香港創業及私募投資協會

The Association for Private Capital in Asia

ESG in Private Equity Investing - A refreshed view

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FOREWORD

ESG IN PRIVATE EQUITY INVESTING - A REFRESHED VIEW

At time of writing, Australia is undergoing the worst wildfire in its history. The unfortunate event is hopefully finally giving the investment world a visceral enough wake-up call that ESG – in this case climate change-- is starting to fundamentally hitting the core of investment portfolio performance.

The goal of this issue of HKVCA Journal is to give our readers a holistic showcase as to how ESG, beyond the premises of green investing, impact investing and annual audit compliance, is weaved in the fabric of the private equity investment ecosystem. We have input from the perspectives of a large Asian asset owner, in fund-of-funds investing, in private equity secondaries, and of peer direct investment practitioners in real estate and in the frontier market as microeconomic-level examples. We also introduce tools for ESG benchmarking advocated by the Institutional Limited Partners Association, as well as cutting-edge technologies that utilize artificial intelligence to turn ESG-related data into actionable strategy to generate investment alpha and manage beta, from a homegrown venture-backed fintech upstart.

We sincerely hope that, with the case studies and tools brought forth in this issue, readers will start more seriously thinking about ESG in an integral, strategic light in their course of private equity investment activities, and see through how the lack of ESG mindfulness in investment management may put their portfolio at risk.

Denis Tse
Chairman, HKVCA Research Committee

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HKVCA Annual Events

Date	Event
6 March	• HKVCA Golf Day 2020
27 March	• Asia Venture Capital Forum 2020
29 May	• China Private Equity Summit 2020
September to November	• Private Equity Fundamentals Course 2020
December	• HKVCA Christmas Cocktails 2020
January 2021	• HKVCA Gala Dinner 2021
January 2021	• Asia Private Equity Forum 2021

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Affirming the Importance of ESG

Interview with Kim Chong, Head of Risk Management and Compliance, Hong Kong Monetary Authority

Kim Chong, Head of the Hong Kong Monetary Authority's Risk Management and Compliance Division, reaffirmed the government body's view of the importance of having and implementing a substantive ESG strategy

Risk management is the process of identifying and analyzing the underlying uncertainties in a business that are part of the investment decision. All investments involve a certain amount of risk, a simple but important point made by Kim Chong, Head of the Risk Management and Compliance Division at the Hong Kong Monetary Authority (HKMA) and the champion of environmental, social and governance (ESG) practices at Hong Kong's de facto central bank.

Kim stressed that "investors have to be forward looking in their evaluation of ESG in terms of risk perspective". He added, "it's a long-term approach rather than short-term focus. Asset owners who embrace ESG initiatives should select an external manager who applies ESG principles, over peers who don't deliver based on similar return profile.

Recognising that climate risk is becoming increasingly acute with serious impact, the HKMA does consider the impact of climate change as part of its investment decisions and takes heed of recommendations made by a number of global think tanks. Kim also said that learning from peers and institutional investors help shaped the Authority's ESG strategy. For instance, the HKMA follows the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) which recommends using scenario analysis for assessing implications of opportunities and risks brought about by climate change. It is also aware of various reports issued by the Intergovernmental Panel on Climate Change (IPCC) on global warming in 2018 and 2019.

The guiding principle adopted by the HKMA is to give priority to green and ESG investments if the long-term return is comparable to other investments on a risk-adjusted basis. As ESG assessment is highly situational and project specific, it looks to guidance from a variety of sources - for example, private equity fund managers and their portfolio companies who have experience dealing with such issues as environmental safety and pollution.

The asset owner also conducts ESG due diligence at the fund level, with different funds applying different investment philosophies and various ESG practices. Hence, in addition to due diligence, Kim's team also communicates with fund managers before making an investment commitment. "The compliance team will make sure that the investment has no material ESG issue before allowing it to be presented to the investment committee for further deliberations and approval.", Kim said.

Opportunities for co-investment are also subject to ESG analysis, Kim said. "Take a sports equipment retailer for example – while the company might generate good returns, it might also be involved in the sale of products that might be deemed as arms, such as gaming rifles, semi-automatic rifles and guns. After due consideration we decided not to invest given the ESG risk involved."

Investors in Europe are willing to reconcile conflict between ESG mandate and return, even though as much as 52% of them acknowledge that making ESG considerations a factor of their investment strategy may somewhat limit

their return, according to a recent study[1] by NN Investment Partners. The same was true among institutional investors from North America. For instance, the California State Teachers' Retirement System incorporates ESG considerations into its risk analysis of investment decisions and its ownership policies and practices. It emphasizes that using short-term gain at the expense of long-term gain is inconsistent with their investment policy as well as their beneficiaries' interest[2]. Now indeed, most US-based pension funds consider ESG policies as essential when selecting external managers.

The HKMA has integrated ESG criteria into their Exchange Fund investment decision-making process, though investment exclusion approach is not the preferred method. "We hesitate in selecting managers who may want to downplay ESG to pursue quick return at the expense of long-term return implications. But at the same time, it is also true that we will be unable to have an influence over portfolio companies if we don't commit to their funds. For example, in oil and gas, asset owners have the opportunity to pressure portfolio managers to engage in companies this sector to consider investments in renewable energy."

Of course, having a holistic approach in ESG implementation is essential. The recent example of California-based Pacific Gas and Electric Company (PG&E) is illustrative. The company ranked high on ESG scorecards, but was forced into Chapter 11 bankruptcy in 2019 due to catastrophic wildfires in Northern California, no doubt exacerbated by climate change, in 2017 and 2018. As Kim noted: "Climate change is prominent, but ESG is not an individual asset class. Instead of adopting any one-size-fits-all threshold to assess ESG risks of a project, we tend to identify ESG factors which are relevant to a project, and then assess their impact on the project in order to achieve better risk-adjusted investment decisions. As we recognize that climate change presents both risks and opportunities, we are actively sourcing and reviewing investment opportunities globally as appropriate, including projects with sustainable features such as renewable energy and green buildings."

Kim was quick to state on the other hand that, beside looking at risks, investment opportunities do exist with companies that apply ESG criteria. For example, in considering risks of Climate Change, Green Bonds and renewable energy projects may be attractive investments for sovereign wealth funds. As a government authority, the HKMA has also unveiled three sets of measures aimed at stimulating the development of green finance in Hong Kong. These measures include (1) implementing a three-phased approach to promote green and sustainable banking in Hong Kong; (2) implementing responsible investment by the Exchange Fund; and (3) establishing a Center for Green Finance. [3]

Given the crucial and influential role played by LPs in the private equity ecosystem, assets owners have to proactively broadcast an ESG message across the industry. "As a government-backed institution, our role is to lead in promoting ESG through a variety of mechanisms, such as organizing relevant events. And of course, we will continue interacting with ESG related organizations, such as the UNPRI and NGFS", Kim said.

Indeed today, ESG investment criteria are not simply a marketing pitch to potential investors – they are compulsory for private equity firms. Some GPs recruit environmental scientists as well as establish proper ESG investment teams. ESG risk mitigation is important for both GPs and LPs, and assets owners cannot afford to forgo it without adversely impacting their returns in the next 10 years and beyond.

Kim Chong, Hong Kong Monetary Authority

Kim heads up the Risk Management and Compliance Division of the Hong Kong Monetary Authority (HKMA) from August 2015. He is responsible for all aspects of risk management relating to the investment portfolios of the HKMA. The role extends to compliance aspects of our investment transactions and also at the portfolio level. He is also responsible for performance measurement of the overall investment portfolio. His team is responsible for ESG research and implementation.

[1] https://www.ipe.com/chart-of-the-week-investors-still-believe-esg-investing-limits-returns/10033473.article
[2] https://www.calstrs.com/sites/main/files/file-attachments/calstrs_esg_policy.pdf
[3] https://www.hkma.gov.hk/eng/news-and-media/press-releases/2019/05/20190507-4/

Private Equity Fund Managers Bridge the Inequality Gap in Myanmar

Juliet Shwe Gaung, Project Manager, Myanmar Private Equity & Venture Capital Association

When Daiwa PI partners, a subsidiary of Japan's Daiwa Securities Group Inc. started looking at investment opportunities in Myanmar during late 2016, the PE firm had a mental picture of what the frontier country offered as an investment destination: "A lot of potential and opportunities".

Yet, Daiwa acknowledged the challenges around the decision to choose Myanmar to be the first country for the private equity team at Daiwa PI to have an overseas presence. The challenges ranged from such things as a lack of clarity on regulations, to investee companies having a hard time following good corporate governance practices to an absence of statistics to guide investment decisions.

None of these prevented the PE firm from deciding to make around US$50 million of equity investments in Myanmar over the next two years (from 2018 to 2020).

"We consider (the challenges) more like an opportunity. If we fill the gap, there will be business opportunities," said Yusuke Takahashi, chief representative of Daiwa PI Partners in Myanmar.

Three years later, Daiwa PI Partners has a footing and, like other institutional investors, is trying to be a catalyst in filling the country's "missing middle"—growing good businesses to fill the gap between plentiful micro and small enterprises and the few large corporations. Growing small firms to sustainable medium and eventually large companies will help reduce poverty and inequality.

The handful of investments the group has made are in its target areas of communications, online and consumer-focused businesses, and finance firms.

One of its latest investments is in Rent 2 Own (Myanmar) Ltd, a motorcycle rental service firm. Its hire purchase approach for motorcycles fills the gap between what microfinance firms and banks offer to people living in the rural areas. "R2O is able to provide new opportunities for rural people to access markets," said Takahashi.

Daiwa PI Partners is now extending its finance focus with a planned investment in a microfinance firm that it said will have a direct impact of allowing people to have new income sources.

Over the past decade, Myanmar experienced a good performance in terms of reduction of people living in poverty. According to a report by the World Bank Group and UNDP, between 2005 and 2017, the national poverty line declined to 24.8 percent from 48.2 percent, as a result of robust economic growth.

However, vulnerabilities remain. The prospect of negative shocks from, for example, basic commodity price hikes and the rising cost for healthcare are concern which will be felt most by poorer sections of the community.

Takahashi also notes, based on his experience, that overall business performance has been improving only slowly.

"In general, we haven't seen rapid expansion in consumer purchasing power in the past two years. I saw many companies facing falling revenues in 2018," said Takahashi. A lot of factors are behind such dips, including the need for

improved infrastructure such as more electricity, and a failure to fully boost exports.

"We still believe in high potential in the market," he said. "There are also some gaps in the country that are also an opportunity. We can certainly contribute from the social point of view," he said.

Josephine Price, inaugural chair of the Myanmar Private Equity & Venture Capital Association (MPE&VCA), mentioned the important impact the private equity investments can make in terms of overall economic growth.

"The ability of the private sector money to increase economic growth benefits everybody. It increases tax base, provides more revenue for the government, and provides capital for a business to grow, which all helps decrease income inequality," said Price who is also the co-founder of Anthem Asia, another PE group.

Above all, Price said private equity investments, at one point, can help to reduce the gap in the "missing middle" market in the corporate landscape.

In terms of reducing the inequality gap, Myanmar can replicate the trend of its larger economy neighboring countries such as Indonesia and India, said Price.

"We do see income inequality reduced in other markets like India and Indonesia. The middle class has emerged over the past 10 or 20 years. That will happen here," said Price.

Among the tangible benefits private equity firms are already making, one is creating jobs. One Daiwa PI Partners investee company, internet provider Frontiir, has grown its workforce four to five times since Daiwa first invested. One of Anthem Asia's investments, Rangoon Tea House, now has more than 250 employees, compared to 50 when the PE firm started putting money in the company.

Another leading regional private equity firm, Emerging Markets Investment Advisers (EMIA), that has made a number of investments in Myanmar, points out the benefits that PE industry can make when being more serious about the way investee companies are performing in the market.

"If the PE industry also maintains a certain hurdle or standard for how its investee companies should behave (in terms of environmental and social behavior, integrity and developing good governance), then that growth can be achieved in a way that promotes equality in a broader sense, because of the way in which a company interacts with employees, customers and the community at large," said Trent Eddy, director of EMIA.

In Myanmar, EMIA has made investments in the property portal Shwe Property, in MFI Microfinance Delta International (MIFIDA), in travel group Oway and in Myanma Food for Thought, all of which are under its CLMDF II Fund.

Microfinance is one area where PE firms have an appetite and one which can contribute to the growth of the middle market.

EMIA's MIFIDA is now one of the top 20

microfinance operators in the country with an average loan size of US$250. Today, MIFIDA has more than 100,000 borrowers, primarily low-income, rural citizens.

"In a country where only ~10% of the people have bank accounts, the microfinance industry as a whole has had a significant impact on reducing income inequality because it provides access to capital for micro-entrepreneurs to grow their trade and increase their incomes," said Eddy.

With a population of about 54 million, Myanmar's gross domestic product per capita is growing at around 6.6 percent and is targeted to reach 6.8 percent for 2020, presenting an attractive investment destination.

Despite suffering from a reputational setback with some investors and other stakeholders in the international community, due to humanitarian issues in the country, Myanmar is still considered to be a frontier country with an attractive consumer market.

The government is expecting that the private sector will contribute more than 70 per cent of the total investment for the year, 2019-20. The recently approved National Plan law is expected to support the country's GDP growth to reach 7 per cent, hitting K95.4 billion (US$63.03 million) in nominal terms.

Currently, the MPE&VCA represents 14 active institutional investors dedicated to investing in Myanmar, each of whom have made at least one investment in the country. In Myanmar there is roughly between US$200 - 300 million in "dry powder" - committed capital, still available for investment by institutional investors.

PE firms that have a regional presence are also making and looking to make investments in the country. EMIA for example, has a regional footprint target and a goal of having a positive impact on the economic development in its favoured countries.

"For our part, as in our other markets – Cambodia and Laos - there are opportunities to make great investments in Myanmar that make a contribution to reducing inequality in both the limited financial sense and the broader one about greater access to products and services. We can build great businesses that grow fairly and sustainably," said Eddy.

Juliet Shwe Gaung, Myanmar Private Equity & Venture Capital Association

The Myanmar Private Equity & Venture Capital Association is an independent, non-profit membership organisation that was incorporated in May 2019. The association includes the leading private equity and venture capital organisations operating in Myanmar, each of which has extensive experience working within Asia. These institutions have come together to highlight the importance of venture capital and private equity to the economy in support of entrepreneurship, innovation and overall economic development.

ESG: Going (way) Beyond Negative Screening

Maud Savary-Mornet, Regional Director - Asia Pacific, responsAbility

In early November, responsAbility reached a significant milestone with 10 bn USD invested in private debt and private equity across 90 emerging countries and 500 companies. Operating in a specific niche known as "impact investment", this success would not have been possible if we had not adopted, at an early stage, Environmental, Social and Governance (ESG) criteria which have helped us in shaping our portfolio by preventing negative or unintended adverse external factors. At a time when APAC investors seem to be lagging behind their European and US peers, it is time to debunk some myths and explain how ESG is fully integrated within the risk management process.

What is ESG? As an early adopter of ESG standards, our approach consists of using a set of standard indicators to screen potential investments, such as:

- Environmental criteria that look at a company performance as a steward of the natural environment;
- Social criteria that examine how a company manages relationships with employees, suppliers, customers and the communities where it operates; and
- Governance which deals with leadership, executive pay, internal controls and shareholder rights.

There are several sets of standards available which, sometimes, can create some level of confusion – a good starting point is to look at IFC standards. IFC is the private sector arm of the World Bank Group.

What is ESG versus impact?

For responsAbility, ESG is a necessary approach to identify and mitigate the risks, although this is not sufficient to drive change. It is only one selection criteria within our investment process. We actually select high impact companies defined by a set of measurable impact themes, all related to the Sustainable Development Goals.

What are the main steps of an ESG assessment?

Any ESG assessment starts with an exclusion list. Typically, this would include tobacco, child labour, trade in wildlife and certain pesticides. But- and this is very important- it should not stop there: The E&S management system should also be used to identify both E&S opportunities as well as risks. Compliance with E&S standards is part of a business's key success factors. Ultimately, well-implemented and effective E&S management can contribute to increasing quality (improved input, production and operating standards), lower costs (improved resource efficiency and staff retention) and thereby increase productivity.

ESG assessment does not end with an exclusion list. The ESG risk profile and management risk profile is assessed for every part of our portfolio. The potential investee is then given an ESG risk profile. All risks are considered in the context of inherent sector risks, the scale of the company's operations and whether the investment involves new or continued operations and locations. As we are sector thematic, we invest mainly in 3 sectors: Financial inclusion (microfinance, SME banks, leasing companies, Fintech); sustainable food and climate finance where the type of risks linked to environmental,

social and governance criteria are intrinsically very different.

Defining the ESG profile of a portfolio: 70% of our investments are categorized as low risk while 30% are categorized as medium risk- we follow up on the investees periodically to measure the progress and make sure they make progress on the flagged areas- in other words, mitigation measures are introduced before an investment can be taken further. For example, a small-scale hydropower plant could create issues for the local environment and community unless the right measures are introduced early on in the process. We do not have any investment classified as high risk in our portfolio as it could create irreversible damage in our portfolio.

How is the process fully embedded in our investment approach? Let's take a look at our ESG assessment in one of our asset classes, namely sustainable agriculture equity investment. At a minimum, all companies are expected to operate in compliance with the IFC standards. For the "E" side, it is also expected that the companies conduct an environmental impact assessment to identify risks linked to loss of biodiversity, emission of greenhouse gases, degradation of water quality and air quality, etc. For the "S" side, investee companies are expected to pay wages that meet or exceed industry or legal national minima, treat their employees fairly, and create structures to allow for work-place consultation to give employees the opportunity to present their views to management. For the "G" side, investees are expected to assess the health and safety risks arising from business activities and to take appropriate action to eliminate or reduce risks to health and safety.

Preparing the due diligence: The on-site due diligence allows us to additionally verify the desk-based findings and to extend the due diligence to those checks that can only be assessed on the ground, such as inspecting operating and working conditions. Furthermore, the due diligence process may extend beyond the investee company. The assessment will look at the local area beyond the property line to assess induced or cumulative impacts on the community and environment, as well as up and down the supply chain. We rely on internal ESG specialists as well as external specialists to produce an environmental and social impact assessment. The risks are ranked in order of priority based on the severity and likelihood of occurrence of any potential negative impact. Alongside this, the mitigating measures and opportunities for improvement are considered in the context of ESG, their ease of implementation (taking into account costs for instance) and the likelihood of their effectiveness. As a result of this analysis, a draft action plan for improvement is then formulated. The action plan details each ESG concern with its risk level, actions required to mitigate the issue, a time frame for implementation, the proposed monitoring programme, and the costs involved.

Engaging with the company: the final action plan will be prepared in consultation with the management of the investee company. The ESG analysis, including both risks and opportunities, is submitted to the investment committee when making a final decision on the investment. It is presented as an integral component of the investment proposal at the investment committee level and the proposal will clearly articulate whether measures are required over the investment period.

Monitoring the ESG risks: monitoring ESG risks is a good way to engage and maintain the dialogue with the investee. It includes regular interactive reviews of progress on the action plan for ESG improvements with the management of the investee companies. Representation on the Board of the investee companies also allows to gain influence on an on-going basis and helps to monitor and improve corporate governance of the investee companies. Site visits are also required on a regular basis.

Case in point: 10 years later, what are the benefits for one of our investees, Khushhali Microfinance Bank?

A good example of our early approach in introducing ESG for one of our frontier equity investments can be seen in Pakistan where we took a participation into the Khushhali Microfinance Bank. Pakistan is an underbanked market with tens of millions of underserved customers. The country is a gateway to central Asia with the China-Pakistan Economic Corridor (CPEC) project promising continued economic growth, trade, and development. Khushhali Microfinance Bank (KMB) was set up in 2000 by the government of Pakistan. KMB's objective was to provide microfinance to the rural poor, in particular loans to small farmers. After a successful start, KMB's progress had plateaued after 10

years, with low profitability and slow growth. Its product portfolio was too narrow and its lending was spread too thin with very small loan sizes meeting only part of its customers' needs.

After the shareholders decided to restructure the KMB's ownership, responsAbility Investments (rA), along with a consortium including the United Bank Limited and other PE firms bought a controlling stake in 2012. At the time, the bank had a balance sheet with assets of USD 92 million and was generating a mid-single digit Return-on-Equity (ROE). With a head office in Islamabad, it had branches across most of Pakistan's provinces with a particular focus on Punjab, the top agricultural province.

At responsAbility, having worldwide experience as partners with microfinance and SME banks, we recognized the importance of transforming the bank from a narrow-based group lender to a diversified financial institution. To this end we took several initiatives. **On the "Governance"** front, we introduced and nominated a senior microfinance bank transformation expert to the Board of the bank, providing crucial guidance on strategic and operational matters, including business planning, profit-center driven branch management, deposit strategy, and product development. As a renowned corporate governance expert, he also contributed to bringing Board procedures to international standards. We then identified and appointed a seasoned product development consultant to drive the development of a new MSME loan product. These initiatives had a very positive impact. It allowed the replacement of informal sources such as local moneylenders that charged exorbitant interest rates for short term loans. Further, savings and money transfers offering an interest-paying safe store of money supported and encouraged low cost remittances from urban to rural areas. More specifically, it resulted in:

- A tripling of the average loan size that allowed the bank to serve its customers more fully and to further reduce their dependence on informal loan sharks, even as the bank had almost tripled its number of customers to more than eight hundred thousand.
- Profit-driven branches meant increased financial intermediation, with lower cost of funds which ultimately supported lower cost loans for borrowers, based on increasing the deposits-to-loans ratio from ~65% to more than 100%.
- MSME loans being offered from virtually all of the Khushhali's 175 branches and hundreds of staff members having been trained in MSME credit assessment. With up to 3 million MSMEs lacking access to appropriate financial services, the new product overwhelmingly contributed to filling an immense demand for such financing among Pakistani entrepreneurs.

This turned the bank around, with loan growth reaching 38% compounded over the past four years, with a strong deposit base fully covering the loan portfolio, and generated a healthy ROE providing firm support for future growth, resulting in a balance sheet with assets of more than USD 500 million USD as of December

2018. The Consortium partners and the KMB management team collaborated closely to drive these changes.

In conclusion, ESG investment criteria and monitoring are critical risk management methods that contributes to sound investment practices. Not only is it a compass for the sustainable investment community, it is part of standard investment criteria. At responsAbility, it is fully embedded in our investment process and our belief is that it will become mainstream across all the financial industry.

Maud Savary-Mornet, responsAbility

Ms Maud Savary-Mornet, Regional Director, Asia-Pacific of responsAbility. responsAbility is a leading impact asset manager with 16 years track record, managing over 3 bn USD of assets invested in 450 fully compliant ESG high impact companies across 90 emerging economies in the sectors of financial inclusion, climate finance and sustainable food. Maud is in charge of Asia Pacific region and the offices in Hong Kong, Mumbai and Bangkok. She has led the investment team in financial inclusion, developing the portfolio of microfinance and financial institution in 20 countries of South and South East Asia for responsAbility over a decade. She has 25+years of experience in ESG and impact investing, banking regulation, emerging markets and impact investments at the French central bank, European Commission and French Consulate in Hong Kong, including 12 years in Asia Pacific. She has published several articles on China, Hong Kong and microfinance. She graduated Economics and Finance at Sciences Po (Paris).

Article has benefited from the contribution of Henning Haugerudbråten, Principle – Private Equity, responsAbility; and Pedro Fernandez Diaz, Senior Social and Environmental Specialist, responsAbility."

How an RMB PE Firm Became a Leading Force of ESG Investment in China

Frankie Fang, Founding Managing Partner, Starquest Capital

Founded in 2017, Starquest Capital is the first RMB FoF/PE firm to become a signatory to the UN-backed Principles for Responsible Investment (PRI). Since then it has spearheaded ESG practices in China, and in September 2019 became the first Chinese institution - and the only Asian institution – to have won a PRI award

China has faced serious ESG problems for years and there is little doubt that investment practices as they relate to ESG are woefully inadequate. Environmental problems such as air and water pollution remain prominent, and social problems - such as P2P lending fraud and harmful vaccine incidents - influence the whole society. And, while China has been exposed to ESG practices since at least 2003, the actual utilisation of ESG criteria in investment decision-making is very limited. At present, only preliminary results have been achieved in the secondary market investing and the utilisation of ESG investment criteria in China's private equity market remains very limited.

Yet, despite the lack of a ESG culture in China, Starquest remains convinced that it will increasingly become a priority in the investment process for both Asian LPs and GPs. For LPs who invest globally, including in Asia Pacific, the focus is more on Asian GPs' capacity and commitment to managing ESG risks. For Chinese local government-backed funds who are following China's 2016 green finance policy, there is an increasing awareness of GPs' responsibility for utilising ESG factors in their investment decision-making.

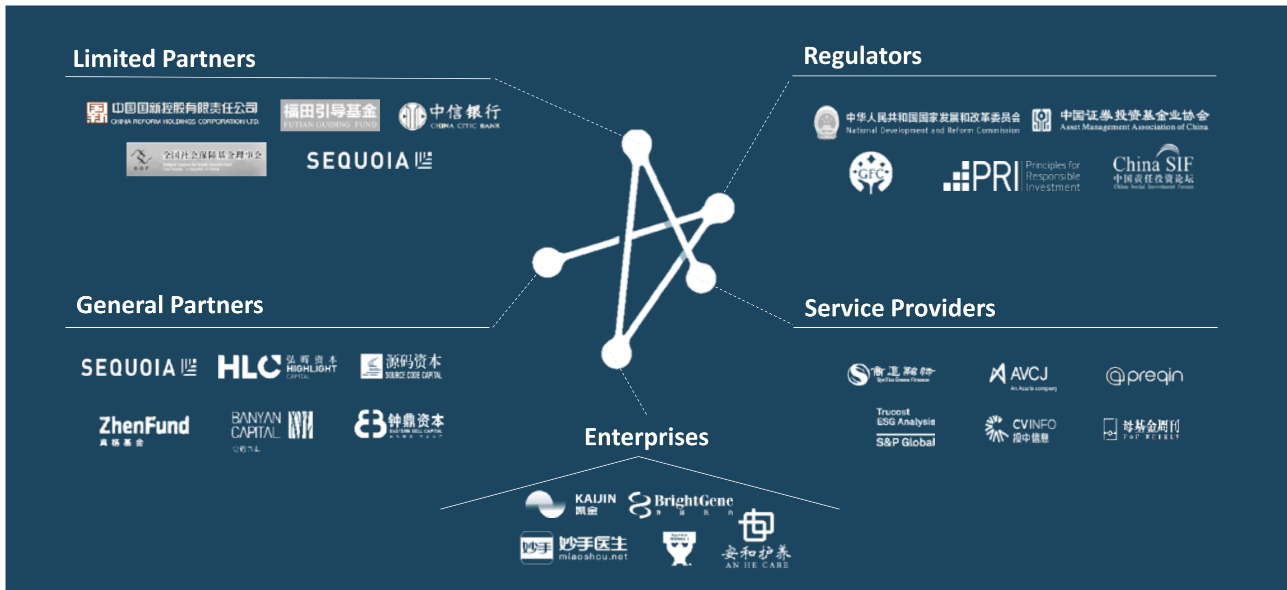
Adoption of ESG criteria in the Chinese VC/PE market, will be driven from the top down. Regulators such as the China Securities Regulatory Commission (CSRC) and the Asset Management Association of China (AMAC) will play an increasingly essential role in ESG criteria research and policymaking. LPs such as state-backed funds and FoFs will likely also become another significant power in supervising and guiding the GPs which manage their portfolios. Local PEs must understand, either voluntarily or mandatorily, that the question is not whether they should consider ESG criteria, but whether they should already be proactively engaged in considering ESG factors as part of their decision-making.

Recognizing the global trend toward ESG, and the nascent ESG climate in China, Starquest Capital sees itself as a leader and driver in the utilisation of ESG criteria in the Chinese PE market.

So how is Starquest doing?

For Starquest, ESG has been part of its DNA since

Starquest Capital won the PRI award at 2019 PRI in Person, Paris



Starquest Capital's Five-Star Ecosystem (FEEC)

its inception. Frankie Fang, the founding managing partner, as well as the president of the firm's ESG Committee, has over 13 years of ESG-related experience. Beginning on day one, Starquest began working towards setting-up its own internal ESG committee and an ESG implementation framework. It also speaks frequently with regulators and other private equity institutions discussing best practices in China.

In designing its innovative yet practical and adaptable ESG approach, Starquest has committed to taking on board the work of ESG experts both globally and domestically. It has collaborated with the National Institute of Financial Research at Tsinghua University and industry experts from MSCI.

It also proactively participates in ESG-related conferences and seminars. Recent efforts include being part of a panel discussion on the future of the PRI reporting framework at PRI in Person 2019, a leading global conference on responsible investment. The conference was attended by 1,700 delegates and there were over 100 expert speakers representing the investment industry.

Starquest is the only private equity institution that has signed-on to the Green Investment Principles (GIP), which are dedicated to promoting eco-conscious investment in the Belt and Road regions.

By engaging experts and internal study, the firm's ESG team has spent almost a year developing a comprehensive, firmwide ESG approach. Steered by an independent committee, ESG considerations are made at each stage of the investment process and evaluated both quantitatively and qualitatively by its ESG assessment system. Original questionnaires are also designed in a simple and progressive way so as to cater to the unique characteristics of Chinese GPs.

Difficulties faced

Nevertheless, the promotion of ESG in the Chinese primary market continues to face a series of difficulties. Chief among these is the lack of awareness of ESG criteria in the VC/PE market. Based on the firm's own survey data, 50% of respondents had limited exposure to ESG principles, while 13% had never even heard of it.

Starquest highlights the example of a target GP of a first-time fund who had never even heard of ESG. Starquest encouraged the GP to embrace ESG education and either seek to train or take on an ESG specialist. However, during the due diligence stage it emerged that the GP's partner, while stating a willingness, had nevertheless failed to take any concerted action. Such cases are not uncommon in China.

Another difficulty lies in how ESG factors are incorporated into the investment process. Though some US dollar GPs have already made initial efforts in terms of developing an ESG strategy and assessment, the actual result leaves a lot to be desired. For GPs who have some ESG experience, Starquest encourages them to gradually establish ESG criteria assessment systems covering each stage of the investment process. However, GPs continue to find this difficult to implement.

Starquest is aware of one target GP that had invested in many ESG-friendly companies within the healthcare and consumer goods sectors. However, due to its large number of portfolio companies, and a lack of ESG monitoring incentives, it was not able to form a truly effective monitoring approach to track the portfolio companies' ESG performances.

Starquest's adaptable ESG approach

Drawing on its own practical experience, Starquest adapts its ESG approaches so they are easily embraced by GPs and LPs in China. The approaches are tailored for investors in emerging markets. They initially focus on the establishment and improvement of ESG assessment systems and later focuses on the implementation of ESG considerations in the investment process. Starquest's ESG approach can be applied broadly, it believes, because it incorporates the following elements:

- Systematic methodology: At the core of its approach is a systematic methodology capable of being replicated widely across different kinds of GPs and LPs. The methodology is top-down. An efficient decision-making center is set up to supervise the entire team and at least one ESG specialist is designated. Starquest suggests that firms establish a rigorous and comprehensive assessment process that takes ESG factors into consideration step by step. Each stage in the process must include ESG assessment and accountability on the part of team members.
- Original ESG questionnaire: Questionnaires have a user-friendly interface and questions are linked to the progression of due diligence. Such design addresses the pain point around the fact that many LPs find it hard to collect valuable ESG information from GPs.
- Quantifiability: To minimize subjectivity and improve accuracy, Starquest has developed a practical guide on how to quantitatively analyze ESG practices and the analytic tools used are best at solving various non-deterministic problems. For instance, the analytic hierarchy process (AHP) used can easily integrate qualitative and quantitative data.

Indicators found in Starquest's portfolios

For firms using Starquest' ESG methodology, there is a positive correlation between using ESG criteria and investment performance.

One of Starquest's portfolio companies is Supermonkey, a fitness service provider that sells courses using a retail model. Consumers pay on a course-by-course basis and are not required to register for membership. Supermonkey can be viewed as a typical ESG-friendly firm because:

- The company's customized products are a greater benefit to the consumer than the

SuperMonkey's Gym

subscription method commonly seen in traditional fitness products. The user's fitness experience is easy and fun, greatly increasing enthusiasm for fitness activities, and contributing to the wellbeing of a healthy society.

- The group courses bring together users with similar fitness needs, allowing them to communicate and share experiences. The business model meets both the needs of the individual as well those of a healthier society.

Starquest also co-invested in a bio-pharmaceutical company known as BrightGene in late 2018. In less than a year, BrightGene successfully listed on the Shanghai Stock Exchange. The company's stock performance has to date been steady. BrightGene is involved in the R&D and manufacturing of innovative medicine as well as special generic APIs (active pharmaceutical ingredients) and FDFs (finished dosage forms). When assessing its ESG-related risks, Starquest scored the company much higher than average because:

- BrightGene is a highly research-driven company. For the past three years, its R&D expenses accounted for more than 25% of its total revenue, more than three times higher than that of listed companies in the same sector. On the other hand, its marketing expenses accounted for only 3%, one of the lowest levels in the sector.
- One of its most popular drugs, entecavir, has efficacy in reducing the amount of hepatitis B virus. The drug is widely used in hospitals due to China's high incidence of hepatitis B. To alleviate the financial burden on patients, BrightGene worked to reduce the price of entecavir from 39 RMB per pill in 2010 to 0.18-0.19 RMB per pill today.

Starquest hopes to keep improving its ESG approach while discovering good investment opportunities by combining ESG factors with financial indicators in the assessment process. It is also dedicated to helping its portfolio companies on their own ESG journeys, and firmly believes that the importance of ESG in the PE/VC market will ultimately be recognized by Asian regulators, LPs, GPs, entrepreneurs and services providers.

Frankie Fang, Starquest Capital

Frankie Fang is the founding managing partner of Starquest Capital, a leading China focused private equity and fund of funds (FoF) firm with initial AUM of around RMB 30 billion. Mr. Fang oversees the FoF investment, ESG integration, business development and various activities.

Prior to founding Starquest Capital, Mr. Fang served as the Head of LGT Capital Partner in China for 12 years. In addition, he also initiated the ESG development across the LGT Pan-Asia team. LGT Capital Partner is a leading global alternative investment firm with USD 60 billion of AUM sponsored by Princely Family of Liechtenstein.

Before joining LGT Capital Partners in early 2007, Mr. Fang worked for AXA Private Equity Group in Singapore focusing on FoF and direct investment in Pan-Asia region. Prior to that, Mr. Fang served as project manager for Burger King, responsible for the opening of the first restaurant in China. Mr. Fang began his career as an auditor and senior consultant in Andersen Consulting.

The Chinese Communist Party on the Board

Jamie Allen, Secretary General, ACGA
Nana Li, Senior Research Analyst, ACGA

China PRC is the largest private equity market in Asia. According to our fellow EMPEA's figures, some $9.8 billion in PE investments were recorded there in the first half of 2019. Recalling Chin Chou's interview of last year, when he shared that the increasing disposable income in China was the key factor driving the economy growth, one can conclude that it is definitely a good omen for PE firms exploring investing opportunities there.

However, acquiring certain businesses in China may sometimes involve SOEs which have to report to the Party Committee, a body established by the Chinese Communist Party (CCP). This has consequences and on that specific topic, the HKVCA has been allowed to reproduce and disseminate a comprehensive report prepared by the Asian Corporate Governance Association (ACGA), an independent, non-profit membership organisation dedicated to working with investors, companies and regulators in the implementation of effective corporate governance practices throughout Asia. The 300+ pages publication covers a bunch of insights from experts who have done business in mainland China, and we summarise below a few main takeaways. Readers are welcomed to go through the full version here (or access the http://acga-asia.org website).

HKVCA Staff writer

The Party Organisation: Leadership Core

The role of the Party Organisations is one of the least understood aspects of corporate governance in China. With a legal basis in both Company Law and the CCP Constitution, Party Organisations play a leadership role in state enterprises and are increasingly influential in the private sector. Their role has been reinforced in recent years, with many SOEs adding them to their Articles during 2015 to 2017.

Introduction

One of the unique aspects of corporate governance in China is an entity called the "Party Organisation" or "Party Committee", a body established by and reporting to the Chinese Communist Party (CCP). Despite its long history, especially in state-owned enterprises (SOEs), the Party Organisations/Committees are perhaps the least understood feature of corporate governance with Chinese characteristics. As is apparent from our 2017 survey of foreign institutional investors (see Figure 1), one-fifth of respondents were unaware of the existence of Party Organisations, while the remainder would welcome greater clarity as to their role and lines of accountability. This lack of understanding is due to the limited transparency historically provided on the power and responsibilities of the Party Organisations and their relationship with the board and other governance bodies in a company. Such disclosure is not required by company law or securities regulations.

Policy initiatives enacted from 2010 to 2017 reaffirmed the leadership role of Party Organisations in state enterprises and their

status above the board of directors in the business and governance decision-making chain. They are also more and more widespread in domestic private firms where they serve as a focal point for Party members, exercise leadership over the trade unions, and provide guidance on complying with state laws. More recently, multinational corporations in China have come under increasing pressure to welcome such Party Organisations, and many have complied.

While these policies would appear to be in direct conflict with previous more pro-market trends in China—and certainly offer a different model of corporate governance—they are best understood as an integral part of what the CCP calls the process of "socialist modernisation". As the preamble to the CCP's new constitution of October 2017 makes clear, the Party remains stoutly opposed to "bourgeois liberalisation" (ie, Western liberal values) and is still at an early stage of building a "socialist market economy". It is an economy in which "public ownership plays a dominant role", although different forms of corporate ownership can "develop side by side". The CCP plays the core leadership role over the entire society and "shall be firm in consolidating and developing the public sector" as well as "guiding the development of the non-public sector".

What do Party Organisations/Committees do?

In theory, the function of the Party Organisations/Committees is to participate in the governance of enterprises, while at the same time not directly meddling in their management and operational decision-making. From the beginning, Party committees were established to ensure that significant decisions made by enterprises would not deviate from national laws and regulations, Party discipline and basic political principles. Indeed, as the CCP Constitution makes clear, Party Committees "set the right direction" and "keep in mind the big picture", while ensuring the "implementation of Party policies and principles" and deciding on "major issues". In practice, Party Committees have three functions:

1. Making the "Three Important, One Large" decisions: namely, decision-making on "important issues", the appointment and dismissal of "important cadres", investment in "important projects" and the use of large amounts of funds.
2. "Double entry, cross offices": Party Committee members can also serve on either the board of directors or supervisory board, and be part of the executive team and vice versa. This helps to put into effect the ideas of the Party and coordinate communication between the Party, the board of directors and executives.[1]
3. Overseeing the system of "Party supervising cadres" and "Party supervising talents": The former is aligned with the appointment of executives by the board of directors and human resource management.[2] In respect of "supervising talents", the Party carries out the induction, training and development of professional talent by implementing the "National Plan of Talent Development in Medium and Long Term (2010–2020)".[3]

Putting the Party into the articles

From late 2015 onwards, enterprises listed in China began amending their articles of association to incorporate Party Organisations. One of the earliest was Harbin Electric Corporation Jiamusi Electric Machine, which did so in December 2015, followed in January 2016 by Xinjiang Tianshan Cement and Sinoma International Engineering. From late 2015 to June 2017 almost 180 enterprises followed suit, according to data gathered by Institutional Shareholder Services, an international proxy voting advisory firm.

This wave reached Hong Kong in 2017, when more than 30 large state enterprises incorporated in China and listed in the city put forward similar resolutions to either annual or special general meetings. While some institutional investors

[1] CPC Central Committee, "Opinions of the Organisation Department of the CPC Central Committee and the Party Committee of SASAC of the State Council on the Party Committee of the Central Enterprises Giving Full Play to the Role as the Political Core under the Modern Corporate System", No. 5 [2013], April 2013.

[2] CPC Central Committee, "Opinions of the Organisation Department of the CPC Central Committee and the Party Committee of SASAC of the State Council on the Party Committee of the Central Enterprises Giving Full Play to the Role as the Political Core under the Modern Corporate System", Article 13.

[3] CPC Central Committee, "Opinions of the Organisation Department of the CPC Central Committee and the Party Committee of SASAC of the State Council on the Party Committee of the Central Enterprises Giving Full Play to the Role as the Political Core under the Modern Corporate System", Article 16.

were happy to accept these changes, others voted against them. For example:

1. Sinopec received almost unanimous support from both its A and H shareholders, achieving votes in favour of 99.99% and 99.68%, respectively.
2. Industrial and Commercial Bank of China (ICBC) received a mixed response: overall votes against (both A and H shares) amounted to only 5.7%, yet it would appear that a high proportion of H shareholders objected to the amendments. Total votes against numbered almost 17.5 billion, which was equal to almost 39% of the 45.2 billion H shares represented at the meeting. (While not all against votes may have been from H shares, it is reasonable to assume that the vast majority were, given the high concentration of state ownership in the company via A shares.)
3. China Construction Bank also saw mixed results: votes against amounted to 12.8% of all votes cast, but this accounted for only around 13% of all H shares voted.
4. Chongqing Iron & Steel witnessed a very different pattern: more than 70% of its H share votes were opposed to the amendment.

Challenges

While the government's motives for pushing through these amendments are clear, there are a number of governance challenges:

Less Efficient Decision-making

There are some concerns within China that formalising the role of the Party Organisation/ Committee could make business decision-making less efficient. Some enterprises say that Party Committees previously intervened in board decision-making only in principle. They did not have to make formal decisions on specific issues. Under the new policy, major issues first require the approval of the Party Committee before going to the board of directors. This will require even more coordination than currently and add to the workload and documentation tasks of the board secretary.

Limiting the Role of the Board

Because of the system of "double entry, cross offices", there is a high degree of overlap between the composition of the Party Committee and the board of directors, supervisory board, and management. The term "double entry" refers to people holding two roles or positions in an enterprise. "Cross office" refers to one person being both the secretary (head) of the Party Committee and chairman of the board of directors. There are also cases where the board chairman is the deputy secretary of the Party Committee. Or where the secretary of the Party Committee holds the post of vice chairman of the board. However, best practice today is for the Party secretary and board chairman to be the same person, so as to avoid conflict and competing agendas.

Since most Party Committee members also serve on the board of directors and hold senior executive positions in enterprises, it is clear that this inner group will already have discussed key issues before any board meeting. There will be little need, therefore, for most executive directors to say much in board meetings, with only the chairman or general manager conveying the agreed opinions of the Party Committee. This would diminish the potential for discussion between directors and reduce the contribution of non-executive directors, especially independent directors, on major decisions.

Clarifying the Division of Labour and the Role of Board Committees

While the new policies state clearly that Party Committees should pre-approve all important decisions of the enterprise, it is likely that foreign investors will remain confused as to the division of labour between the Party Committee and the board. The reforms also raise questions about the function of certain board committees, especially on nomination, since oversight of major appointments to the board and management come within the purview of the Party Committee, which itself reports to higher ranking Party organisations.

Concerns of Foreign Direct Investors

Under this new wave of reform, privately-owned enterprises in China have to accept that Party Committees in their firms will do more than just 'organise social events for Party staff members'. Some seem happy to do so, including foreign-owned ones. Qi Yu, deputy head of the Central Organisation Department, said at a briefing on the side of the 19th National Party Congress in October 2017: "Some senior executives at foreign-invested companies say Party Organisations can help them understand China's policies in a timely manner, resolve labour disputes and provide positive energy for their companies' development.

The majority of them welcome and support Party Organisations carrying out activities in their companies."

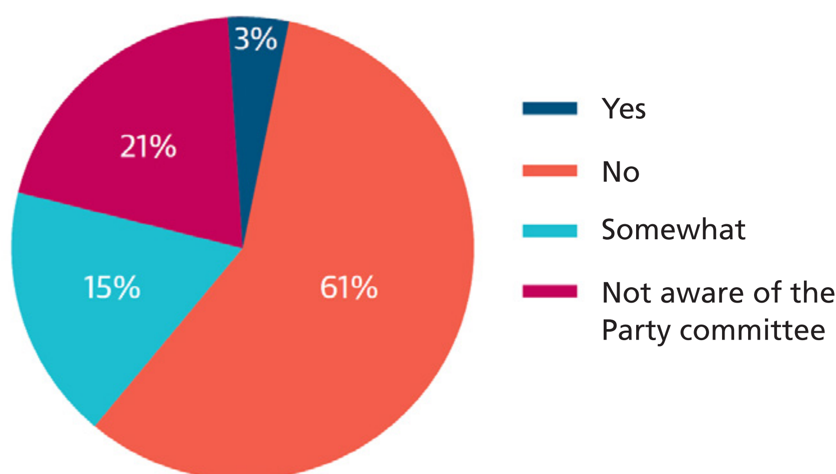
Indeed, Party units in foreign-invested companies more than doubled over 2011 to 2016, from 47,000 to 106,000, according to Qi. And around 70% of all foreign-funded firms in China—about 75,000—had set up Party branches. This is about the same proportion as for China's private sector, where almost 68% of private businesses had set up Party branches by the end of 2016.

Nevertheless, not all foreign multinationals have been so sanguine. In early November 2017, the European Union Chamber of Commerce in China issued a statement saying that while it respected China's law allowing for the establishment of Party Organisations in businesses in general, including foreigninvested enterprises, it objected to the formal extension of Party Organisations into the governance of joint ventures: "The corporate governance requirements under the Company Law and the Equity Joint Venture (JV) Law are clear, the board of directors is the highest authority of an equity JV and responsible for all key matters of the JV … The European Chamber is not aware of any legal development that provides a basis for changing the corporate governance arrangements in JVs in this manner." And further: "A fundamental change of this nature would introduce an additional layer of governance and would have serious consequences for the independent decision-making ability of these JV companies."[4]

On 24 November 2017, the Delegations of German Industry & Commerce in China, part of the German Chambers of Commerce Worldwide Network, expressed identical concerns regarding wholly foreign-owned companies operating in China.[5] This came one week after the German Chamber of Commerce in China told a press conference that German companies were worried about the possibility of having Party members interfere in their operations. In their announcement, the Delegations stated: "Current legal and business practices create neither an obligation nor legal basis for companies to proactively promote the development of the Party within the respective companies … We do not believe that foreign invested companies generally should be required to promote the development of any political party within company structures. This is an individual decision by corporate management and should not be guided at the behest of third parties." They also

Is the Party's role clear?

Foreign investor views on whether the Party committee has a clear and accountable role in listed companies



[4] The European Union Chamber of Commerce in China, "Chamber Stance on the Governance of Joint Ventures and the Role of Party organisations", 3 November 2017. See: http://www.europeanchamber.com.cn/en/press-releases/2583/chamber_stance_on_the_governance_of_joint_ventures_and_the_ role_of_party_organisations

[5] Delegations of German Industry & Commerce, Press Announcement, 24 November 2017. See: http://china.ahk.de/. See also South China Morning Post, "German trade body warns firms may pull out of China over Communist Party pressure", 29 November 2017. See: http://www.scmp.com/news/china/economy/article/2122104/german-trade-body-warns-firms-may-pull-out-china-over-communist

declared: "Should these attempts to influence foreign-invested companies continue, it cannot be ruled out that German companies might retreat from the Chinese market or reconsider investment strategies."

Conclusion: Next steps

As our Foreign Institutional Investor Perceptions Survey 2017 shows, most foreign institutional investors would welcome more explanation and clearer lines of accountability around Party Organisations/Committees. What would such transparency look like? First, a model already exists with the reports that boards of directors and supervisors must present to the annual meeting. A report from the Party Organisation/ Committee could include details on membership, structure and specific activities during the year. Second, the report could explain how the committee has addressed the "Three Important, One Large" decisions and explain its relationship and division of labour with the board of directors. Third, enterprises could engage more actively with their minority shareholders and brief them on the Party organisation's work.

Indeed, for any H-share company listed in Hong Kong, it is expected that they will now need to disclose the role of the Party Organisation/ Committee under the listing rules of Hong Kong Exchanges and Clearing (HKEX). Hong Kong's code of corporate governance requires that listed companies comply with, or explain their reasons for not doing so, board governance principles such as: "An issuer should be headed by an effective board which should assume responsibility for its leadership and control and be collectively responsible for promoting its success by directing and supervising its affairs." This is clearly a different model to that existing today in mainland China and requires corporate governance policies and practices to be adapted.

ACGA

The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership organisation dedicated to working with investors, companies and regulators in the implementation of effective corporate governance practices throughout Asia. ACGA was founded in 1999 from a belief that sound and improving corporate governance is fundamental to the long-term development of Asian economies and capital markets.

ESG Investing in Real Estate – How a Family Office Put it into Practice

K O Chia, Deputy CEO & Director, Grace Financial Ltd.

Introduction

In recent years, there are many discussions on ESG (Environmental, Social & Governance) considerations in private equity investments. However there seems to be confusion around the concept and its application and how it relates to other initiatives like CSR (Corporate Social Responsibilities) and SRI (Sustainable Responsible Investments).

Adding further to the confusion is the emergence of a variety of acronyms such as UNPRI, Cert B Corp, UN SDG, etc. from different organizations. Each seems to propose the next ESG reference standard. The question is whether there are significant differences in each of these; or, are they saying the same thing in different contexts, practices or measurements using different terminologies. Hopefully, over time there will be convergence into a set of standardized metrics in accordance to sectors.

For people wanting to engage in understanding ESG and the other acronyms, it is necessary to understand the context and its applicability to the particular situation and sector. In my mind, each of these acronyms has its own merits and applications with emphasis on addressing certain ESG elements. They have to be viewed in the context of their respective sector and their applicability to said sector. In certain sectors, like health care or education, the sector is inherently social in nature as compared to others like oil and gas or electricity generation that causes pollution concerns. So, we need to reserve judgment as one size does not fit all.

However, there is some common ground. In general, all of these are expressions of genuine responsible, sustainable and ethical business practices rather than a "tick the boxes" activity. The common view is that ethical, sustainable and good companies are likely to provide better returns over a longer period when CSR or ESG are put into practice. But on the other hand, corporate CEOs are constantly faced with the dilemma of being measured on quarterly earnings against longer-term programs so that they may or may not see the benefits of the implementation of CSR or ESG. Hence, CEO's decision-making between a shorter versus a longer-term perspective is often being compared against their traditional and customary performance measures.

The Role of Development Capital and Institutional Capital

Initially, the ESG framework came about through the Development Financial Institutions (DFI) from Europe, and the International Finance Corporation (IFC) in the U.S. The motivation was to engage emerging market private equity fund managers to build long term sustainable companies when they become LPs. The original idea is to use DFI capital to engage fund managers to build sustainable companies through the ESG framework. It is to develop, inculcate international standards of good governance with a view to uplift communities through economic means in emerging markets. The ESG initiative focuses on building sustainable businesses and help focus the mind on measurable outcomes as a way to generate better returns over the longer term. That is the mission of DFI and IFC.

As it evolves, institutional LPs, particularly

government and public pensions, realize that the ESG framework is a good way to assess and manage risks. It also helps the fund manager and their portfolio companies to become more aware of the merits of the ESG framework and the need to think longer term. Since these institutional LPs represent pensions that are public money, it is also their fiduciary duty to their clients to ensure that the pension money is invested in a responsible way and in sustainable investments. This framework fits well into the due diligence process that is similar to the one used by DFIs.

The trend has now spread towards public markets to the point that many stock market exchanges now insist that listed companies report on their ESG initiatives. Since 2016, the Hong Kong Exchange's listed companies must report on their 'comply or explain' stance on ESG guidelines. Prior to 2016, such reporting was on a voluntary basis. The requirement to report focuses the attention of management beyond just a tick box activity. Initially, ESG reporting by listed companies merely focused on staff volunteering activities in partnership with non-profit organizations for social communities. In more recent years, it has become more sophisticated and requires reporting on carbon emissions and credits, and ESG audits on their supply chains to ensure their products and services are not impacted because of the supply chain. Indeed, this has created an overall positive awareness of corporate ESG responsibilities.

Family Office role in ESG investing

Family Offices (FOs) were early advocates and adopters of ESG investments in using capital as a way to activate transformation. While FOs have traditionally engaged in conservative investment programs, the new generation of FOs managed by younger family members tend to be more aware of the environment and social issues around them. Therefore, investing using the ESG lens has gained a more robust momentum through FOs, particularly through the well-publicized Gates Foundation, and the former eBay founders, Jeff Skoll and Pierre Omidyar respective initiatives.

Although every FO is different, ESG and purposeful investing seems to be a consistent and common denominator. However, each FO has its own different interpretation of the ESG framework. Some consider it is a good idea, particularly the younger generation. Others feel it should be best dealt within their philanthropy efforts. Each approach is different, some focus on thematic sectors like education, healthcare or more broadly on climate change while others pursue in accordance to their passion and values in a more innovative way.

ESG in Real Estate Investing

Real estate is perhaps one of the more traditional, conservative and established investments. In recent years with the technology disruption and emergence of a new generation of investors and family offices there are changes in real estate investing. One of the changes is incorporating ESG factors into real estate investments.

At Grace Financial as a FO, we attempted the Community Based model to incorporate ESG factors with the deliberate engagement of the community eco-system where the real estate is

located. Community consists of tenants, non-profit organizations, local people living around there, local council and other businesses. We worked together with like-minded local investment partners to brainstorm different ideas. Rather than the classic landlord-tenant as them-us closed system in the commercial property, tenants are treated more like client-partners and form the core of community eco-system where community activities involve them. In the re-furbishment process of old properties while bringing them up to the latest international standards with energy saving climate control systems and high-speed broadband connectivity, certain heritage characteristics are retained. In line with community theme, the property launch was by inviting a team of professional drone flyers to stage a drone flying competition within one of the building's large open floor plate. Naturally it attracted a crowd and the press where it became the talk of town.

Within the commercial property it was an opportunity to open up the once closed lobby to create an open lobby for co-working purpose with a café that also became a community hub. The space also attracted different community groups to organize events of talks and knowledge exchange and traffic flow. The other difference is the company chosen to operate the cafe was not only a profit-making entity but also deliberately employed and trained ex-offenders to give them an opportunity to reintegrate into society. Besides serving good quality coffee and services as the requirement, it has a meaningful social element where it is making a difference in the life of certain coffee shop employees who are given a second chance. That in our mind is more ESG and impactful than any other measured metrics.

Through a series of deliberate social, art and cultural programs involving different community stakeholders it was a purpose way of being part of the local community. An example of one such program was to work through a non-profit organization to bring disadvantaged youth in the city to our real estate outlet on an open day to inspire them to be barristers through visiting a law firm that is one of the tenants; or, simply knowing how a barista works in the coffee shop. This brought the different tenant clients to get to know each other. Such community engagement brings buzz and traffic flow into the real estate facilities in a meaningful and deliberate way.

In another real estate investment, the once closed sports facilities on top of the buildings are being upgraded and opened for the community again. It is welcomed by the community. The previous owner had closed them for cost-cutting reasons.

While I have mainly described the real estate investments, we apply a similar approach for other types of private equity investments. The key to such effort is the ability to engage with like-minded partners who share the same philosophy of not just making good profitable investments but who also share the view that it has a positive impact on the community. The profit target is not compromised, as it is sometimes believed. For us, it has been an amazing experiential journey where we continuously challenge ourselves to learn to unlearn and re-learn in the process. I believe this is an alternative way of investing that brings meaning and positive impact that is ever more fulfilling.

KO Chia, Grace Financial

Mr. Chia is Director of Grace Financial Ltd., a Hong Kong based family office, serving as a member of the executive team. He brings 30+ years of diverse international experience as venture capitalist, entrepreneur and corporate executive across Asia, Europe and U.S. Currently he serves as President of the HK Venture Capital & Private Equity Association (HKVCA) and Member of Advisory Committee, School of Continuing & Professional Studies at Chinese University of Hong Kong. Previously he had served as Chairman of Advisory Board, College of International Education at Hong Kong Baptist University as well as a member of the HKSAR government's Community Investment & Inclusion Fund (CIIF) to promote social capital for community revival from 2007-2013.

He holds an MBA from Strathclyde University, Scotland, DipMS from Edinburgh Napier University, Scotland and BEng (Hons) Electronics Engineering from Sheffield University, England. He is also a Fellow of Hong Kong Institute of Directors.

ESG Integration: When One Size Does Not Fit All

Samantha Anders, Research Associate, ILPA

Environmental, Social and Governance ("ESG") strategies, criteria and monitoring methods are topics of discussion that have become extremely prevalent in the private investing ecosystem. From the conference circuit to due diligence discussions to internal institutional investor conversations, investors and fund managers alike are eager to define, understand and integrate ESG elements that reflect their organizational values and investment objectives. Formulating ESG strategies, criteria and monitoring methods is a process that is unique to each entity. When it comes to private equity best practices, the Institutional Limited Partners Association ("ILPA") will often offer a prescriptive approach for consideration. Yet, ESG criteria formulation and integration is an area where one size does not fit all. Thus, the Association better serves the industry by sharing a broad swath of resources – an ever-expanding toolkit -- that allows LPs to curate their own strategies from a range of options.

ILPA's ESG toolkit is currently comprised of guidance featured in our recently released Principles 3.0, our standard Due Diligence Questionnaire (ILPA DDQ), and the Portfolio Metrics Reporting Template (PortCo Template). These tools, however, are just the beginning. Through numerous channels, we intend to continuously gather additional ESG insights and share those with LPs on a global basis.

ILPA Principles 3.0

Initially published in September 2009, the ILPA Principles is a best practices document aimed at improving the private equity industry for the long-term benefit of all participants and beneficiaries. A third iteration of the Principles ("Principles 3.0"), released in June 2019, builds on prior versions by addressing an expanded array of issues, taking into consideration evolving industry and market dynamics impacting private equity fund partnerships. Notably, the most recent version of the Principles addresses and provides guidance regarding ESG integration.

In Principles 3.0, we assert that LPs should have timely access to and notifications on material ESG matters pertaining to the portfolio, and expect that all potentially material risks and opportunities for the fund are identified and managed by the GP. Several reporting frameworks have been established to help LPs understand, verify, and assess a GP's processes for ESG integration including: ESG Disclosure Framework for Private Equity; PRI Limited Partner's Responsible Investment Due Diligence Questionnaire; IFC Toolkit for Disclosure and Transparency; PRI ESG Reporting Framework; and ILPA's PortCo Template voluntary ESG reporting section. Additionally, LPAC mandates should include reviews of material ESG incidents and/or risks to the fund's portfolio, and LPAC meeting agendas should include ESG reporting.

Principles 3.0 also offers guidance on how to apply ESG-related expenses borne by the fund such as consulting costs for ESG due diligence, management and reporting. ILPA advises these expenses should be treated similarly to operational due diligence consulting costs. If specialized consultants are required by an

individual LP, then those fees should be borne by the requesting LP. Notably, LPs should consider the ability of the GP to deliver on more bespoke or detailed ESG-related disclosure requirements when formulating such requests. Conversely, GPs should take into account that LPs may have limited flexibility to change their ESG disclosure requests due to institutional policies and other requirements.

The Principles also include best practices for GPs regarding ESG integration. First, GPs should consider maintaining and periodically updating an ESG policy, providing most recent iterations to all LPs or potential LPs on request. The policy should include sufficient information to enable an LP to assess the degree to which the GP's investment strategy and operations are aligned with an individual LP institution's ESG policies, including how ESG is factored into due diligence as well as incident disclosures and performance reporting. The policy should identify procedures and protocols that can be verified and/or documented. GPs can also demonstrate their commitment to ESG as an investment philosophy through a responsible investment policy, or by adhering to industry standards such as the Principles for Responsible Investment or the AIC guidelines for Responsible Investment.

The ILPA Principles assert that both the LP and the GP will benefit from a clear understanding of mutually agreed outcomes at the start of a fund. LPs may wish to affirm this understanding in the fund terms through a side letter, if their requirements are not already covered by the applicable representations made by the GP in the LPA. However, the LP should understand that the GP's approach to ESG will evolve over the lifetime of the fund. Therefore, while expectations should be made clear, there should be flexibility for adaptation and dialogue.

ILPA Due Diligence Questionnaire (ILPA DDQ)

ILPA released an updated version of its due diligence questionnaire in September of 2016, expanded to include an ESG section, which was adopted from the PRI's Responsible Investment DDQ. Included are several fundamental questions to help LPs understand a GP's approach to ESG, whether they have ESG policies and standards in place, whether they make ESG commitments to investors, and whether they encourage ESG standards in their portfolio companies. More detailed questions then give GPs the opportunity to expand on their ESG policies in general, and how ESG factors influence their investment beliefs. The questionnaire also asks GPs to provide detail on how their firm identifies and manages material ESG-related risk, how it uses ESG factors to create value, and how the firm contributes to its portfolio companies' management of ESG-related risks and opportunities. Finally, it asks GPs to provide information on how LPs can monitor, and, where necessary, ensure that a fund is operating consistently with agreed-upon

ESG-related policies and practices, including the disclosure of ESG-related incidents.

In September 2018, ILPA expanded its DDQ to include elements that promote the advancement of diversity and inclusion within the private equity industry. This expanded version included a set of questions to enhance understanding of a GP's policies and procedures in areas such as hiring, promotions, family leave, mentoring, and harassment and discrimination. These questions are meant to enable LPs to gain a better understanding of a GP's existing diversity and inclusion related initiatives, as well as recent progress made and the GP's willingness to make positive changes in the future.

There are also questions aimed at helping LPs understand GP firms' track records regarding diversity and inclusion, specifically discussing recruitment, composition, retention, and promotion of diverse groups. GPs are also asked to disclose any claims of sexual or general harassment, misconduct, or discrimination that have been made against any of the current and/or former firm employees within the last five years. A Team Diversity Template is also included along with the updated questionnaire, intended to measure both the gender and racial/ethnic composition of GP firms by seniority in select regions of the world.

ILPA Portfolio Company Metrics Template ("PortCo" Template)

In February 2019, ILPA published its PortCo template, answering the need for a more efficient and comprehensive method of reporting portfolio company metrics for buyout and growth equity funds to limited partners. The PortCo Template offers a standardized format for these reporting details about the individual companies so that LPs can receive more timely and consistent data, while GPs can report more efficiently without the burden of fulfilling multiple, customized requests. The PortCo template contains a separate, voluntary ESG template, to be used by GPs who wish to support the growing LP-demand for transparency into enterprise-level ESG initiatives. This template gives GPs the opportunity to report on a number of material ESG factors relating to their portfolio companies, including policy, monitoring, resources, and industry and sector specific KPIs.

ESG and LP Insights

ILPA has recently hosted interactive, LP-focused events in Stockholm, Copenhagen, and Toronto, facilitating discussions focused on ESG strategies and approaches. The objective of these forums is to bring LPs together to share philosophies and experiences about respective ESG journeys, and to share practical advice on ESG implementation. These forums, which are expected to continue, will be especially valuable as ILPA facilitates the sharing of best practices that can be applied to our member programs.

Looking Forward: A Roadmap for Consideration

There is no doubt that ESG is becoming increasingly important to the private equity industry– specifically to LPs. It comes up repeatedly, and while LPs are at all different levels of ESG integration, most are actively considering how they will address the increasing call for responsibility and accountability in their programs. To further address the needs of the LP community, ILPA will be releasing an ESG Roadmap & Resources guide by the end of 2019. This document will catalogue practical actions and industry resources which LPs of all sizes and stages of "ESG readiness" can take to further integrate ESG considerations into their investment strategies. It is intended to be a living document, compiling resources from a variety of industry sources, including ESG-focused associations and organizations, as well as LP institutions.

Momentum towards ESG integration continues to grow, and the landscape for action is constantly evolving. ILPA looks forward to working with the PE ecosystem to continue to advance the ideals that are important to limited and general partners alike, and allow for a healthier, more vibrant industry.

ILPA

With more than 540 member institutions representing over $2 trillion USD of private equity assets under management, the Institutional Limited Partners Association (ILPA) is the only global organization dedicated exclusively to advancing the interests of LPs and their beneficiaries through best-in-class education, content, advocacy and networking. For more information, please visit ILPA.org.

Integrating ESG in the Private Equity Secondary Market

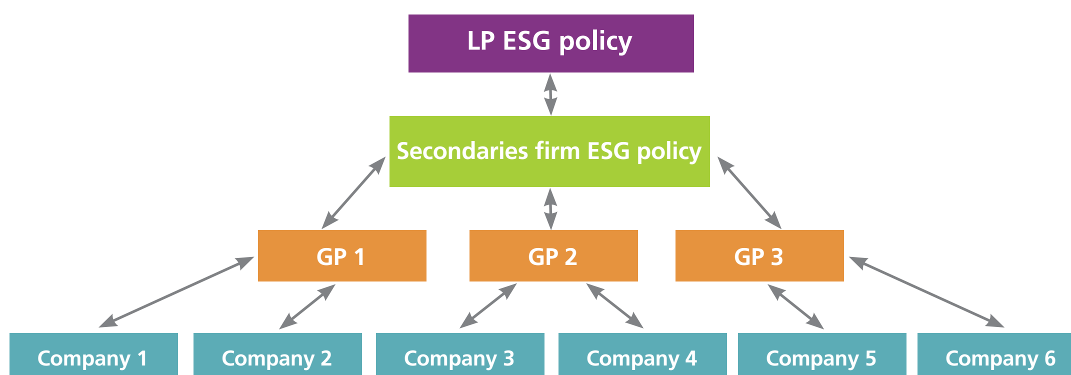
Adam Black, Head of ESG & Sustainability, Coller Capital

In the 1990s and early 2000s ESG factors were largely seen as short-term risks to be discussed as part of a firm's due diligence during price negotiation. It should be noted that some banks and pension funds became concerned about reputational factors and exposure to longer-term risks. Few, if any, managers at the time actively engaged with their portfolio companies on ESG factors, and it was rare to see ESG highlighted on exit as a lever of value creation. By 2010, however, much more progress had been made: the United Nations had launched the Principles for Responsible Investment (PRI); the first GPs had signed up to the Principles; and many more had adopted formal ESG policies. Critical to this progress was the role of asset owners – with LPs becoming increasingly interested in ESG. The integration of ESG into private equity had begun. At the sponsor level, buyout managers led the charge, because of their greater ability to affect meaningful changes at portfolio companies.

There was less focus on ESG by secondary managers, most of whom relied on portfolio company managers, or undertook only high-level due diligence. Coller Capital started the process of integrating ESG into secondaries in 2011 by developing an ESG policy. We recognised that in the secondary market there is the potential to engage many managers – thereby amplifying the impact of ESG.

Integrating ESG into the investment management process of secondary managers, not only amplifies the impact of the secondary fund itself, but also of the fund's investors (to the extent they actively pursue ESG policies), as demonstrated in the diagram below.

In secondaries, a different approach is required for traditional fund positions and 'direct' secondaries. For traditional secondary investments, where usually the fund takes a minority position, a typical approach would be to form a view on the ESG policies and performance record of underlying managers and a sample of their underlying portfolio companies (typically the larger businesses). It is



also helpful to overlay a 'screening' tool, such as a third-party database (RepRisk). A secondaries fund manager has more influence in 'direct' secondaries, and would therefore seek to ensure that ESG is a formal component of the GP/ portfolio company relationship throughout the lifecycle of an investment and often ask more detailed questions about ESG at the GP and portfolio company level.

Integrating ESG into the investment process

By integrating ESG into the investment process, a secondary investor can influence underlying GPs and their portfolio companies. The objective is to achieve appropriate behaviour of underlying GPs by influencing their ESG cultures and emphasise the importance of the potential positive financial impacts of ESG-related risk management). ESG can be integrated into all stages of the investment process, for all transaction types and asset classes, and some level of ESG analysis should be undertaken for every investment under consideration. Processes should also be in place to notify investors of material ESG-related incidents should they arise and engage where needed, post investment.

Where appropriate, a secondary fund manager can help develop or enhance ESG policies and programmes at underlying GPs within their platform. They can do this by working closely with certain managers where there is room and potential for influence. For example, they can organize ESG workshops, visit portfolio companies, and assist in crisis situations. In addition, all investment professionals should receive training in ESG matters in investment decision-making and management, e.g. in-house training, on the job training and ESG e-learning courses.

ESG is an important tool that can be used to create and protect value, mitigate risk, and enhance the overall investment management process. It is important to take a commercial approach to ESG adoption and promote a positive culture in the management of ESG factors.

ESG initiatives at portfolio companies

Each GP adopts its own ESG style and approach, and managers differ significantly in how they engage with their portfolio companies. GPs should be encouraged to back ESG initiatives that fall into one or more of the following categories:

- Revenues: top-line growth and competitive advantage derived from new, ESG-related products or services (e.g., on-site renewable energy generation; or the sale of greener or more socially responsible products).
- Savings: financial cost savings and/or reduced ESG impact (e.g., production or supply chain operating efficiencies resulting in fewer incidents or accidents; improved energy efficiency; reduced waste generation or water consumption).
- Brand protection: cost avoidance and value enhancement from de-risking a business and reducing the likelihood of reputational damage, e.g., measures to reduce the likely severity of an incident or to de-risk a supply chain.

A secondary manager and any investor directly investing in funds should seek a meaningful consideration of ESG issues by portfolio GPs at all stages of the investment process: during initial due-diligence; within the holding period; and through to exit.

Organisational ESG culture

ESG monitoring and reporting

ESG performance should be tracked through various formal and informal mechanisms (bespoke, quarterly, annually) and communicated to investors. It is important to ask for material information on both risks and opportunities, by exception and regularly. Periodically, the secondary fund manager should engage with GPs who have been identified as 'higher priority' from an ESG perspective, because of their investments or ESG programmes.

All major underlying portfolio GPs should complete an annual ESG questionnaire in order to track their progress on ESG. This enables reporting at the portfolio-level, where progress can be reported to investors, as well as used as a benchmark for the firm's progress in implementing their own ESG policy.

ESG at the level of secondary managers

In addition to their engagement with portfolio GPs, secondary managers should pursue appropriate ESG initiatives with respect to their own operations. Coller Capital, for example, is focused on improving diversity and inclusion throughout the firm. The firm has also introduced measures to ensure that ESG and sustainability considerations are part of the procurement process, and this year it has achieved climate neutral status, by offsetting its carbon emissions.

Conclusion

Secondary managers' ESG programmes continue to evolve. Coller Capital believes it is important to continue to embed ESG considerations both into investment management processes, and more generally into practices and behaviours as a business.

Adam Black, Head of ESG & Sustainability, Coller Capital

Adam is Head of ESG & Sustainability based in the Firm's London office.

Adam has been an ESG specialist for over 25 years (10 years in private equity). He is active with Invest Europe, the BVCA, Hong Kong VCA and the UN-supported Principles for Responsible Investment (including as a former member of the Private Equity Steering Committee). He is a frequent speaker and writer on ESG in private equity, and the finance sector more broadly.

Prior to joining Coller Capital in 2016, Adam was a Principal and Head of Sustainability at mid-market private equity firm Doughty Hanson. During his time there, he developed the Firm's responsible investment strategy and supported the deal team and portfolio management to address environmental, social and governance risks at company and fund level. Previously, he worked at KPMG, at ERM and at Halliburton.

Utilizing Alternative Data for ESG Due Diligence

Interview with Jason Tu, Co-founder and CEO of MioTech

Making use alternative data to support ESG due diligence and monitoring is becoming a reality.

Alternative data, or unstructured non-financial statement information about a particular company that is provided by sources outside of that company, are increasingly utilized by institutional and professional investors in investing and risk management, thanks to the improved power of artificial intelligence (AI) enabled by analytic technology providers. Miotech is one such AI platform providing integrated data and analysis to investors, and it differentiates by specializing in and advocating ESG intelligence as a way to deliver differentiated return and manage volatility and risk.

"Buyside firms, banks and even sovereign wealth funds are leveraging alternative data for conducting ESG due diligence", says Jason Tu, Co-Founder and CEO of MioTech. Fund managers are increasingly required by investors to have an established ESG strategy or to at least conduct ESG-related reporting as a way to mitigate risk. "We are seeing investors starting to use enhanced ESG strategies since late 2018 as they chase alpha and manage beta, while banks and asset owners want to collect data to analyze ESG risk", said Tu. "This has moved beyond just using corporate social responsibility reporting as marketing and branding gimmicks of mutual funds", he added.

Miotech in particular sees the opportunity in Asia when it comes to ESG strategies. Compared to the investment industry in Europe, Asian managers are lagging considerably with respect to the rigor and readiness in the adoption of ESG strategies. "The European ESG concept is different from that in Greater China", says Tu. "You might find, for instance, that some mainland Chinese companies believe that simply replacing a senior manager is enough to resolve an ESG issue," said Tu.

At the same time, Tu knows that to tackle ESG risk in China, systematic ESG data analysis is needed to identify and quantify the impacts in terms of investor perspective. The time is coming quickly when it will no longer be enough to rely only on a corporate's own data. Tu cited a recent case in Wenzhou where a truck fell from a collapsing bridge, the construction of which, it turned out, was faulty. Under the existing listing requirements, China-listed companies are only required to report their top five suppliers, but no detailed supply chain data. Following the incident, investors were eager to seek out information on all of the suppliers and service providers of the responsible publicly listed construction company, and discovered that supply chain information is not available in its public filings. In such a case, a comprehensive ESG analysis involving alternative data might have revealed the presence of potential outstanding safety issues.

Structured alternative data is also highly desirable in loan financing, for example: a state-owned bank provides CNY 100 million loan facility to a client. The bank is concerned about the possibility of default, so it needs to monitor information on the client – not just information provided by the bank, but also from alternative sources given that a significant ESG risk could

impact the client's potential liability and ability to repay the loan.

The demand is not just from investors. Regulators may also utilize analytics of alternative data to identify and address emerging risks by establishing rules and compliance guidelines. And insurance companies need to consider ESG data when analyzing the risk profiles of their clients.

This is why ESG analytic platforms like Tu's MioTech are increasingly proving desirable in extracting and making sense of alternative ESG data. "ESG data analytics is different from traditional accounting and valuation, as investors are simply not able to pull that data from existing financial statements – the data is not standardized", Tu said. In terms of processing ESG data analytics, he said the most challenging part is "cleaning" unstructured data from a basket of raw information. "Most ESG data sources are scattered and discontinuous, and data is present in different formats, be they images, text, video, sound, and so forth. The data is difficult to quantify, and it is challenging to conduct historical back-measurement over time. Moreover, alternative data collected by environmental protection organizations and NGOs typically contain a lot of 'noise', which requires us to 'clean it' and de-duplicate it many times over before it is actually useful."

Tu believes that ESG analytics will continue to grow substantially over the coming years as it begins to be used across more sectors and in imaginative new ways. "Greta Thunberg was just selected as Time's Person of the Year, and there is no doubt that climate change will be a leading issue from here on out", Tu observed. He added: "Miotech's ESG analytics will expand data coverage from the micro level to the macro level, such as geospatial data. Sophisticated technologies will be applied in terms of functionality, embedding processes such as image recognition and multi-language processing technologies, especially minority lamguages, that can be used across Asia."

It is clear that it is no longer enough for investors to rely on traditional reports and financial statements to mitigate the risk associated with ESG issues. The systematic use and application of alternative data is now an essential tool for providing a broader range view and executing appropriate ESG due diligence in investment decision-making and monitoring.

Jason Tu, Miotech

Jianyu (Jason) is the Co-Founder and CEO of MioTech. Jason's career spans across banking and tech startups around the globe. He kicked off his career at Standard Chartered Bank in Hong Kong, and has since then worked at a number of startups such as WeLab and Robinhood in Mainland China, Hong Kong, and the U.S. Jason holds an MBA degree from Stanford Graduate School of Business, master's degree from Toulouse School of Economics in France, and bachelor's degree from Purdue University.

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