Asia Insight

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Asia's ESG Leadership

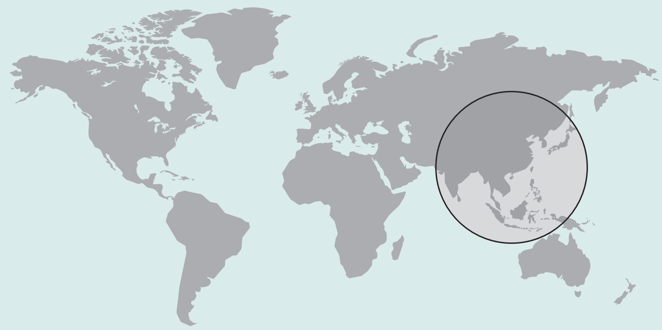
For investors interested in environmental, social and governance (ESG) strategies, a regionally diversified approach can help capture global growth. Asia offers a prime opportunity to invest in profitable companies addressing critical ESG challenges through robust and sustainable business models. ESG innovation in Asia is evident across many sectors, including health care and pharmaceuticals, technology, finance and alternative energy. The pace of innovation in Asia may also appeal to investors seeking unique return drivers as Asia's progress often flies under the radar of the global investment community. To fully capture the growth and profits of the world's most innovative ESG companies, it is worth considering Asia.

Facing deep ESG needs, Asia is primed to serve as a hub for ESG innovation. Reducing carbon emissions, for example, is a major challenge that Asia will need to address at scale to continue growing its economies and maintain a healthy workforce. Over the past 25 years, Asia represented 85% of the growth in carbon emissions worldwide, making it the dominant global contributor to new carbon emissions.[1] Asia also has some of the lowest per capita spending on health care. Roughly 1.5 billion people across Asia spend an average of US$100 or less on health care annually, necessitating novel approaches to providing health care services.[2] And gender diversity at the highest ranks of business management in Asia lags that of Europe and the U.S. The percentage of women on corporate boards in Japan is only 4.2%, while in South Korea the number is only 2.5%. In contrast, women represent roughly 40% of corporate board members in Norway and France and 14.2% in the U.S.[3] The region's embrace of ESG emanates from its desire to start tackling some of these challenges, while improving the quality of life of its citizens. It also comes from the realization that an ESG focus will help improve the quality of GDP growth and secure its long-term competitiveness.

Asia's response to ESG challenges will have major global consequences, as the region is home to over half of the world's population (see Figure 1) and accounts for a third of global GDP and over half of global GDP growth.[4] On the environmental front, Asia is making great strides toward clean energy innovation, supported by positive regulatory trends. While U.S. President Donald Trump has signaled his intent to withdraw the U.S. from the Paris Climate Accord, for example, China, India and Japan are all signatories. With aggressive plans to continue investing in clean energy, China is likely to become the defacto leader for addressing climate change. Government support and consumer demand have made China a world leader in areas such as renewable energy and sustainable transportation infrastructure.

Figure 1. **ASIA'S GLOBAL RELEVANCE**

There are more people living inside the circle than outside of it



Source: United Nations, Department of Economic and Social Affairs, Population Division (2017)

Asia's leadership in ESG business models is also expanding to health care, financials and a range of other consumer-driven sectors. South Korea, for example, is a leader in biosimilars, which are medical products that are near-identical copies of an original product that is made by a different company. Meanwhile China is emerging as a novel biologic drug innovation hub and India has fostered one of the world's largest manufacturers of generic drugs, promoting better health care outcomes at lower costs globally. On the financial innovation and inclusion front, Indonesia and Bangladesh boast rapidly growing phone networks and digital platforms, providing the kind of basic banking services required to bring millions of people into the middle class.

Integrating ESG data into the investment process can help investors capture this growth potential through a disciplined, long-term approach to investing. New growth industries, such as battery cells for electric vehicles and microlending platforms, must be evaluated through fundamental metrics including cash flow and balance sheet analysis to determine which businesses are likely to generate solid long-term revenue growth and sustainable profits. Deep insight into regional markets is required to determine which companies in Asia have truly sustainable business models and are run by trustworthy owners and managers. In addition, evaluating positive ESG outcomes associated with sustainable businesses requires extensive on-the-ground research

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capabilities. Here, we consider some examples of ESG innovation in Asia today.

Environmental: Profiting from a Lower Carbon Future

While electric car maker Tesla garners headlines for its stylish design ethos and lengthy waiting lists for new vehicles, Asia has quietly dominated the global battery cell market with its innovative and reliable lithium-ion batteries and other critical components. (See Figure 2.) Global leadership in battery cells belongs almost entirely to companies headquartered in South Korea, Japan and China. Why is this so? Partly because Asia has historically dominated manufacturing of consumer electronics that required rechargeable battery technology development and partly because Asia accounts for a significant portion of new electric vehicle sales. China is currently the world's largest market for electric vehicles, with the U.S. coming in a close second. Of the 2 million electric cars on the road in 2016, 32% were driven in China, while 28% were driven in the U.S. Japan and France each represent 7% of the electric vehicles on the road.[5]

Battery cells are just a small part of the innovative sectors helping to power a cleaner energy future, including solar and wind power, energy efficiency, high-speed trains and factory automation. Solar panels are another area in which Asia in general, and China in particular, is taking a leadership role in clean-tech industries. China makes 70% of the world's solar panels and installs more than half of them.[6]

Social: Growing Returns Through a Growing Middle Class

Among critical social issues facing communities in Asia, inclusion is a key focus area. Social progress requires bringing more people into the middle class globally, along with ensuring greater access to health care, more women in the workforce and more opportunities for people to advance through education and training. Moving hundreds of millions of people out of poverty has been the foundation for social advancement. It has also presented a prime opportunity for global investors who wish to support this progress by investing in companies championing inclusion in Asia's fast-growing economies. As a starting point, living a middle class life requires becoming part of the "formal" financial system, often by opening a bank account. Millions of people across Asia lack basic banking services. Credit, even in small amounts, can make a huge difference to families living in poverty. Microlenders are leveraging digital platforms to massively scale up lending without the need to build large brick-and-mortar infrastructure.

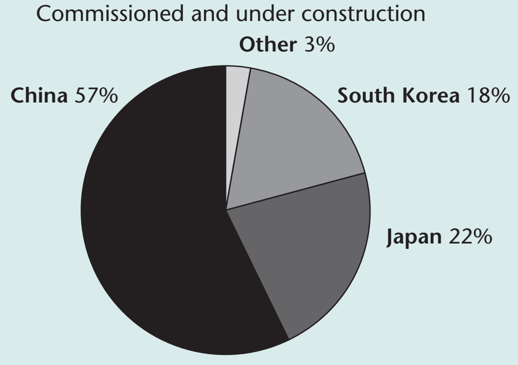
As Asia looks to add 2 billion more people to its middle class by 2030,[7] financial inclusion will be a key enabler for this transformation by creating and supporting livelihoods. Profitable companies servicing this need provide microlending, micropayments and insurance. In 2017, India had 45 million microborrowers, demonstrating the size and scale of this growing marketplace. (See Figure 3.) Most jobs in emerging Asia are found in micro and small enterprises. Access to capital through financing makes a big difference in the ability of these firms to grow and create more jobs. Therefore, micro and small enterprise lending is an underappreciated social opportunity. Bangladesh and Indonesia are fast-growing markets for micro and small enterprise lending.

Governance: Essential for Long-Term Investment

Trust, transparency and accountability are required for healthy financial markets worldwide. Asia has made tremendous progress over the past six years in the area of increased transparency, achieving parity with Europe and North and South America in corporate responsibility reporting. In 2011, just 49% of large Asian companies reported on corporate responsibility, but that number rose to 78% by 2017—comparing favorably to 77% of European companies and 83% of the Americas (see Figure 4).

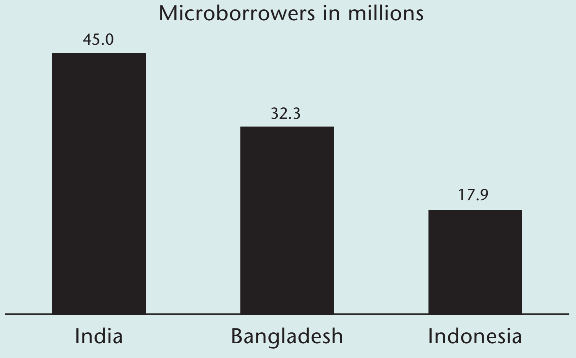
Data on corporate responsibility reporting is useful, but it is not nearly enough. Many gaps still exist in reporting on broader ESG issues, especially when it comes to small and mid-sized

Figure 2. **ASIA DOMINATES EV BATTERY CELL INDUSTRY**



Source: Bloomberg New Energy Finance; data as of Feb. 6, 2017

Figure 3. **ASIA SCALES UP MICROFINANCE**



Sources: Credit and Development Forum Bangladesh, Economic Times India, Bank BTPN, Bank Rakyat Indonesia, 2017

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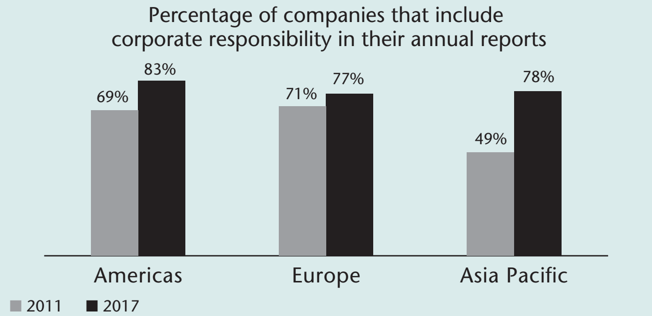
Figure 4. **ASIA ACHIEVES GLOBAL PARITY IN CORPORATE RESPONSIBILITY REPORTING**



Source: KPMG Survey of Corporate Responsibility Reporting 2017

companies, as well as companies in less developed parts of Asia. That is where active management and fundamental analysis can add significant value. A key consideration is a company's track record in distributing profits to minority shareholders in the form of dividends. Equally important is gaining a clear understanding of the strength and quality of the human capital that operates the business, composition and quality of the board, a company's use of capital over time, and the long-term viability of a company's business model. In markets that are rapidly growing and still inherently inefficient, identifying companies with strong corporate governance is essential for investors with a long-term view.

Integrating ESG into Investment Decisions

At Matthews Asia, our ESG strategy seeks to invest in cash-flow generative businesses that are improving quality of life and promoting positive environmental, social and economic outcomes. We define ESG integration as taking an "investment-first" approach to building an ESG portfolio. This means that companies must first be identified as sound long-term investments before we start to look at their ESG record. We deliberately avoid an overly thematic or sector-specific approach to ESG. In our view, a thematic approach can include the inherent dangers of investing in the latest fads or trending topics. Rather, we focus on what we do best—identifying attractive long-term investment opportunities through bottom-up, on-the-ground fundamental research. We also maintain a sharp focus on corporate governance. Since the inception of our firm over 27 years ago, closely examining corporate governance has been a hallmark of our investment process at Matthews Asia.

Our active due diligence process differentiates us from other managers who may rely solely on third-party ESG ratings for security selection. By conducting extensive proprietary research, we improve the quality of the ESG inputs we use in our investment process and broaden the opportunity set by including companies that may not be rated by third-party providers.

Once we have evaluated and are satisfied with a company's financial fitness, then we will begin to evaluate their additional merits through an ESG lens, focusing on potential ESG impacts. Every financial decision begins with our commitment to helping our clients meet their long-term financial goals. And in the process of building a sound portfolio, we can also help investors meet related ESG goals.

Filling the Gap

Many global investors tend to be underweight emerging markets (EM) in general and Asia in particular. A dedicated allocation to Asia ESG can fit comfortably within an overall EM allocation, while also providing differentiated exposure to countries, industries and individual securities that may be missing in an existing portfolio. For investors who are looking to invest in some of the world's most successful ESG-focused businesses—those with profitable, innovative and sustainable models—the answer may lie in Asia.

Vivek Tanneeru
Portfolio Manager
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Shareholder Engagement

We use our voice and influence as a shareholder to encourage positive change within the companies whose shares we own. As Asia investment specialists, we have invested in the region for over 27 years and are often one of the largest shareholders in company registries. Each year, we have roughly 2,500 touchpoints throughout the region in the form of company, supplier, customer, regulator and other stakeholder meetings. With a large team that has a strong background in Asia, we are fluent in the region's languages and familiar with its cultures. Respectful of Asia's diverse cultural landscape, we typically do not take a Western-style, confrontational approach to company engagement. Rather, we prefer in-person engagement, which we find more productive within Asia than filing shareholder resolutions. As a long-term shareholder, we seek to build trust and promote open dialogue with our investee companies—a trust that we believe has helped move companies in the right direction on issues that impact financial outcomes, including a broad range of ESG factors.

1 Source: Trends in Global Co2 emissions 2016 report by PBL Netherlands Environmental Assessment Agency and EU Joint Research Center
2 Sources: Global Health Observatory, World Health Organization, Health Statistics and Information Systems (HSI); based on data updated in August 2014
3 Source: Deloitte, "Women in the Boardroom, a Global Perspective"; data as of March 2017
4 Source: International Monetary Fund; World Economic Outlook Database, April 2017
5 Sources: International Energy Agency analysis based on Electric Vehicle Initiative country submissions, complemented by European Alternative Fuels Observatory; data as of 2016
6 Source: The Diplomat. "China's Solar Power Dominance and Trump's Trade Tariffs" February 2018
7 Source: Brookings, Global Economy and Development Working Paper, February 2017, "The Unprecedented Expansion of the Global Middle Class"

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Disclosure and Notes

ESG factors can vary over different periods and can evolve over time. They may also be difficult to apply consistently across regions, countries or sectors. There can be no guarantee that a company deemed to meet ESG standards will actually conduct its affairs in a manner that is less destructive to the environment, or promote positive social and economic developments.

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Matthews Asia portfolios do not hold positions in Tesla.

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