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MSCI ESG IVA Country Report: China

September 2012

Excerpt

The following is an excerpt from the MSCI ESG IVA Country Report on China. The report was published by the MSCI ESG Research team based in Beijing in September 2012.

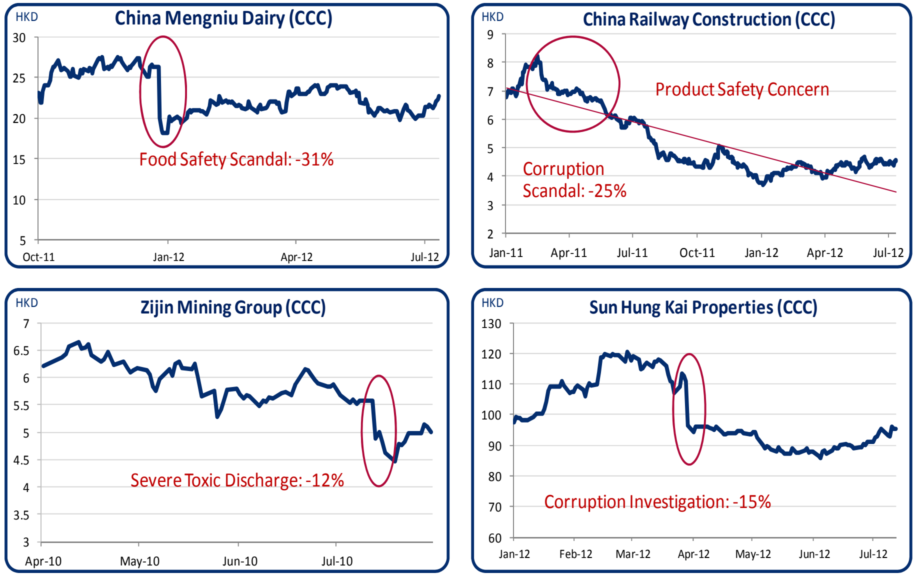
To obtain a copy of the full report please contact ESG Client Service at **esgclientservice@msci.com.**

ESG Materiality in China

As China's economy continues to expand and its middle class grows, the concept of sustainability and associated environmental, social and governance (ESG) factors are receiving greater attention from the general public and media. This has the potential to move markets as well as precipitate policy action – both systematic and sporadic – from the Central Government, which may see linkages between ESG factors and potential threats to social instability. Further, the recent 11th and 12th Five Year Plans signaled a change in China's development path towards a more sustainable growth model, with significant implications for companies' operational and investment strategies. A number of new government policies will increase the sensitivity of company operations to ESG factors.

The stock performance charts in Figure 1 offer a glimpse of how ESG factors have recently caused both short-term shocks and medium-term deterioration to company valuations in China. These charts demonstrate that a lack of management attention to negative externalities can increase a company's risk of encountering unexpected obstacles to success, and highlights previous patterns of unsustainable growth.

FIGURE 1 **Stock price impacts of ESG events**



INCLUDED IN THE FULL REPORT

SCOPE

This report summarizes key findings about ESG risk management based on MSCI ESG IVA research into Chinese constituents of the MSCI Emerging Markets Index (the MSCI China Index).

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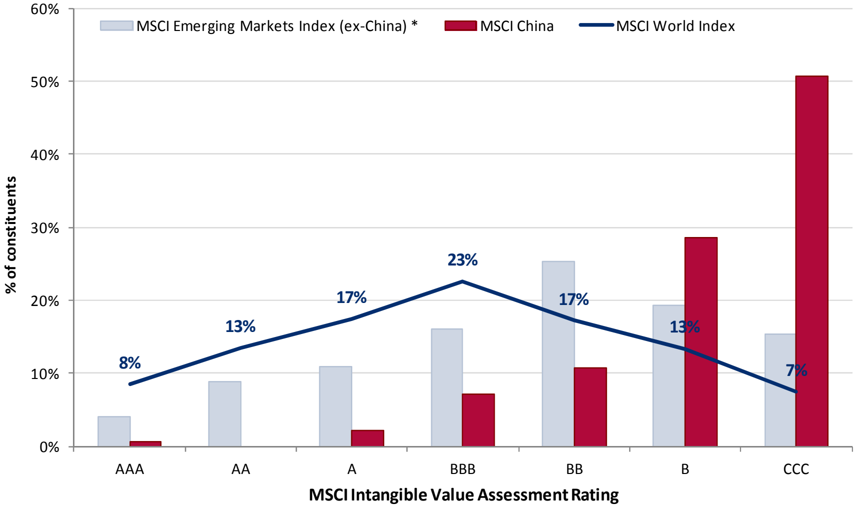
CHINA PERFORMANCE SUMMARY

- Chinese companies in all sectors ***significantly underperform other emerging market and developed market peers*** across the universe of ESG issues we analyze (see Figure 2 below). Factors contributing to this result are:
  - » The race to take advantage of rapid market expansion has sidelined considerations of negative financial impact in the medium term arising from ESG factors;
  - » A generation of executive managers who have not been sensitized to ESG issues and hence do not prioritize ESG factors in providing transparency about corporate strategies and management structures;
  - » High levels of state ownership resulting in less exposure to international investors who engage companies on ESG issues;
  - » The traditional absence of free and robust media scrutiny which, until recently, has limited the dissemination of news on ESG controversies and the scope of reputational risks.

FIGURE 2 **MSCI ESG IVA rating distribution**



* based on approx 70% of index market capitalization

- However, **the ESG landscape in China is rapidly evolving and we expect these operating assumptions to change**, forcing new actions by Chinese companies to stay ahead of regulatory enforcement and reputational pressures.
  - » Evidence points to ***increasing sensitivity of company stock price to ESG-related problems***, such as the impact on China Mengniu Dairy and China Railway Construction from food safety scares and corruption investigations, respectively.
  - » Chinese ***capital markets are opening up*** to international investors, particularly with the significant April 2012 boost of the qualified foreign institutional investor quota from US 30 billion to 80 billion.
  - » The ***Chinese public has become more attuned to social and environmental issues, including through social media***. China has been estimated to have more than twice as many Internet users than the US, and these users spend more time on social media sites than counterparts globally.
  - » Since the mid-2000s, the Chinese Government has introduced policies that signal an increasing ***alignment between sustainability and long-term economic growth***. The most recent 11th and 12th Five Year Plans have included goals to achieve ambitious environmental and social targets, and the implementation of these will directly impact companies' strategic and operating plans.
  - » Disclosure is trending towards greater transparency:
    - The ***Shanghai Stock Exchange has issued guidelines for environmental disclosure*** from listed companies, and requiring CSR reports from certain companies (those 240 companies included in the Exchange's Corporate Governance Index, those listed in domestic and overseas markets, and financial companies).
    - Since 2010, the ***Ministry of Environmental Protection has required annual environmental disclosure*** from companies in heavy-polluting industries.
    - The ***Hong Kong Stock Exchange has released an ESG Reporting Guide***, and indicates an intention to move to a 'comply or explain' reporting framework in the future (relevant to MSCI China companies that have H-shares listed in Hong Kong).

TAKEAWAYS FOR INVESTORS

The following takeaways are drawn from industry-level analysis and case studies examined in the China Report:

- **Environmental, social and governance (ESG) factors have caused both short-term shocks and medium-term deterioration to some Chinese company stock prices** in recent years.
- With China now stepping up pollution control efforts, **many heavy polluters appear ill-equipped to mitigate more stringent regulatory risks**. Furthermore, these environmental risks are transmitted to banks through lending activities in China at a higher rate than in other markets due to the high resource intensity of Chinese industry.
- Intensifying regulation also represents ESG opportunities in China. **Utilities' early investments in renewable energy will be key** as they come under pressure to adapt to a carbon-constrained China.
- **Corruption-related risks are becoming more material for Chinese companies** due to mounting public outrage and intensified regulatory efforts to eliminate corruption. **Large state-owned enterprises have been implicated in corruption controversies more frequently** than other Chinese companies as close ties with government and reliable access to public funds fosters misalignment of interests between executives, shareholders and the public.
- Consumer-facing companies in China face increasingly stringent regulatory and consumer scrutiny regarding product safety. Following **severe food safety scandals,** Food Products companies face **high potential reputational damage and loss of market share**, requiring **significant investments** to improve product safety systems.
- Low-cost labor is diminishing as a competitive advantage for China as a new generation of workers call for better working conditions and higher pay. We are concerned that some **manufacturing companies are failing to address labor concerns that could lead to protests and operational disruptions**.
- Macro-economic factors are coalescing to **intensify the commercial imperative for banks to improve access to finance for underserved segments**, particularly small and medium business customers.

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MSCI ESG Research is a leading source of environmental, social and governance (ESG) ratings, screening and compliance tools to advisers, managers and asset owners worldwide.

About MSCI

MSCI Inc. is a leading provider of investment decision support tools to investors globally, including asset managers, banks, hedge funds and pension funds. MSCI products and services include indices, portfolio risk and performance analytics, and governance tools.

The company's flagship product offerings are: the MSCI indices which include over 120,000 daily indices covering more than 70 countries; Barra portfolio risk and performance analytics covering global equity and fixed income markets; RiskMetrics market and credit risk analytics; ISS governance research and outsourced proxy voting and reporting services; FEA valuation models and risk management software for the energy and commodities markets; and CFRA forensic accounting risk research, legal/regulatory risk assessment, and due-diligence. MSCI is headquartered in New York, with research and commercial offices around the world.

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