

Summary Risk Assessments: ChemChina and China Three Gorges

September 23, 2020

Background

On August 28, 2020, the U.S Department of Defense (DoD) released a second list of companies identified as being owned by, controlled, or affiliated with the People's Liberation Army (PLA) of China. This followed the release of an initial such list in June 2020. The two lists were prepared in response to Section 1237 of the National Defense Authorization Act (NDAA) of 1999 and include several state-owned conglomerates that have ties to China's military and defense-industrial complex. Many of these companies also have risk-related track records stemming from alleged corruption and poor adherence to environmental, social, and governance standards.

On September 15, 2020, reports emerged that two of the companies on the second list, China National Chemical Corp. (ChemChina) and China Three Gorges Corp. (CTG), had priced a combined \$3.4 billion in U.S. dollar-denominated bond offerings earlier in the week. According to the *Wall Street Journal*, ChemChina's bond offering is being underwritten by Bank of America and Goldman Sachs, alongside various overseas institutions. JPMorgan Chase and Morgan Stanley are among the underwriters of CTG's bond offering.¹

Although the DoD designations do not preclude the identified companies from issuing U.S. dollar-denominated bonds or working with U.S. banks to do so, and there are no official restrictions barring designated companies from fundraising in general in the U.S. capital markets, the bond offerings are notable in their seeming lack of regard for the reputational and financial risk factors embodied by this negative official scrutiny. Moreover, the broader risk profiles of the companies in question and the potential that exists, especially in today's environment, for these companies to experience future sanctions that could interfere with the flow of capital and goods to the company, hold ominous implications for stakeholders.

¹ <https://www.wsj.com/articles/chinese-companies-in-pentagon-spotlight-hire-global-banks-to-sell-dollar-bonds-11600165226>

Company Profiles

China National Chemical Corp. (ChemChina)

Publicly Traded Subsidiaries:

Bluestar Adiseo Co., Ltd. (600299.SS)
China Bluestar Shenyang Chemical Co., Ltd. (000698.SS)
Haohua Chemical Co., Ltd. (600378.SS)
Cangzhou Dahua Group Co., Ltd. (600230.SS)
Adama Agricultural Solutions Co., Ltd. (000553.SZ)
KraussMaffei Group (600579.SS)
Aeolus Tyre Co., Ltd. (600469.SS)

ChemChina is China's largest chemical conglomerate, established on the basis of a reorganization of enterprises directly under the former Ministry of Chemical Industry. Accordingly, ChemChina operates a large portfolio of subsidiary companies and units, many of which were previously PLA factories and institutes, producing a range of chemical raw materials, components, and products. Several remain important suppliers of China's aerospace and defense industries, such as key subsidiary China National Bluestar (Group) Corp., which is one of China's key propellant manufacturers.² Another subsidiary, Shuguang Rubber Industry Research & Design Institute, serves as a production base for military aircraft tires and manufactures protective clothing for military and paramilitary (armed police) troops.³

ChemChina's former military assets include:

- ❖ China National Chemical Engineering No. 14 Construction Co., Ltd. (CNCEC No. 14), formerly Unit 00811 of the PLA Infrastructure Engineering Corps, engages in petrochemical engineering and construction.⁴
- ❖ Shanxi Synthetic Rubber Group Co., Ltd., formerly the 414th Factory and the 3528 Factory of the PLA General Logistics Department's Military Equipment Department, produces neoprene rubber products.⁵

² <https://www.hainanu.edu.cn/stm/jiuye/200843/56620.shtml>

³ <https://www.chemchina.com/portal/zt/qrbsh/hh/webinfo/2017/11/1591142228783833.htm>

⁴ <http://www.sasac.gov.cn/n2588035/n2588325/c13562385/content.html>

⁵ <https://zh.m.wikipedia.org/zh-hans/%E5%B1%B1%E6%A9%A1%E9%9B%86%E5%9C%98>;

https://news.tianyancha.com/ll_9afxjp1vz5.html;

<http://gb.oversea.cnki.net/KCMS/detail/detail.aspx?filename=N2006010156000933&dbcode=CYFD&dbname=CYFD>

- ❖ Nanjing Lead Oriental Rubber & Plastic Technology Co., Ltd., formerly the PLA's 7425 Factory, manufactures rail transit rubber products.⁶

China Three Gorges Corp. (CTG)

Publicly Traded Subsidiaries

Chongqing Three Gorges Water Conservancy & Electric Power Co., Ltd. (600116.SS)

China Yangtze Power Co., Ltd. (600900.SS)

Hubei Energy Group Co., Ltd. (000883.SZ)

CTG was responsible for the construction of the eponymous Three Gorges Dam on the Yangtze River in Hubei province, the world's largest hydroelectric power plant, which went into operation in 2008 and is now managed by CTG's listed subsidiary, China Yangtze Power. Despite persistent concerns about its effectiveness as a flood control mechanism, Three Gorges Dam is regarded as a strategic asset and a symbolic achievement.⁷ In 2017, the Communist Party of China (CCP) was added to the corporate charter of CTG as the ultimate authority.⁸

Overseas power infrastructure projects undertaken by CTG and its subsidiaries have faced several allegations of having caused damage to local communities and the environment, ranging from flooding to drought and displacement.

- ❖ CTG and its subsidiary China International Water & Electric signed on to build the Rositas hydropower project in Bolivia in 2016. The project, consisting of a set of seven dams planned for Santa Cruz, has been rejected by local communities due to lack of transparency about its potential impacts: the involuntary resettlement of a dozen farming communities, potential flooding and loss of existing infrastructure crucial to local industry, and disproportionate effects on the indigenous community. Indigenous groups have staged protests and filed lawsuits in response.⁹
- ❖ The contract that CTG signed with the Pakistan Water and Power Development Authority in 2011 for the construction of the Kohala hydropower project has faced allegations of

⁶ <http://www.nj7425.chemchina.com/zcjt/index.htm>;

<http://www.chemchina.cn/xiangjiao/gywm/zjzg/webinfo/2012/01/1325312700596870.htm>

⁷ <https://www.cnn.com/style/article/china-three-gorges-dam-intl-hnk-dst/index.html>;

<https://pdfs.semanticscholar.org/4403/c591ea87732e3ecc368590849f1884666d7d.pdf>

⁸ <http://en.sasac.gov.cn/directorynames.html>

⁹ <https://dialogochino.net/en/climate-energy/23572-the-controversial-referendum-to-revive-bolivas-rositas-dam/>

corruption due to the absence of a formal bidding process.¹⁰ It was reported in February 2019 that major demonstrations were held in response to the diversion of the Neelum and Jhelum Rivers during the construction process, with demonstrators alleging that the CTG's occupation of the rivers was in violation of UN Security Council resolutions.¹¹

- ❖ CTG faced backlash after neglecting to release an environmental report on the Murum dam project in Malaysia, in violation of World Bank project reporting standards. The report revealed design flaws that have left the dam vulnerable to cascading failure, which can cause intense and widespread flooding, endangering the residents of neighboring villages. The project's construction also allegedly displaced indigenous communities and resulted in the removal of rainforest.¹²
- ❖ In August of 2016, it was revealed CTG had been denied an environmental license for a proposed hydropower dam on the Tapajos River in Brazil. The dam would have introduced the risk of flooding of indigenous Munduruku territory recognized by the federal indigenous affairs agency, in violation of Brazil's constitution.¹³

As a major contractor of domestic critical infrastructure projects, CTG has benefitted from having a relationship with both military and private security forces that provide the company with security and medical services.

- ❖ In October 2015, CTG signed a cooperation agreement with the PLA General Hospital (301 Hospital) in Beijing to increase cooperation in joint military and civilian activities. Under the agreement, the PLA General Hospital will help CTG to establish telemedicine sites and teleconsultation systems along the Jinsha River, which flows through the provinces of Qinghai, Sichuan, and Yunnan in western China, and overseas, to provide company employees deployed to hydropower and energy projects in remote areas with domestic medical services.¹⁴
- ❖ Three Gorges Dam has been heavily guarded by troops since the early 2000s due to its importance as a flood prevention mechanism and the widespread catastrophe that a major

¹⁰ <http://www.irs.org.pk/spmay13.pdf>

¹¹ <https://www.aninews.in/news/world/asia/anti-china-protests-held-in-pok-against-illegal-construction-of-dams20200707072545/>

¹² <https://www.sarawakreport.org/2014/08/cascading-failure-catastrophic-warning-on-murum-dam-was-kept-hidden-major-exclusive/>

¹³ <https://news.mongabay.com/2016/11/top-scientists-amazons-tapajos-dam-complex-a-crisis-in-the-making/>

¹⁴ <http://gkiea.site/sxjt/xwzx/tpxw/549354/index.html>

structural failure, like a dam collapse, could cause. Local newspaper *Huaxia Times* reported in November 2004 that soldiers had started patrolling the waters near the dam and the People's Liberation Army (PLA) had deployed armed helicopters, patrol boats, armored vehicles, and a bomb disposal unit near the project.¹⁵ A detachment of the paramilitary People's Armed Police, and troops from the PLA Second Artillery Corps (Rocket Force) and the PLA Air Force's aviation and ground defense units were also reportedly stationed at Three Gorges Dam.¹⁶

Presence in Major U.S. Indexes and ETFs

On May 14, 2018, after three years of deliberation and negotiations with Chinese regulatory authorities – and a reportedly considerable amount of arm-twisting by Beijing¹⁷ – global index provider Morgan Stanley Capital International (MSCI) released a list of large-cap China A Shares (stocks of Chinese companies traded on the Shanghai and Shenzhen Stock Exchanges) to be included in its MSCI China Index, Emerging Markets (EM) Index, and All Country World Index (ACWI) beginning on June 1, 2018.¹⁸ Previously, only Chinese companies listed in Hong Kong as H Shares or in the United States were included in MSCI indexes.

Following MSCI, FTSE Russell was the second major index provider to include China A Shares in its indexes. On June 24, 2019, FTSE added 1,097 China A Shares into its FTSE Global Equity Index Series (GEIS, which covers the FTSE Emerging and All-World Indexes) in the first stage of inclusion (20%), drawing an expected \$10 billion from passive U.S. investors.

Exchange-Traded Fund (ETF) products are passively managed, tracking specific stock market indexes that measure the performance of a fixed set of securities:

- ❖ MSCI Emerging Markets (EM) Index
Benchmark for BlackRock's iShares MSCI EM ETF

¹⁵ http://www.chinadaily.com.cn/english/doc/2004-09/14/content_374398.htm

¹⁶ <https://www.taipeitimes.com/News/world/archives/2006/05/19/2003308974>; <https://jmqmil.sina.cn/dgby/doc-ifyecfnu7954621.d.html>

¹⁷ <https://www.wsj.com/articles/how-china-pressured-msci-to-add-its-market-to-major-benchmark-11549195201>

¹⁸ The MSCI China Index represents the Chinese securities in the MSCI Emerging Markets and MSCI ACWI.

- ❖ MSCI EM Investable Market Index (IMI)
Benchmark for BlackRock’s iShares Core MSCI Emerging Markets ETF
- ❖ MSCI All Country World International (ACWI) Index
Benchmark for BlackRock’s iShares MSCI ACWI ETF
- ❖ MSCI ACWI ex-U.S. Index
Benchmark for BlackRock’s iShares MSCI ACWI ex.-U.S. ETF
- ❖ FTSE Emerging Index
Benchmark for the Vanguard FTSE Emerging Markets UCITS ETF
- ❖ FTSE All-World Index
Benchmark for the Vanguard FTSE All-World UCITS ETF

ChemChina – Publicly Traded Subsidiaries

Security Name	MSCI EM Index	MSCI EM IMI Index	MSCI ACWI Index	MSCI ACWI ex-U.S. Index	FTSE Emerging Index	FTSE All-World Index
Haohua Chemical Science & Technology (A)						
Bluestar Adisseo (A)					X	X
China Bluestar Shenyang Chemical (A)						
Cangzhou Dahua (A)						
Adama Agricultural Solutions (A)					X	X
KraussMaffei Group (A)						
Aeolus Tyre (A)						

CTG – Publicly Traded Subsidiaries

Security Name	MSCI EM Index	MSCI EM IMI Index	MSCI ACWI Index	MSCI ACWI ex-U.S. Index	FTSE Emerging Index	FTSE All-World Index
Chongqing Three Gorges Water Conservancy & Electric Power (A)						
China Yangtze Power (A)	X	X	X	X	X	X
Hubei Energy Group (A)	X				X	X

Presence in U.S. Public Employee Pension Systems

The savings of tens of millions of Americans across state lines are invested in Chinese companies through some of the largest retirement and public pension systems in the country. These include both active investments selected by fund managers and passive investments in index and related funds, the constituents of which some state administrators may be unaware of. The charts below show the subsidiaries of ChemChina and CTG that are held by three of the largest state-sponsored public employee pension systems: California Public Employees’ System (CalPERS), Florida Retirement System (FRS) Pension Plan, and Texas Teachers’ Retirement System (TRS).¹⁹

California Public Employees’ Retirement System (CalPERS)

Security Name	Shares	Market Value
Cangzhou Dahua (A)	8,000	\$15,899
Bluestar Adisseo (A)	3,300	\$4,982
iShares MSCI EM ETF	778	\$33,384

¹⁹ CalPERS data is from the FY2019 report; NYSCRF data is from an asset list dated March 31, 2019; FRS Pension Plan data is from a Q2 2020 document, and Texas TRS data is from a July 31, 2020 report.

iShares Core MSCI EM ETF	87,729	\$4,512,780
Chongqing Three Gorges Water Conservancy & Electric Power (A)	17,100	\$19,868
China Yangtze Power (A)	37,400	\$97,471
Hubei Energy Group (A)	16,000	\$10,110

Florida Retirement System (FRS) Pension Plan

Security Name	Shares	Market Value
China Yangtze Power Co., Ltd.	803,391	\$2,150,976

Teacher Retirement System (TRS) of Texas

Security Name	Shares/Par Value
China Yangtze Power Co., Ltd.	2,050,200
Hubei Energy Group Co., Ltd.	2,266,800
iShares MSCI EM ETF	1,000
Vanguard FTSE EM ETF	1,000,000

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