Carbon emissions in Emerging Markets

China in September

Going into September, Chinese equities had a small rebound before Evergrande's debt crisis news and a widespread power shortage weighed on investor sentiment. Over half of China's provincial-level jurisdictions have faced power rationing, triggering household blackouts and forcing factories to cut production.

The shortage is caused by an insufficient supply of coal due to energy conservation and emission restrictions, coupled with lower electricity supply from alternative energy sources amid severe weather conditions. The Chinese government is taking steps to address this by increasing the coal supply and liberalising electricity pricing.

"For the month, the MSCI China index was down 5% while the MSCI China A Onshore Index was flat. We see that, once again, when a new risk factor emerges in China, foreign investors tend to react more strongly than domestic investors."

At the macro level, China's economic growth slowed down in the third quarter, with GDP up by 4.9% year-on-year, below the 5.2% consensus forecast. Manufacturing PMI came in at 49.6 for September, falling below 50 for the first time since February 2020. The housing market also cooled with shrinking sales areas across the nation and falling prices in several cities. On a positive note, restrictions in the property sector have started to moderate and there is a growing expectation of policy reflation very soon to support the economy.

"On Evergrande, the troubled property developer, as of now, the prospect for the company still looks gloomy. Despite having avoided default on a recent dollar bond coupon payment and the company selling assets to raise cash, the capital market is pricing its securities at a high probability of bankruptcy."

As discussed in our previous letter, RisCura believes Evergrande will go through an orderly restructuring process and the chance of triggering systemic risks is low.

Reducing carbon emissions in emerging markets

With the COP26 conference happening now, we wanted to share our thoughts on China's carbon footprint and emerging markets in general.

MSCI 5%

MSCI China Index down 5%

49.6

September's Manufacturing PMI down to 49.6 for the first time since February 2020

China and many other emerging market countries operate as the factories of the world – either by delivering most of the world's raw materials or by supplying components and finished goods that are and will always be essential to our lives. Even as the world moves towards net-zero emissions, it is the mines that deliver the copper and cobalt that we need in our electric vehicles, or the steel and aluminium that will still be required by the construction industry.

In addition to a significant skew to high emission sectors, emerging markets are also well behind developed market peers concerning emissions within each sector.

"At the same time, asset owners, especially in Europe and increasingly so in Southern Africa, have never been under as much pressure to demonstrate action towards net zero and undoubtedly there is more regulation to come."

In the quest for reducing absolute emissions, investors should not forget the manufacturers of essential goods in emerging markets. Simply put, we need these companies. They need sufficient capital to ensure that they can meet the global demand for their products, and also make the necessary investments to reduce their emissions. Reductions in their emissions can have a dramatic impact on global emissions – some large companies in China, Brazil and Russia have the potential to reduce emissions over the next 5-10 years that is greater than the total emissions of smaller European countries.

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Take Gazprom, the large Russian state-owned gas company, as an example. Most of Europe is reliant on gas supplies from Russia and hence from Gazprom. It has a very poor ESG rating by all the rating agencies. However, what may be surprising is the company initiatives to reduce emissions. Thanks to the hard work of many local asset managers the company has improved its governance over recent years and committed to significantly reducing its carbon emissions. It reduced these by 8m tonnes CO2 equivalent over the last year just by making small efficiency improvements. This equates to roughly 13% of Sweden's total emissions. Furthermore, it has committed to reducing b a further 22.6m tonnes by 2031. A Russian investment manager told us that their portfolio companies have announced annual emissions reductions equivalent to 130% of Sweden's annual greenhouse gas emissions. Gazprom's share price has also doubled over the last year.

"This case study demonstrates that it is possible to deliver both returns and reduce emissions. However, it requires exceptional investment managers that are willing to engage with companies and even the Kremlin in this specific example."

We strongly believe that it is possible to achieve similar results by investing in Chinese companies. In previous editions, we wrote about Anhui Conch, a cement company, which enjoyed strong returns as it took market shares from its competitors that were unable to meet ever-increasing environmental regulations. Most recently, CNOOC, the state-owned offshore oil and gas company, announced their carbon neutrality plan and established a Carbon Neutral Institute. This followed from an engagement from investment managers at the end of last year through the Climate Action 100+1 .

$423bn

Shenzhen (15m people with $423bn GDP) to reach net-zero by 2030

$165bn

China's machinery and equipment exports reached €165bn last year, taking up 15.8% of the world's total

Almost every investment manager, bank or economist that focuses on China tells us that the government is very serious about its commitment to achieving carbon neutrality by 2060. Individual cities, such as Shenzhen, have even more ambitious targets. Shenzhen, a city of 15m with a GDP of $423bn, plans to reach net-zero by 2030. It is the first major city to realise the full electrification of its bus fleet of 16,000 vehicles. It had to build 895 charging terminals to service the fleet.

A report by German newspaper Die Welt said China's machinery and equipment exports reached €165bn last year, taking up 15.8% of the world's total. China had, for the first time, overtaken Germany to become the champion of machinery and equipment exports, which is in addition to what it produces for its own use. To be globally competitive, it is essential for Sany Heavy Industries, the Chinese maker of construction machinery (equivalent to Caterpillar of the USA or Komatsu of Japan), to deliver products that are the same or higher level of energy efficiency. Its ESG reports reveal how it is working on initiatives that increase energy efficiency and reduce pollution in mining and industrial processes such as welding and spray painting. The company has also launched construction equipment products across mixer trucks, dump trucks and tractors that are either fully electric or powered by hydrogen fuel cells.

Whilst it is very exciting to see the world taking overdue action on emissions, the transition needs to be managed carefully. Gas shortages in Europe or coal shortages in China are a reminder that the transition requires a fine balance between making the transition but not going so fast that the economic consequences become counterproductive to the cause.

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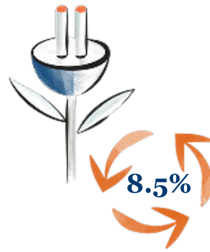
The transition to a green economy also provides abundant investment opportunities in China, which is the global leader in the production of renewable energy, electric vehicles and their supply chains. RisCura's pooled China equity fund has benefited from its investment in CATL, a global leader in battery production, Li Auto, a high-end electric SUV manufacturer, LONGi Green Energy Technology, the world's largest producer of monocrystalline silicon wafers, and many other companies in these sectors.

CATL has reduced its greenhouse gas emission per unit by 8.5% year-on-year in 2020 and it has also adopted a further 218 energy-saving projects. The company also exercises strict ESG controls over its suppliers, given its strong position versus its suppliers as well as downstream customers.



CATL reduces 2020 GHG emission per unit by 8.5%

Finally, no discussion on carbon emissions can be complete without considering the matter of reporting. ESG reporting has historically been poor in China although it is rapidly improving. The Hong Kong SFC is intending to implement climate risk disclosure requirements that are consistent with the TCFD and no doubt the onshore regulators will follow in due course. According to CDP, an NGO focused on environment-related global disclosures, TCFD reporting of Chinese companies has increased sharply over the last three years. There are 1300 companies delivering some reporting across 11 sectors and the quality of data has improved. In 2016 they only had one company that achieved their highest rating and now there are more than 12 that have A or B ratings. No doubt there is still more room for improvement, but the trend is in the right direction.

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Note: We are grateful to East Capital for sharing their interesting insights into Gazprom.

1 - An investor led initiative working with the world's largest corporate greenhouse gas emitters to take necessary action on climate change