ESG for the capital market

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I. A historical review of ESG and capital markets

Looking back at the history of global capital markets and environmental, social and governance (ESG), ESG was formally introduced in 2004, but its prototype has been around for a long time. British scholar Oliver Sheldon was the first researcher to propose the concept of corporate social responsibility (CSR) in 1924. In 1970, Milton Friedman, winner of the Nobel Economics Prize, put forward an important idea that has sparked widespread discussion, asserting that a company’s primary objective should be to maximize profits and shareholder value. However, critics believe that it is too narrow for companies to focus only on shareholder interests, and one of the more influential is the "stakeholder theory" coined by Edward Freeman in 1980, that is, the goal of a company is not only to maximize the interests of shareholders, but also to maximize the value of the community. Since then, the concept of ESG has become more and more popular in capital markets.

In 1990, the Domini 400 Social Index, the first ESG-related index, was introduced. In 1992, the UN Environment Programme advocated at the Earth Summit that financial institutions should incorporate ESG factors into their decision-making processes and leverage the power of financial investment to promote sustainable development. In 1996, Global Reporting Initiative (GRI), the world's first independent international organization to formulate guidelines for sustainable development reporting, was established. After the year of 2000, governments worldwide significantly increased ESG-related regulations and legislations, and ESG-related concepts such as "responsible investment" have emerged in capital markets and become the general consensus of the markets.

The development of ESG is inseparable from the development of capital markets. ESG is a tool, instrument or way of behavior that ultimately helps companies achieve secure and healthy sustainable development and long-term profitability, while also creating value for a broader society and the environment. ESG has become an indispensable factor in capital markets, with growing attention from regulatory bodies and asset managers worldwide. ESG has also become one of the most important factors influencing investors' decisions in capital markets.

II. ESG, a metric that impacts on long-term shareholder value assessment

ESG provides a systematic framework to evaluate corporate sustainability across three dimensions: environmental, social and governance. The environmental dimension considers the resources used and consumed by a company and its impact on the environment; the social dimension considers the alignment of the corporate interests with those of its stakeholders and the public; while the governance dimension focuses on the company’s internal governance, scientific management and the quality of decision-making processes. Companies consider ESG not only from the perspective of their own interests and moral needs, but also from the perspective of being responsible to various stakeholders and seeking to maximize long-term value from the point of view of sustainable development of capital markets and even society as a whole.

Traditional valuation is oriented towards financial information, focusing on corporate profitability, operational capacity, solvency and industry position, specifically including revenue size, gross profit margin, compound growth rate of revenue, gearing ratio and return on net assets. ESG valuation, on the other hand, is a method that incorporates environmental, social and governance factors to assess the value of a company. It considers the impact of a company's ESG performance on its long-term value and combines ESG factors with traditional financial factors to provide investors with comprehensive information.

ESG evaluation metrics can help investors identify companies that may have issues with poor management, environmental pollution, lack of social responsibility and inadequate governance. For example, environmental pollution may lead to large fines, closures or other legal actions by environmental authorities; lack of social responsibility may lead to public dissatisfaction, boycotts and severe negative publicity; and weak governance may lead to ineffective internal control, fraud and financial misrepresentation. All of these may damage a company’s reputation and profitability and negatively affect the stability and sustainability of its operations, thereby lowering its valuation and leading to a drop in share prices and lower investor returns.

III. Developing a high-quality capital market begins with a focus on ESG, ensuring strict standards for companies seeking IPOs

ESG is a mandatory question to answer for companies in their IPO review process.

The Hong Kong Stock Exchange (HKEX) issued the Environmental, Social and Governance (ESG) Reporting Guide in 2012 and incorporated it into the Listing Rules. In its publicly released IPO Guidance Letters, HKEX set out the requirements for IPO applicants to disclose ESG information and establish ESG management mechanisms. These included establishing ESG mechanisms to meet the HKEX's requirements; appointing directors as early as possible to join the necessary corporate governance and ESG mechanisms and policies; and adding information about the applicant's environmental and social matters and management of major ESG-related risks to the list of key areas to be referred to in the "Business" section of the listing application documents.

The Shanghai Stock Exchange (SSE) issued the Guidelines of Shanghai Stock Exchange for the Application of Self-Regulation Rules for the Listed Companies on the SSE STAR Market No.2 - Voluntary Information Disclosure in 2020, which included ESG information disclosure. The Shenzhen Stock Exchange revised the Administrative Measures for the Information Disclosure of Listed Companies, also focusing on whether ESG information, including environmental, social responsibility and corporate governance, is disclosed. Furthermore, in recent years, ESG-related issues have also been given special attention in regulators' public feedback inquiries on IPO applications.

Examples of IPO concerns

1. Environment

In IPO review practices, regulators pay attention to the performance of the prospective listed company in terms of resource utilization, emissions, environmental governance and production safety.

Resource usage includes whether natural resources is utilized reasonably and whether energy, water and other raw materials are used effectively. Based on practical experience, capital markets are particularly cautious in dealing with IPO applications from "heavily polluting" and "high energy-consuming" companies.

How the prospective listed company will take effective measures to ensure manufacturing safety is also a focus in the review process. If a prospective listed company has had safety accidents during the filing period, regulators will investigate whether the prospective listed company has committed major violations of the law and assess the specific rectification actions and their effectiveness.

2. Social

In IPO review practices, the regulators focus on the performance of the prospective listed company in terms of employee rights and benefits, product safety and quality, social impact and supply chain management.

For instance, in respect of employees, the attention will be paid to the prospective listed company' employee remuneration and benefits, and whether it has a reasonable mechanism for the introduction and cultivation of talent. These factors can imply whether the company has good human resource management capability, which is crucial for assessing its ability to sustain operations.

In respect of product liability, whether the products of the prospective listed company have been involved in safety and quality accidents and whether the after-sale service mechanism is perfect will be focused. These factors can indicate whether the prospective listed company has good awareness of product liability and ability of management.

3. Governance

In IPO review practices, regulators focus on the performance of the prospective listed company in terms of governance structure, compliance system and internal control system.

In terms of governance structure, the review will pay attention to whether the positions of the board of directors, supervisory board and senior management of the prospective listed company are reasonable, whether the appointment of independent directors and committees are in line with the company’s bylaws and regulations, whether the board members and senior management are mobile, and whether the proportion of female members is appropriate.

The prospective listed company needs to highlight the construction of internal control systems, particularly for key business processes, whether the relevant systems and policies are effectively implemented, and the establishment of complaint and reporting systems.

IV. Conclusion

The capital market serves the mission of the real economy. A well-functioning capital market is conducive to improving the efficiency of corporate resource allocation, providing reasonable and accurate valuation and pricing, and mitigating systemic risks. ESG is a forward-looking approach to identifying and guiding companies toward long-term investment value propositions and more diversified sustainability goals, effectively improving the investment and financing functions of the capital market and enhancing information disclosure. We believe that as ESG becomes more deeply ingrained in businesses, it will significantly promote the high-quality development of China's capital market.

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