M&G Public Fixed Income

ESG engagement in the China property sector

M&G Investments

- At M&G, ESG analysis is considered vital in complementing the traditional credit research undertaken by our analysts, allowing us to gain a more comprehensive picture of the risks affecting a particular fixed income security.
- We believe that company engagement forms a key part of this analysis, and recently initiated an engagement process with companies in the Chinese real estate sector.
- We think that closer ESG engagement with these companies – many of whom are significant bond issuers – will ultimately help us to enhance risk-adjusted returns for long-term bondholders, particularly at a time when the sector is coming under increasing scrutiny for its rapid, debt-fuelled growth.

The value and income from a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested. Where any performance is mentioned, please note that past performance is not a guide to future performance.

Reasons for engagement

The property development sector has played an important part in China's recent economic expansion, and is now the largest component of China's economy. It accounts for more than a quarter of gross domestic product (GDP) when related industries are included, according to some economists' estimates. There has been considerable interest in the sector in recent years; a growing list of investors, including corporate bondholders, have helped to fund this growth.

The sector has been in the global news headlines lately as problems have emerged with the indebtedness of some of the industry's leading players, particularly after Beijing unveiled a "three red lines" policy in order to tackle what it saw as reckless and excessive debt-funded growth.

From an environmental, social and governance (ESG) perspective, the sector throws up a number of challenges. Companies are vulnerable to a range of ESG risks, including worker health and safety, the energy efficiency and environmental standard of new developments and the adoption of increasing sustainability demands. The COVID-19 pandemic has also shone a light on various social inequalities present throughout the operations of many of these companies, raising doubts over the duty of care they provide for many of their employees and contractors.

More recently, accounting practices have been called into question in the sector, as some firms – who had stated having ample liquidity – subsequently defaulted within a few weeks. Combined with disclosure standards, these are major concerns for credit investors and need to be factored in when assessing financially material risk in the sector.

As investors who embed ESG considerations into our investment processes, it is important for us to understand the various specific risks involved across all of the different industries we invest in. As such, as part of our ongoing assessment of our holdings' ESG credentials, we attempted to engage with nine different companies to gain granular insight into how these firms are adapting to various ESG criteria. Through our engagement, we sought to obtain information on some of the largest property developers that exist in our bond universe. This exercise

Real estate is now significant part of Asian credit markets, but ESG reporting in the sector is still in its infancy.
Source: Getty Images

enables us to compare and contrast different approaches to ESG and sustainability, to better identify ESG leaders, and also to ultimately encourage best practice in the sector.

Despite reaching out to nine companies, M&G only received responses from three – Yuzhou Group, Times China Holdings, and CIFI Holdings. Sadly, we believe this is indicative of the lack of transparency and ESG reporting standardisation that is prevalent within China's real estate sector. All three companies are, or have previously been investment holdings in a range of emerging market and global high yield bond funds within M&G's fixed income range.

The first phase of the engagement took the form of an extensive ESG questionnaire process. A short summary of our findings is outlined below.

Yuzhou Group

Yuzhou operates as a real estate development company, developing and marketing high rise-residential buildings and commercial properties. As of June 2021, Yuzhou had more than 179 ongoing development projects across 39 cities, including Beijing, Shanghai and Hong Kong. We were keen to initiate a productive dialogue with Yuzhou to gain better insight into its positioning on a range of ESG matters.

The company representatives informed us that within four years, all of the company's new projects will be certified to China's national green building standards, and that, as of 31 December 2020, 135 of their developments already met this certification. In addition, three of their projects have been awarded a Leadership in Energy and Environmental Design (LEED) Gold Certificate. The LEED framework was developed by the US Green Building Council (a non-profit organisation), and is a globally recognised building certification. Gold certification is the second highest level a building can achieve and is indicative of high energy and environmental design standards.

Turning to the company's environmental ambitions, Yuzhou representatives informed us that at least 90% of new developments are set to employ rainwater reuse systems, and at least 70% will have solar water heating systems. In addition, the company says it is attempting to take ecological and environmental impacts into account throughout the planning process by ensuring that soil excavation is minimised and that native plant species are integrated throughout new developments. The company was able to demonstrate progress in its sustainability reporting by disclosing its Scope 1, 2 and 3 emissions[1]. Furthermore, at the start of 2021, the company issued a six-year $562m 'green bond' – which it said was the largest issuance of this kind by a Chinese property company – to help finance green projects with environmental benefits.

Yuzhou maintains close communication with stakeholders throughout the development process, to assist with any queries or concerns. Although these make up only a small percentage of its total number of developments, the company does provide social housing developments in several cities, including Shanghai, Yangzhou, Foshan and Fuzhou.

Monitoring for instances of modern slavery and robust employee health and safety policies are key concerns for us, particularly when examining emerging market businesses where standards can lack stringency or are sometimes seen as less enforceable. We were satisfied with the company's thorough responses to our queries in this area. It provided us with a detailed breakdown on its process for monitoring for modern slavery, both within its own operations and its supply chains. In addition, the company informed us of the extensive details regarding various safety training that workers must undertake, including the use of working groups to discuss health and safety objectives and raise concerns. Finally, the company operates a policy whereby director-level remuneration is linked to overall health and safety performance.

In comparison to the other two companies we engaged with, Yuzhou stood out in terms of its ESG disclosure, providing concrete data and metrics to explain both its current status and its goals for the future. ESG matters appear to be integrated throughout the company's operations, from the initial planning stages right through to project implementation and construction. That being said, we will be engaging with the company further on certain social matters where we were less satisfied with responses. For example, specific data was notably lacking regarding the displacement of local communities close to its project sites, and regarding worker demographics. We look forward to continuing discussions with the company to better understand how it intends to address these gaps and improve information disclosure going forward.

Times China Holdings

Times is an investment holding company that is principally engaged in property development. The company has worked on a range of projects, including holiday villas, office buildings, hotels, residential properties and industrial parks. The initial stages of this engagement took the same form – an extensive questionnaire process to give us a sense of how seriously the company is taking ESG matters and how imbedded they are in company culture.

In terms of the environmental standards of its new buildings, Times informed us that in 2020 two of its projects had obtained the internationally-recognised LEED Gold certification, and it intends to construct new buildings to levels that exceed China's own green building standards. In addition to this, the company provided details of energy-saving materials it uses in the construction process, such as a heat-reflective insulation coating that it claims has reduced energy loss from

[1]Emission Scopes form the basis for corporate greenhouse gas (GHG) emission reporting globally. Scope 1 emissions are made by a company directly, while Scope 2 and 3 emissions are made indirectly.

buildings by one third. However, beyond this, the company was lacking in hard data, particularly in relation to the company's carbon emissions, and the extent to which its new developments take place on greenfield sites. We intend to pursue further disclosure on these areas in the next phase of our engagement.

When responding to questions on some of our material social risks, Times did not provide us with any meaningful ways in which it attempts to monitor or mitigate modern slavery in its supply chains, nor did it disclose how many local communities it displaces, nor offered us any information on its social housing provision. On numerous occasions, the reason given for its lack of data was simply that its buildings were accredited with the local government standards, regardless. Unfortunately, this is indicative of a wider issue in the Chinese real estate sector, whereby the government's lack of ESG reporting requirements means the depth of reporting is often not meaningful, and tends to lack clarity and quantitative evidence. For us as active bond investors, this would be a cause for concern, particularly for our growing range of funds that have adopted a sustainable investment label, which actively seek to invest in issuers that meet our ESG and sustainability investment criteria, while applying a value-based investment approach.

Ultimately, in comparison with the other companies that we engaged with, Times provided us with much less informative data and analysis, and we were left unconvinced that the company is taking ESG and sustainability matters as seriously as some of its peers. We have subsequently sold down our position, due in part to fundamental ESG concerns.

CIFI Holdings

CIFI is a large Hong Kong-based investment holding company that consists principally of property-related interests. The company develops and markets offices, commercial buildings and residential properties.

We were encouraged to hear that CIFI ensures that all new residential developments fulfil at least the "one-star standard" design requirements in relation to China's green building evaluation standards, all commercial projects meet the two-star standard, and all high-end projects fulfil the three-star standard. Additionally, CIFI measures and publicly discloses its Scope 1 and 2 emissions, and, whilst it does not yet measure its Scope 3 emissions, company representatives provided information on the steps they will be taking to rectify this gap in the future. Providing Scope 3 data would be considered best practice from a carbon disclosure perspective and we would welcome this initiative from the company in its future reporting.

CIFI informed us that it publicly discloses its Environmental Impact Assessment (EIA) reports as part of its risk mitigation strategy, throughout the development process, as an attempt to improve communication with locally-affected communities. Furthermore, the company regularly utilises its EIAs to monitor the ways a new project may impact local communities and the environment. As well as thoroughly monitoring and recording health and safety incidents throughout its operations, CIFI provided evidence on past incidents, noting that in 2020 there were no severe accidents in the company and only five that resulted in minor injuries.

The company assured us that its board of directors were responsible for supervising ESG management, and that director remuneration was linked to sustainability indicators and goals, something of which we are very supportive at our investee companies. While we were broadly satisfied with its reporting, CIFI lacked detail and more granular data in comparison with Yuzhou. In terms of the company's environmental targets, we would have liked to have seen more measurable, data-driven targets, as opposed to generic supporting statements. We shall continue to monitor the company's environmental data collection and we undertake further engagement to encourage greater transparency and granularity going forward.

Outcomes and next steps

Despite a disappointing response rate in this initial phase of engagement, we were pleased with the content provided by the three aforementioned companies. In our opinion, Yuzhou and CIFI performed better on management of material ESG risks than Times. This engagement series has confirmed some of our concerns surrounding the levels of disclosure, transparency and reliability of ESG information in the real estate industry in China. These are areas we believe need to improve to convince international investors that the companies are effectively managing their underlying ESG risks, and are positioned to take advantage of any related opportunities.

The Chinese property market has grown to a size which makes it too big for fixed income investors to ignore. Any exposure to the sector needs to be carefully balanced with an understanding of the material ESG challenges, a process that requires increased interaction with bond issuers to gain a deeper understanding of the embedded investment risk in the sector.

M&G shall continue to closely monitor these companies, making sure that continuous dialogue takes place to ensure better disclosure in line with our expectations. We plan to follow up with the companies in the new year with specific tasks focused on some of the areas mentioned above.

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Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

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