Ethical Investment: The Growing Focus on ESG Issues in Asia

With the tremendous growth potential in Asia continuing to attract substantial Western capital, investors entering the market have tended to prioritise economic fundamentals. However, as environmental, social and governance (ESG) issues emerge in this developing region, investors are increasingly focused on the quality of their investments beyond the financials. There is growing realisation that concerns over workplace safety and corruption issues, for example, can have a significant impact on returns. In the worst-case scenario, ESG problems could result in liability for damages, harm corporate reputation and brand, or undermine confidence in a company, thereby affecting its long-term prospects in the region. As ESG issues affect even established operations and leading brands in Asia, investors are starting to appreciate that a holistic approach to risk management should include a focus on ESG. Moreover, with governments in Asia strengthening their regulatory mechanisms and enforcement capacity, investors interested in the long-term outlook for the region need to be prepared.

Data Evidence of ESG Impact on Returns

There is a wealth of data alerting investors to the potential economic repercussions of investing in unethical companies. The most persuasive figures highlight the linkages between poor ethics in the workplace and low productivity or inefficiency, showing weak returns from businesses facing certain ESG issues. As one study by the London Institute of Business Ethics found, companies without a code of ethics generated significantly less economic and market value added, experienced more P/E volatility, and showed a decline on average return on capital employed than those businesses with a code.[1] Analysts have further suggested that investments in unethical firms earn abnormally negative returns for prolonged periods.[2] In contrast, a recent review of relevant academic literature by Deutsche Bank found that nearly 90 percent of studies showed companies with high ESG ratings outperform both operationally and in market terms.[3]

We are also beginning to see that companies with unethical business practices are increasingly being punished, with Wal-Mart, Vedanta and Chevron among those most frequently blacklisted by large European investors that want to invest responsibly and avoid reputational damage. This reflects growing concern about investing in operations that do not adhere to internationally recognised ethical standards of labour conditions, protection of indigenous rights and pollution, for example.[4]

Focusing on ESG issues can even indicate underlying problems in a company; GMI Ratings, an ESG ratings company, has downgraded several companies before negative events – that were generally played out in the public domain – destroyed shareholder wealth. For example, GMI Ratings' extra-financial research led to prescient calls on Tokyo Electric Power Company (Tepco) prior to its substandard handling of the Fukushima nuclear disaster clean-up and Olympus before Michael Woodford blew the whistle on its loss-hiding arrangements.[5] More attention to ESG policies, specifically corporate governance issues concerning unreported past incidents and minimal disclosure respectively in these two

[1] http://josephsoninstitute.org/pdf/workplace-flier_0604.pdf
[2] D. Michael Long and Spuma Rao, "The Wealth Effects of Unethical Business Behavior," Journal of Economics and Finance
[3] http://www.dbcca.com/dbcca/EN/_media/Sustainable_Investing_2012-Exec_Summ.pdf
[4] http://www.novethic.fr/novethic/upload/etudes/2013_controversial_companies_study.pdf
[5] http://www3.gmiratings.com/index.php

examples, could have identified tell-tale signs of problems ahead.

Growing consumer awareness of ESG factors is also having an impact on the bottom line of most companies. In one U.S. public survey, 80 percent of respondents stated that their perception of the ethicality of a company's business practices has had a direct effect on their decisions to purchase goods or services from that firm.[6] Consumers are willing to pay a small premium for ethically produced products, but are also more likely to punish companies that operate with low ethical standards. While this is a luxury afforded to more affluent consumers, with the rise of personal disposable incomes across Asia, a similar longer-term trend is likely in APAC.

Dominant ESG Issues in Asia

There are various ESG issues that are particularly acute in Asia, although importance varies across jurisdictions, reflecting the diverse natural resources, cultural differences and stages of development.

The most prominent concern on the environmental side is the deteriorating air quality in certain capitals as headlines on choking smog in Beijing and New Delhi often make global news. While companies cannot control this macro problem, their contribution to global warming through greenhouse gas emissions and waste management can be monitored and reduced as part of an ESG programme. Environmental issues are being given more importance within companies, especially as Asian governments take action to protect their natural resources. Last year China enhanced its Green Credit Guidelines for financial institutions, which seek to redirect loans from polluting projects to green economy sectors.[7] Meanwhile, India has set itself an ambitious target to get 12 percent of its energy requirements from renewable sources by 2017. Foreign investors looking to boost their presence in these markets will certainly have to take note of these and similar initiatives.

On the social side, inadequate working standards across the supply chain, especially in third party manufacturers are a pressing concern. These issues may include excessive use of unpaid overtime, delayed compensation, and even the use of child or possibly prison labour. Some of these problems came to the forefront after a spate of worker suicides at Taiwanese manufacturer Foxconn several years ago. Foxconn's notable products include production of the iPhone, Kindle and Playstation 3 and following the controversies, Apple hired the Fair Labour Association to conduct an audit of its working conditions in 2012. In addition, the recent collapse of a decrepit garment factory in Bangladesh resulted in adverse international publicity for various Western retail outlets, with global brands such as Primark and H&M responding by endorsing pledges that ensure safety of the local working environment.

In relation to governance, corruption is widely viewed as the primary concern afflicting many companies operating in Asia. While this is obviously a global problem, there are certain traits common in Asian businesses that can propagate graft: extensive gift giving as a form of hospitality; personal relationships between institutional partners; unprecedented commercial opportunities; frequent use of intermediaries to facilitate operations; the opaque policy making and enforcement process; and blurred lines between public and commercial functions. Moreover, a number of high-profile scandals highlight wider corporate governance issues in Asia, such as the allegations of fraud against Sino-Forest or the Olympus cover up.

Increased Investor Interest in ESG

Despite the data and pressing regional problems outlined above, few investors in Asia seem to be aware of the importance of ESG issues. A review of the signatories to the UN Principles for Responsible Investment found that an extremely small proportion of asset owners and investment managers have signed across the region.[8] This relatively low interest may be due to the short-term investment attitudes and impatience for growth in Asia, as the positive effects of ESG typically take several years to materialise.

But these attitudes are changing. Alongside growing interest in the region from global investors aware of ESG and associated LP pressure to enhance risk management, there is a nascent demand for relevant, timely and accurate information on ESG compliance from a wide range of local stakeholders. Even stock exchanges in Asia are following the trend that requires listed companies to disclose their ESG practices. ESG reporting, covering ESG policies and KPIs, will be mandatory for listed companies in the UK from October 2013, and the Hong Kong Exchanges and Clearing Limited (HKEx) last year issued an ESG Reporting Guide, with the intention to elevate ESG awareness from a recommended practice to a compliance requirement for Hong Kong-listed companies by 2015. Investors are also increasingly being incentivised to examine ESG issues globally; foreign regulators are looking favourably at investors' emphasising ESG in their portfolio companies, and firms with high reputation ratings may improve relations with bankers and thus facilitate their access to capital.

Conclusion: Identifying and Mitigating Potential ESG Risks

While investors in Asia will remain focused primarily on the monetary returns, with societal concerns or environmental protection issues unlikely to ever dominate investment decisions, many firms have adopted certain ESG strategies. The following actions are recommended by FTI Consulting as part of a responsible investment programme:

- **Policies to identify ESG risks:** The range of potential ESG problems affecting a company can be vast. But investors should prioritise ESG factors prevalent in a particular

[6] http://sloanreview.mit.edu/article/the-hidden-costs-of-organizational-dishonesty/
[7] http://english.peopledaily.com.cn/90778/8334766.html
[8] http://www.unpri.org/signatories/

industry, country or company structure, and ensure these are examined as part of the due diligence process. Private equity firms are developing 'opportunity checklists' in order to test portfolio companies in a consistent methodical manner; the Green Portfolio Program built by Kohlberg Kravis Roberts is an excellent example of how ESG considerations can be incorporated throughout the due diligence and investment process.

- **Assessing ESG awareness:** Companies that rate highly for ESG factors will not necessarily perform well consistently, but a management monitoring these issues will better understand the potential costs and liabilities ahead.

  Review by an independent third party, such as a corporate governance auditor, can further explore potential ESG issues while assessing steps a company could take to measure and improve its ESG management.

- **Tracking ESG-driven value:** Inconsistency of available data on ESG factors make analysis calculation of ESG value-add challenging. But various benchmarks in place; the Hang Seng Index launched a series of indices in July 2010 focusing on corporate sustainability in Hong Kong and China, and there are a variety of green and ethical lists of companies in Asia. Moreover, some ESG-tracking tools are starting to appear such as the ESG Analytics framework developed by asset manager Adveq earlier this year to monitor ESG programmes at their portfolio companies.

- **Promoting sustainable practices:** Awareness of the above measures will assist in screening investment targets, while making a conscious decision not to invest in a company that has unethical issues will reduce the likelihood of ESG problems arising. But further to making an investment, it is important to continue promoting a company's ESG credentials for further growth and to attract prospective new investors. Development of a comprehensive Corporate Social Responsibility (CSR) programme, ensuring corporate governance standards, and implementing robust compliance policies, will all help a company build a positive image with customers, investors, bankers, and suppliers.

The business case for integrating ESG into analysis of risk, quality of management and the future prospects of companies' financial performance is becoming consistently stronger. By ensuring that sufficient checks have been done to mitigate potential ESG risks, investors in Asia can add value through better ESG management and meet tightening regulatory requirements.

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