

Connecting the Dots

ESG: A New Dimension to Investing

In the past few months there is a sudden awakening of mainstream interest in India around pollution issues. The newfound interest can be traced back to the widely debated measures taken by Delhi Government to curb pollution, the Agreement on Climate Change in Paris (COP21) and even World Health Organization (WHO) reports on the alarming levels of air pollution in Indian cities. Some of the statistics are damning – per WHO, 13 out of the 20 most polluted cities in the world are in India, pollution levels in the most polluted city of Delhi as measured by particulate matter most harmful to respiration (PM2.5¹) are almost thrice that of Beijing and nearly fifteen times more than that prescribed by WHO (*Display 1*). The implications have been severe like a reported fourfold increase between 2008 and 2015 in the number of patients with respiratory ailments at the All India Institute of Medical Science in Delhi². A Deutsche Bank report³ quotes a study by the Royal College of London that found an increase in PM2.5 by one microgram per cubic metre reduces life expectancy by 3 weeks which implies that such alarming levels could chop off a significant portion of one's healthy years.

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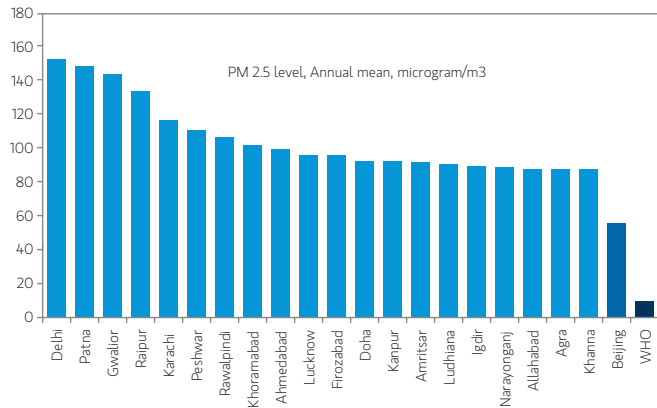
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¹ Particulate matter smaller than 2.5 micrometers

² Leave Delhi (April 2, 2015). *The Indian Express*. Retrieved on April 1, 2016 <http://indianexpress.com/article/india/india-others/leave-delhi/>

³ Jun Ma (March 2013). *China: Big bang measures to fight air pollution*. Deutsche Bank

Display 1: Top Polluting Cities



Source: WHO's Ambient Air Pollution Database, 2014.

WHO Guideline values for PM2.5: 10 microgram/m3 annual mean, 25 microgram/m3 24-hour mean

We have seen a similar spike in interest about the issue in China before. In January 2013, Beijing experienced a prolonged bout of smog, so severe that residents termed it “Airpocalypse”. PM2.5 levels reached 40 times⁴ the WHO standard prompting the Chinese Government to swing into action. In December 2013, the National Development and Reform Commission (NDRC) issued the first nationwide blueprint⁵ for climate change, outlining an extensive list of environmental objectives for 2020. Crackdown on polluting factories and mandatory real time disclosures of air emissions and water discharges followed with Premier Li Keqiang declaring a war on pollution⁶ in March 2014.

Even in India, the Union and state Governments have been alive to the problem and instituted a series of measures to control this menace (*Display 2*). While the jury is still out on how successful or achievable some of them are, what is certain is that we have barely scratched the surface in tackling the issue. If the first step in solving a problem is acknowledging that you have one, we have crossed that hurdle. The second important step is trying to correctly frame the problem which would mean getting good, timely information on the sources of pollution. Nationwide data on the sources of pollution is hard to come by. Also it is difficult to extrapolate global data as sources of pollution are not comparable across the world. Burning firewood as cooking fuel, for instance, is a major source of pollution in India unlike most parts of the world.

⁴ Something in the air? (Jan 19, 2013). *The Economist*. Retrieved on April 11, 2016 from <http://www.economist.com/news/china/21569743-measures-air-pollution-go-scale-public-impatience-rises-something-air>

⁵ China's Policies and Actions for Addressing Climate Change (2013). Retrieved on April 11, 2016 from <http://en.ndrc.gov.cn/newsrelease/201311/P020131108611533042884.pdf>

⁶ China to 'declare war' on pollution (March 4, 2014). *Reuters*. Retrieved on April 11, 2016 from <http://www.reuters.com/article/us-china-parliament-pollution-idUSBREA2405W20140305>

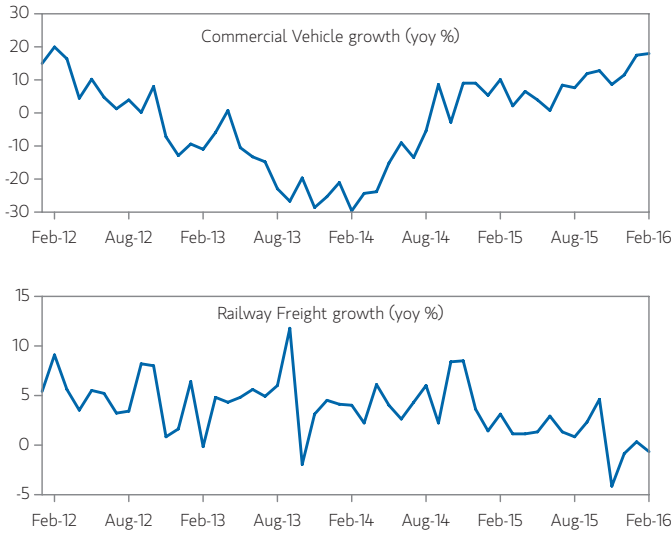
Display 2: Key Regulatory Measures

Auto	Draft regulations to advance the implementation of BS V and BS VI fuel emissions standards by three years versus the original schedule (2019 and 2022 respectively). Also intends to make BS IV (equivalent to Euro-IV) applicable across India by April 2017
Energy	<p>Mandatory supply of crushed coal to all thermal power plants from April 1, 2016</p> <p>Coal above grade G-10 to be transported only after being washed from Oct 01, 2017</p> <p>Preferential allotment of cheaper gas for city gas and piped gas applications</p> <p>Introduction of clean energy cess on imported coal and production of coal, lignite and peat to fund clean energy projects in the gas and renewable space</p>
Power	Stringent norms for emission from thermal plants regarding (1) the height of chimney (2) specific emission limits to be achieved (3) Monitoring of Water usage effluent disposal. (4) mandatory installation of flue-gas de-sulfurization (FGD) units, in certain cases
Measures taken in Delhi	<p>To permit only odd/even numbered vehicles on alternate days for a fortnight from Jan 1, 2016</p> <p>Temporary ban on registration of diesel luxury cars/SUVs (>2000cc)</p> <p>A scheme to ensure compulsory scrapping of diesel vehicles that are over 10 years, under consideration</p>

Source: Kotak Institutional Securities, Nomura Research, IDFC

While getting timely data should be a priority, equally important is coordinated action on the issue. Public policy will have a big role to play here and the states and Union have to work in tandem for this. What we see currently is disjointed and localized action treating the symptoms rather than the disease. Certain policy actions have unintended consequences especially when viewed through the lens of their impact on pollution. In 2014-15, Indian Railways significantly hiked haulage charges for freight transport which co-incided with a large reduction in diesel prices that makes road transport for freight more economical. This meant that transporters aggressively shifted their preferred mode of transportation from rail to road. This is evident in near zero growth in rail freight traffic and a heady 20% growth in sales of commercial vehicles (*Display 3*). What this has effectively done is shifted freight movement in the country to a much more polluting form of transport.

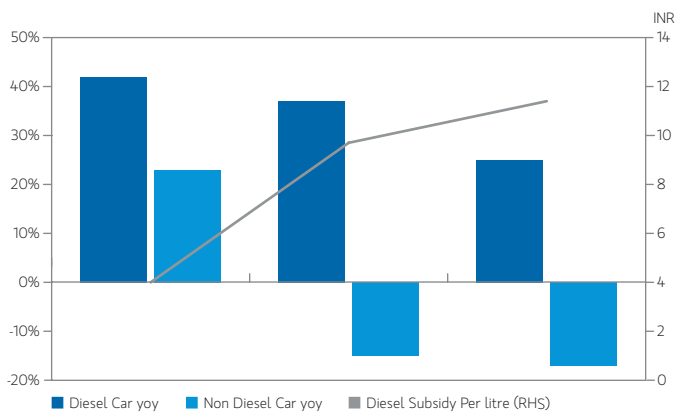
Display 3: Trends in Freight Movement



Source: SIAM, CMIE, Jefferies. Data as Feb 2016.

A similar unintended consequence was the large growth in the sale of diesel vehicles in the country between 2011 and 2013, when diesel was subsidized and petrol and natural gas were not and consumers preferred to buy diesel vehicles due to this incentive structure (Display 4). Or take the case of industrial fuels like furnace oil and naphtha compared to use of natural gas for industrial purposes. These fuels are infinitely more polluting than a gas based solution and yet in the state of Gujarat fuel oil attracts only 5% sales tax while natural gas for industrial use is taxed at 15%⁷. Ideally, a solution which is more environment friendly should be incentivized but priorities have clearly been elsewhere in these cases. Such consequences have to be acknowledged and studied at the design level itself with environmental considerations embedded in all facets of policy making.

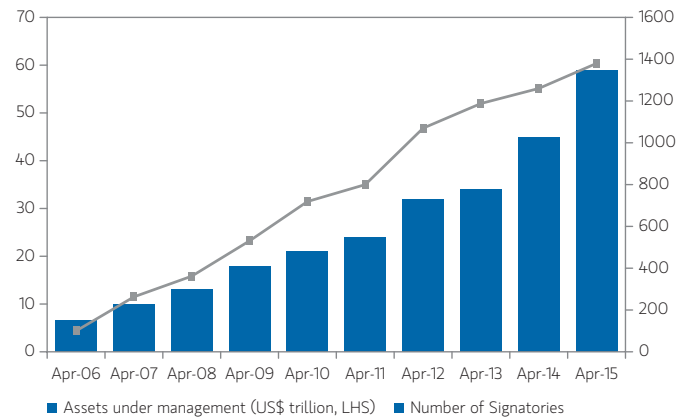
Display 4: Growth in Diesel Car Sales



Source: SIAM, CRISIL, Morgan Stanley Research. Data as of March 31, 2013

In case you are wondering if we have switched professions from being institutional money managers to being green activists, we haven't. Institutional investors and our clients have become increasingly focused on Environmental, Social and Governance (ESG) related matters of companies that we invest in. The number of asset manager signatories to the United Nations Principles for Responsible Investing (UN PRI) is growing rapidly (Display 5) and this means that there will be increasing and more wide-spread pressure on Governments and corporates to make ESG a center-piece of their policies and strategies respectively.

Display 5: UN PRI Signatories– Gathering Momentum



Source: UN PRI, <http://www.unpri.org/news/pri-fact-sheet/>

As investors, we are spending considerable amount of time trawling through Business Responsibility Reports that form part of Annual Reports of corporates, a section that honestly speaking, we flipped over a few years ago. It is a given that more money is going to chase companies that score highly on ESG and that will result in premium valuations. From an investing standpoint, this will be an enduring theme in the markets and companies that help provide environment friendly alternatives to existing methods will be huge beneficiaries. In the Indian context, these could be providers of city gas, technology companies that help reduce emission, those engaged in production of clean power or facilitating it as financiers or contractors. Corporates and investors will do well to sit up and take notice of this new trend.

⁷Source: Nomura Research

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