its capital markets and who can access them. For instance, foreign investors do not have access to all companies and sectors. China maintains two negative lists (National Negative list and Free Trade Zone negative list) restricting foreign investments in various sectors. 2020 saw a large number of sectors removed from the list including the finance industry and power. Rare earths, news agencies, editing & publishing, television, telecoms, internet services, legal services, education and other sectors remain prohibited for foreign investors. Yet, where it is possible to invest, the corporate governance landscape looks rather different to developed markets and investors have also faced various business ethics challenges.

Foreign investors can gain access to the Chinese economy through different markets or mechanisms:

China A-Shares are the shares of mainland China-based companies listed on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE). Both were launched in 1990. Shanghai is the largest of the two stock exchanges, and a large part of its market cap is from formerly state run companies, whereas Shenzhen has more smaller and emerging sector companies.

H-Shares refer to the shares of companies incorporated in mainland China that are traded on the Hong Kong Stock Exchange. H shares are regulated by Chinese law but denominated in HKD. Many companies float their shares simultaneously on the Hong Kong market and one of the two mainland Chinese stock exchanges in Shanghai or Shenzhen, they are known as A+H companies.

VIEs are variable-interest entity corporate structures. These have been used by private firms raising capital for entities operating in restricted sectors of the economy, such as telecoms and internet services, and listed typically in Hong Kong or New York. Sina.com, the online news provider and owner of Weibo, was the first VIE structure in New York in 2000.

Increasingly Chinese companies are also **listing in the US.** As of October 2, 2020, there were 217 Chinese companies listed on the 3 main US exchanges with a total market capitalization of $2.2 trillion, Alibaba being the largest one.

China has had a corporate governance code since 2002, issued by the China Securities Regulatory Commission (CSRC), which covers shareholder rights, and rules for shareholders and Directors as well as disclosure requirements. An updated version was published in 2018 and also includes environmental and social requirements.

An important feature of capital markets in China are the so called State Owned Enterprises (SOEs). Ownership can take different forms, including through the China Investment Corporation, the Ministry of Finance, or the State-owned Assets Supervision and Administration Commission. Many SOEs are in sectors considered to be strategic such as Sinopec (energy), Industrial and Commercial Bank of China (banking), China Mobile Communications (telecoms) and State Grid (electric utilities).

Despite the concept of public markets, Beijing continues to have an important role in the management of businesses, no matter whether they are state owned or not. The revision of the governance code in 2018 saw the addition of the requirement for companies to establish Party Organisations playing a political role in the company. A “Party organisation” or “Party committee”, is a body established by and reporting to the Chinese Communist Party [xiii].

Party organisations are mandatory for SOEs, however according to the Asian Corporate Governance Association: “They are also widespread in domestic private firms where they serve as a focal point for Party members, exercise leadership over the trade union, and provide guidance on complying with state laws” [xiv]. Multinationals operating in China have also been encouraged to create such bodies. The FT Editorial Board recently warned that Beijing’s influence is increasing [xv]. Additional laws in recent years including the 2016 Cybersecurity Law and the 2017 National Intelligence Law, also require all enterprises to assist with national security and intelligence work, whilst keeping their assistance secret.

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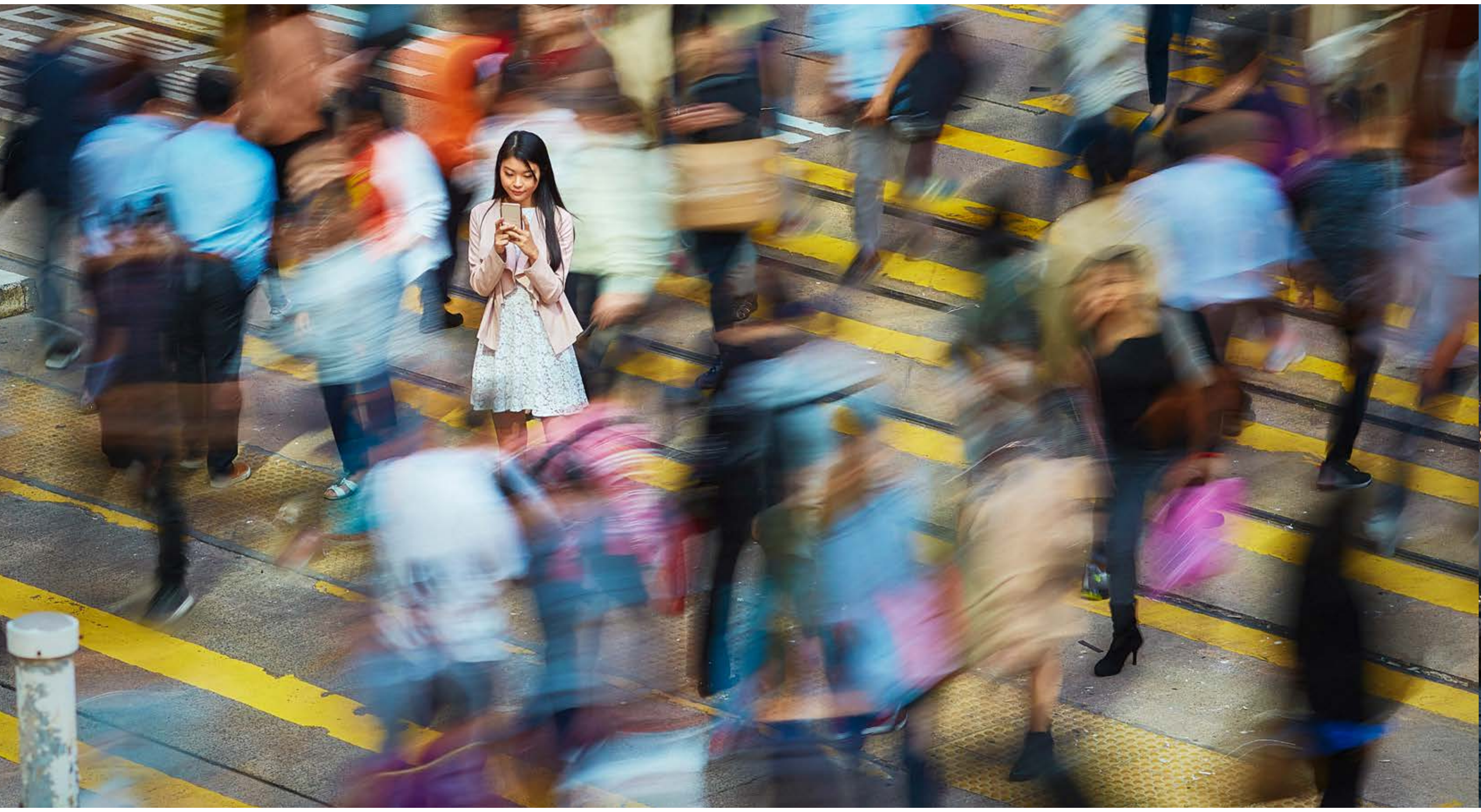
Whilst governance practices seem to be improving and the CSRC tries to raise standards, it is worth noting that Beijing’s influence remains superior to any codes or guidance. The perfect example of that is probably Huawei – a Chinese multinational technology conglomerate based in Shenzhen, and a provider of telecoms infrastructure worldwide. Huawei has become a ‘political football’ over charges of Chinese State influence, links to the Chinese military, and allegations of surveillance and data theft through the roll out of 5G technology. The US in particular has banned Huawei and exerted pressure on allies to follow suit – the UK recently announced its exclusion. Whilst Huawei’s ultimate owner is described as employee led, the company is mired in international controversy due to concerns over Beijing’s influence.

Investors in Chinese companies, but also in multinationals operating in China will be well familiar with the issue of corruption too. Many well-known companies including GSK, Nestlé and IBM have had their fair share of corruption scandals in the Chinese market. Beijing wants this to change; during his inauguration speech, President Xi stated that corruption was a threat to the party’s survival and launched a widespread anticorruption campaign targeting all levels of the party. The campaign has targeted all acts of bribery large and small as well as abuse of power. So far over 100,000 people have been sent to jail over corruption charges, however Transparency International, an organisation which measures corruption worldwide notes that China’s score on the Corruption Index has barely changed [xvi].

It is no longer possible for China’s trader partners to assume private enterprises are free agents.

FT Editorial Board, October 2020

The recent events in Hong Kong and the National Security Law bring new governance challenges for investors. Whilst previously investing in H shares provided more confidence of robust governance standards and independence from Beijing, this can no longer be assumed. As China’s grip on Hong Kong increases, there is a risk of growing influence of the CPC on Hong Kong based and listed businesses, despite the stock exchange being independent.



EdenTree's approach

This Insight reveals some of the environmental, social and governance challenges for responsible investors. It aims to highlight the issues that investors should be aware of, and demonstrate how we navigate these as responsible investors and the different options we have in our toolbox to address these.

Ethics and Values: our exclusion criteria

EdenTree has long used an oppressive regimes screen and applies a ban on direct investment in State Owned Enterprises. This screen was reviewed and improved in 2018, to reflect better the growing complexity of the issue. Based on weighted country ratings provided by Freedom House, Transparency International and the World Economic Forum Gender Gap (political empowerment score), we have created a list of high risk countries. Companies involved in problematic activities in those countries are excluded from investment. It is no surprise then that China is on this list. It is through this screen in particular that we avoid investing in Chinese SOEs, as well as companies that are at high risk of being complicit in human rights violations in China. More information on this screen is available in our RI Expert Brief on Oppressive Regimes.

ESG & Responsibility: seeking responsible businesses

Whilst not everything is captured in our oppressive regimes exclusion, the second step of our screening process, where we look at ESG risks, can also act as a brake. Many of the issues we have highlighted in this insight including poor health and safety, exposure to coal, corruption risks, lack of labour rights and others are captured here and where we believe companies are not meeting our standards we will not invest. In the past this has led to the exclusion of textile manufacturer Texwinca and online retailer Alibaba.

Engagement: constructive dialogue to discuss red lines

This Insight shows how complex many of the issues are and companies can easily find themselves in turmoil because of their operations or supply chains in China. Whilst not all issues are a reason to divest, we do engage with companies on how they navigate the dilemmas highlighted in this Insight. We have for example had in depth conversations with HSBC and Standard Chartered to express our concerns in relation to their support of the National Security Law in Hong Kong. In some cases companies can address these issues and apply the same high standards as in other countries, however we recognise that some issues will be intensely political and therefore tricky to navigate. Microsoft is another example, we engaged with the company to understand how it deals with data privacy in the PRC and we raised concerns about government data requests and censorship. We were reassured that Microsoft stores customer data outside China on purpose; data is only stored in countries where the rule of law applies, to ensure that end user data requests are not possible in China. This is a good example of a company recognising the challenges, but finding the right solutions to respect its own values and policies.

Conclusion

China's place and power in the world means no investment portfolio is immune to the ESG issues highlighted in this Insight. Exposure can come in many ways: investing in Chinese companies, multinationals with direct operations in China, supply chains or through companies selling to China: these are all part of a global investment universe raising many challenges for responsible investors.

At EdenTree we are committed to responsible and sustainable investment globally, meaning that we will conduct robust screening, excluding companies with the most severe breaches of our standards and engage with others when we identify issues. We believe that enhanced due diligence and ongoing engagement is needed with businesses that have exposure to China.

China's development has been remarkable; it is clear however that it is not following the liberal democratic path that many in the west had perhaps hoped for or expected. There is no doubt that China will continue to be a key market and global power in the twenty-first century, and it will likely remain an attractive growth market. Investors will watch closely as China continues to shape the world and follows the Chinese Dream to become a fully developed nation by 2049 when it celebrates the 100th anniversary of the creation of the PRC. However for the responsible and sustainable investor, many challenges remain.

Sources

[i] World Bank GDP data link
[ii] OECD and BMJ
[iii] The Economist & OECD
[iv] Fortune 500 link
[v] McKinsey Global Institute: China and the world Inside the dynamics of a changing relationship, 2019
[vi] U.S Department of State, link, September 2020
[vii] Global Carbon Project
[viii] Carbon Brief
[ix] China Water Risk, link
[x] IEA, link
[xi] The Guardian, link
[xii] China Labour Watch
[xiii] Glass Lewis link
[xiv] Asian Corporate Governance Association - ACGA China CG Report 2018: The evolution of corporate governance in China
[xv] Financial Times link
[xvi] Transparency International

How to contact us

We hope you have found this EdenTree Insight interesting and useful. If you have any questions, or would like to know more about our responsible investment, in-house research and analysis, please get in touch.

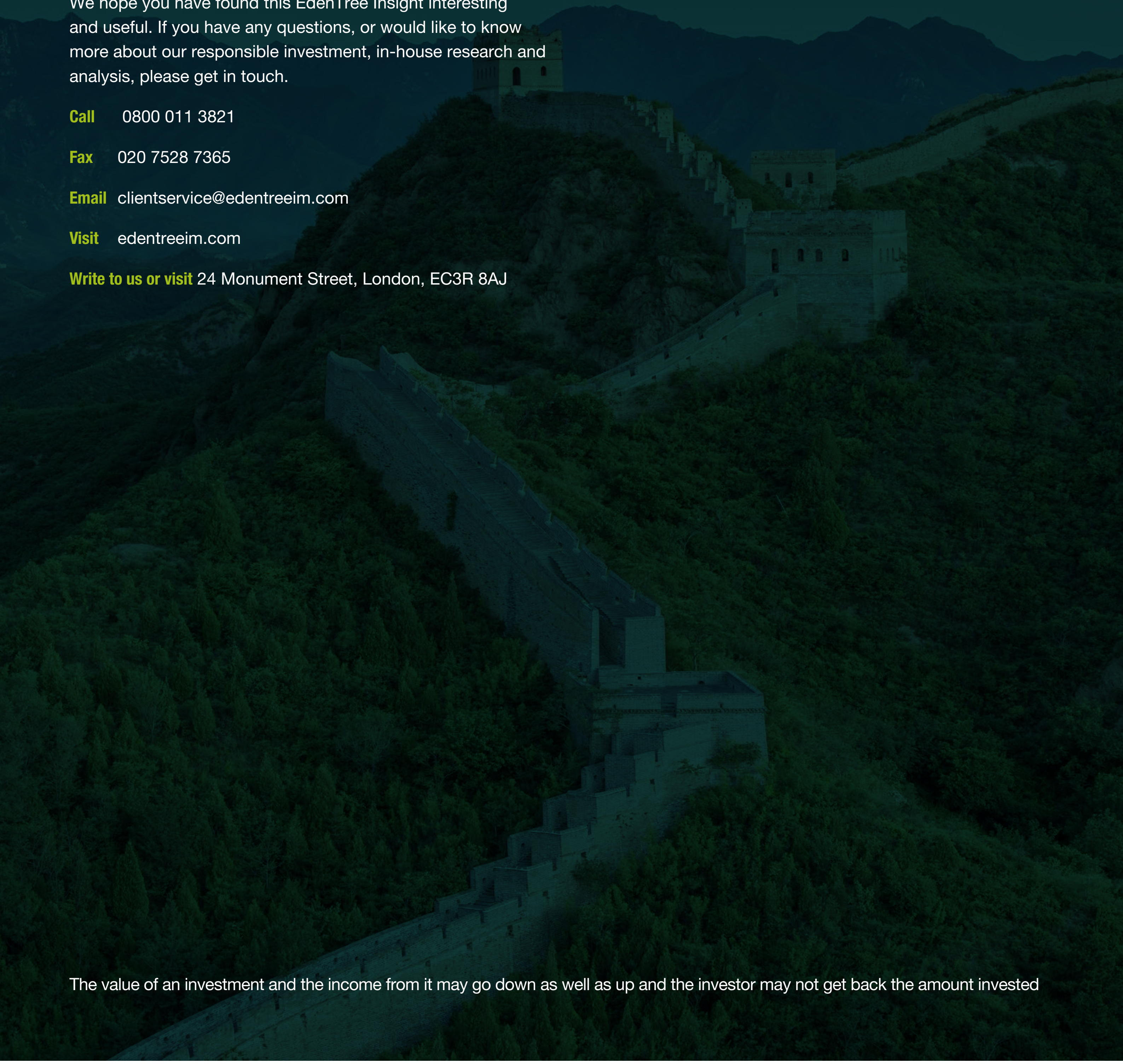
Call 0800 011 3821

Fax 020 7528 7365

Email clientservice@edentreeim.com

Visit edentreeim.com

Write to us or visit 24 Monument Street, London, EC3R 8AJ



The value of an investment and the income from it may go down as well as up and the investor may not get back the amount invested