ESG Investing in Asia: Where are the hard numbers?

Investment in environmental, social and governance assets is growing globally including in Asia but most Hong Kong and Chinese companies are failing to report their ESG data in a way that gives a better insight into their performance. William Cox and Vivian Chow explain where companies are going wrong.

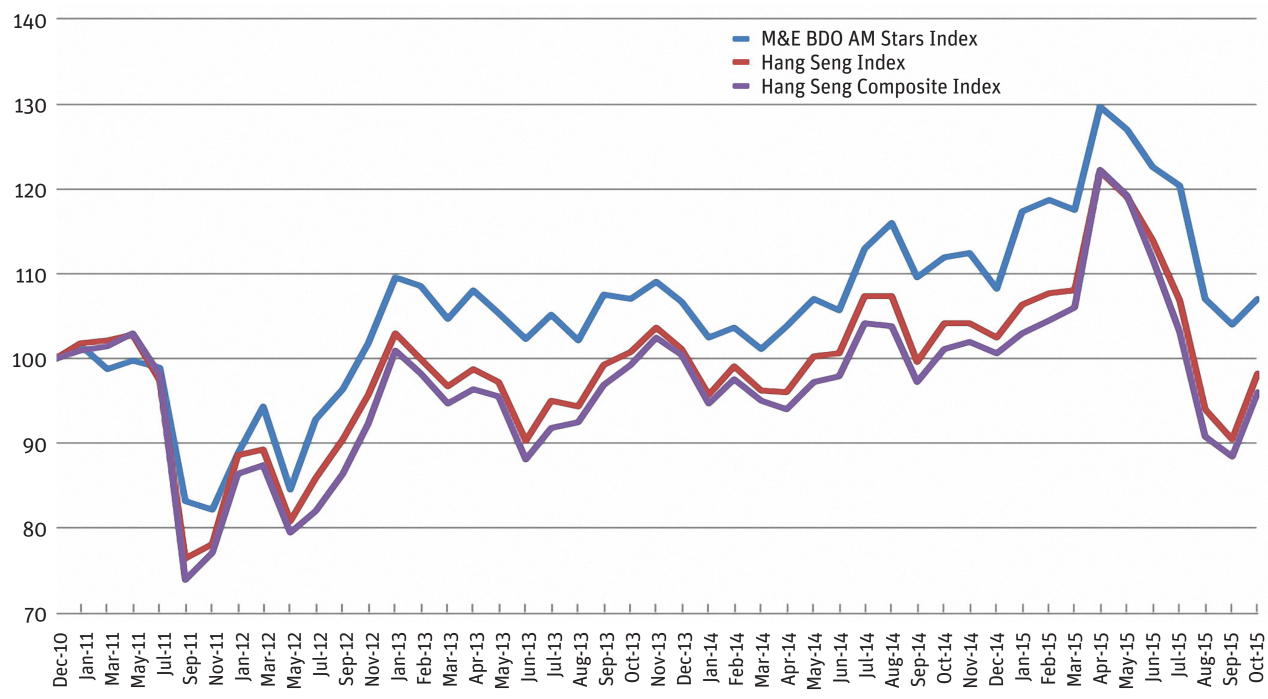
The world market for environmental, social and governance (ESG) investments is booming with the volume of assets shooting up 61% to $21.4tr in 2014, according to the Global Sustainable Investment Alliance (GSIA). Asia made up only a small fraction of that total at $53bn, but with a growth rate of 32%, the region is rapidly catching on to the ESG trend with the markets in Hong Kong, Malaysia and South Korea leading the way.

ESG, which is also known as socially responsible investing (SRI), may be on the rise but what's the attraction for investors? SRI has gained real traction since the 2008 global financial crisis and against the background of low returns from government bonds. There is a growing body of work worldwide that demonstrates a positive connection between strong ESG performance and robust financials. For example, a paper from the University of Oxford this year showed that 88% of the 200 analysed companies proved this relationship.

Investors in Hong Kong will soon be able to track this trend for themselves. In 2016, the Hong Kong Exchange (HKEx) will implement a mandatory ESG "report or explain" policy for listed companies, which will replace the current voluntary scheme.

Among Hong Kong listed companies, 85% already conduct some form of ESG reporting with 45% publishing full ESG reports. CLP Group has been reporting on its ESG efforts since 1997, the longest of any listed company in Hong Kong. However it is HKEx that publishes the most complete and useful ESG data, such as the amount it spends annually on training (HK$5.2m), while CLP only divulges the number of hours that it spends training employees (see chart).

M&E BDO ASIAMONEY HONG KONG STARS INDEX vs HANG SENG INDEX, HANG SENG COMPOSITE INDEX AND HANG SENG CORPORATE SUSTAINABILITY INDEX



SOURCE: M&E; BDO

Even so, ESG reporting is largely a muddled and chaotic system which still fails to relate financially relevant information about revenues, costs, margins and returns to ESG performance. HKEx defines certain key performance indicators (KPI) in areas such as labour practices, health and safety, human resources development and the environment. Yet it's unclear how these data can be used by analysts and investors.

For example, MTR says that it experienced 57 staff accidents in 2014 in its core rail business, down from 67 the year before. However the company, which is a member of the Dow Jones Sustainability Index, does not explain the litigation costs associated with these accidents.

By contrast, the company makes a small mention that in 2013, an internal campaign saved HK$4m in energy costs annually. In its sustainability report, MTR points out that energy consumption per consumer per kilometre travelled has declined for the first time in years, pointing to improved operating efficiency.

ARDUOUS JOB

Another area which does little to reveal whether a company is being run profitably or not is environmental reporting where it is commonplace to list emissions produced and energy consumed. CLP, which is one of the few companies to reveal 2014 numbers, says that it emitted 93 tons of SO2 gases in 2014, up from 50.5 tons in 2013. Is this a good or bad value? How are these data related to productivity or revenues per customer? As it turns out, energy generated by coal was way up in 2014 at CLP, which probably drove emissions. Delving further, CLP's earnings in 2014 rose to HK$11.2bn from HK$6bn the year before, which shows increased environmental efficiency of HK$124.4m in earnings per ton of SO2 emissions in 2014 over HK$118.8m per ton in 2013. Unfortunately, it remains up to analysts to combine and make some sense of these figures.

What makes this job even more arduous is that most companies do not adhere to a uniform reporting scheme. A reporting system supported by the Global Reporting Initiative (GRI), which aims to promote a global standard for ESG reporting, also fails to relate ESG performance data to financial performance. The GRI system covers hundreds of areas, such as whether a company divulges its strategy, but the barrage of qualitative information tends to confound rather than focus attention on performance. According to GRI criteria, Enron would have achieved top marks just before going bust.

So, how should companies report on ESG performance for it to be a useful analysis tool? The examples below have been used to analyse companies in the M&E BDO *Asiamoney* HK Stars Index, which has been outperforming the Hang Seng indices by up to 18%, particularly during crisis times. The ratios relate ESG performance data to correlated financial data, such as training expenses and productivity.

EXAMPLES OF ENVIRONMENTAL ACCOUNTING (E):

Environmental considerations make the most sense for industrial companies which consume the most energy and face the highest risk of fines and costs associated with pollution. For service organisations such as banks, environmental expenses are relatively low. Electricity, for example, is a relatively minor expense and so analysts should not waste time considering these. For service organisations data on staff training and absenteeism are much more important.

Environmental data are typically reported in ways which render them irrelevant. CLP, for examples, mentions that it installed a new high pressure turbine in Yallourn, Australia, which is 3% more efficient than the previous power plant. There is no mention of the costs or amortisation of this investment.

Reporting requirement by the US Securities and Exchange Commission (e.g. forms 20-F and 6-F) are much more rigorous and useful for understanding a company's ESG performance. Environmental fines and cases pending in court are detailed and currency risks are listed. Investors can use such data to determine the proportion of cash that would be at risk in the case of a settlement.

EXAMPLES OF SOCIAL ACCOUNTING (S):

Employee productivity and the impact of their training on productivity indicate operating efficiency and by implication, suggest a robust management process. Training ultimately should impact productivity, although it may also have secondary impacts on innovation and loyalty to the company.

Employee productivity*	MTR	HKEx	CLP
2014	HK$654,011.70	HK$3,618,309.90	HK$1,519,019,90

* net income/employee number (higher=better)

Training effectiveness**	MTR	HKEx	CLP
2014	HK$662.80***	HK$901.40	HK$245.00***

** employee effectiveness/(training expenses/employee number) (higher=better)
*** cost per training hour estimated at HK$143.00

EXAMPLE OF GOVERNANCE ACCOUNTING (G):

Governance is mainly about processes, but a ratio casting some light on relative executive performance used by Management & Excellence (M&E) in its Hong Kong Stars Index is total executive remuneration/net income. This tells us how much shareholders are paying their executives to achieve net income. In 2014 HKEx paid its executive and non-executive directors roughly HK$0.5 for every HK dollar in net income achieved. HKEx paid its leadership 6x this, namely 2.4 cents per dollar of net income.

Executive effectiveness*	MTR	HKEx	CLP
2014	0.4%	2.4%	1.0%

* cost in HKS cents & % of executive remuneration per HK$ of net income

Using up to 45 of these ESG ratios, which connect financial and ESG at a company level, the M&E BDO *Asiamoney* Hong Kong Stars Index has outperformed the Hang Seng and Hang Seng Composite indexes since 2010. Atypically, the Index only includes 19 components, but adjusts their weightings according to their consolidated ESG performances. ■

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