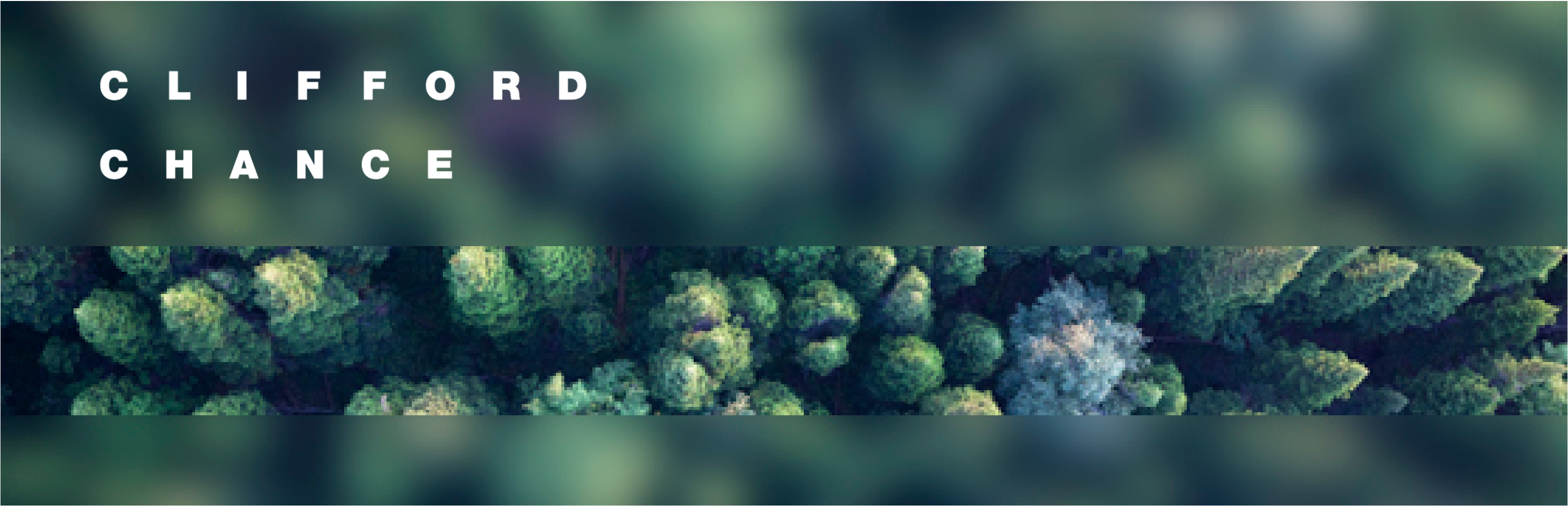

ESG IN ASIAN INVESTMENT MANAGEMENT – WHY THE FUSS?

ESG is making the headlines, one way or another, on a daily basis. Compared with Europe, Asia has generally experienced relatively low and inconsistent regulatory intervention on ESG issues leading to a misconception that ESG may be of little relevance for managers operating in Asia. Nevertheless, there are many practical and compelling reasons why Asia-based managers should ignore ESG at their peril.

Key issues

- ESG refers to a particular approach to risk analysis and mitigation but does not require a manager to pursue an impact investment strategy.
- Recent market and sector shocks have highlighted the general importance of business sustainability.
- Global media has the potential to expose investment managers and their assets to additional reputational risk if local regulatory requirements are met but fall short of international norms.
- ESG-related issues will arise throughout the life of a fund, including in connection with: investor conversations, acquisition and portfolio management, financing, the global regulatory environment, sanctions regimes and portfolio exits.

What is ESG?

ESG is often considered a byword for impact investing. Although the two approaches work together, and may overlap, they are not the same.

"**ESG**" stands for "environmental, social and governance" and refers to an approach to risk analysis and mitigation that pays particular attention to factors that fall within those three broad buckets. A manager that considers ESG factors in its portfolio acquisition process will look to identify areas where a potential portfolio company presents risks of doing harm in one or more of those buckets and will assess whether, and to what extent, such risks may be mitigated. For many managers, this will not be a new process, albeit they may not necessarily have considered the process through an ESG lens.

"**Impact investing**", however, refers to a type of investment approach that actively seeks to make a positive, measurable social and/or environmental impact alongside a financial return.

In short, an ESG approach seeks to identify and mitigate potential harm, whereas an impact approach seeks to create a positive impact.

SUBSTANCE OVER FORM

Two issues frequently associated with ESG are: (a) how to effectively collect, aggregate, analyse and report ESG data; and (b) the risk of "greenwashing". A manager that takes a substantive approach to analysing ESG factors will find that each asset must be assessed on its own merits; two businesses operating in the same sector may have common risks, but will also have a range of risks that are particular to that company's circumstances (e.g., physical location, personnel, supply chains and counterparties, etc.). This may create difficulties when aggregating, reporting and comparing data in a meaningful way. This in turn can lead to the second issue of "greenwashing", where businesses are accused of being selective in the data they gather and report, in order to appear to be ESG-conscious on paper, without actually engaging with the substance of ESG. This may be tempting for managers who are seeking to attract the ever-increasing investor ESG allocation but misses the point.

SUSTAINABLE BUSINESS MODELS

In the age of COVID-19 and a rapidly changing climate (coupled with increased social consciousness, investor focus and political pressure), businesses are experiencing pressures from many directions to be sustainable.

Often, "sustainability" is used as a synonym for "green" and dismissed as irrelevant in the results-driven world of private equity. However, there is a rapidly growing understanding that "sustainability" also refers to the ability of a business to sustain itself through market shocks and weather the storms that may come (in some cases, quite literally).

The COVID-19 pandemic and recent climate events (such as the Australian 2019/2020 wild fires) have brought into stark relief the importance of a business's ability to look after its staff from both a practical perspective (to allow the business to continue to perform), but also a reputational perspective (e.g., if a business is, or is perceived to be, reckless with its staff's health and safety).

In addition, shocks to the day-to-day operations of markets and sectors around the globe, whether as a result of the current COVID-19 pandemic or through more frequent and severe climate events (such as wildfires burning hotter and for longer, or more frequent and damaging floods), may render a business exposed on many fronts (e.g., through disruptions to supply chains, operations, the consumer/client base, etc.).

REPUTATIONAL RISKS

Global media is a factor of day-to-day life, whether through traditional channels or the proliferation of social media, managers are at real risk of lasting reputational damage if the assets in their portfolios are perceived to be reckless, or to do actual harm in the communities and locations in which they operate, even where such assets are fully compliant with the local regulations and norms applicable to their sector. Doing "enough" from a regulatory perspective may no longer be sufficient in the eyes of an increasingly well-informed consumer and investor base. Businesses are now more likely to be expected to "level up" and failing to do so risks not only the reputation of the manager and its other portfolio assets, but also the economic health of the portfolio if consumers/clients turn away from the business. Such reputational risks may come from the actions of the underlying businesses (e.g., poor environmental or health and safety management) or even from the activities of the managers themselves (e.g., poor staff diversity, or shareholder voting records that do not live up to their stated ESG aims).

EYES WIDE OPEN BUT ON FAMILIAR GROUND

Aside from the risks of not engaging substantively with ESG, there are also positive factors that should be considered. Managers will be familiar with an "eyes wide open" approach to risk management, and for good reason. Failing to effectively identify and mitigate risks in a portfolio may cause real damage to the portfolio's balance sheet (whether risks materialise and create liabilities for the relevant fund, or function to reduce the asset's potential sale price on exit), and poorly managed assets may have limited exit options, restricting their market value. ESG builds on what is already common practice in the investment management industry and takes it to the next level; requiring a deeper understanding of the full potential impact of a target's business as well as its exposure to other influences.

FUND LIFE – PRACTICAL ISSUES

In practice, ESG issues are relevant throughout the life of a private fund and can crop up in many ways. We have set out below a few of the more common areas to consider:

- **Investor Conversations**: Managers should be prepared to have meaningful conversations with investors, both at the fundraising stage and throughout the life of the fund. ESG issues are increasingly important, not just amongst development finance institutions ("**DFI**") but also for sovereign wealth funds, pension funds and family offices (albeit a DFI may have a vastly different and detailed set of ESG criteria than a family office). Being prepared to have these conversations from the outset will help to build investor relationships quicker and understanding the substance behind an investor's questions will make these conversations smoother. As a substantive approach to ESG requires detailed and considered tailoring to the wider portfolio as well as each underlying asset, there is no one-size-fits-all approach for dealing with investor ESG questions, but there are some basic themes that the manager can, and should, be prepared to discuss, such as:

  - the manager's policies regarding identification, analysis, rating, monitoring, mitigating and reporting of ESG risk factors; and

  - whether the manager has any "red lines" in relation to ESG risk factors.

  A manager's understanding and expertise in the target asset class, sector and geographies will also be key to these conversations.

- **Acquisitions and Portfolio Management**: Due diligence of potential targets should be tailored and deep. Aside from analysis of generic factors regarding the target's business and location, other factors (e.g., the target's partners/counterparties and customer/client base) may also be relevant and should be assessed on a case-by-case basis. Certain investors may require an environmental and social management system to be put in place, which ensures that the manager will, amongst other things, take steps to assess the environmental, health and safety and community risks and impacts of the proposed target's operations prior to proceeding with an acquisition. After acquisition, the risk profile of an asset may change during its holding period due to both external and internal factors. Therefore, each asset should be the subject of on-going review in order to effectively identify, monitor and mitigate risks during the asset's holding period.

- **Financing**: Sustainability-linked loans have been making their way into the market over the last several years. These are relatively new bespoke products but may include features such as ESG targets or thresholds, which are linked to the interest rate payable under the facility agreement. Any such targets or thresholds should be appropriate and in line with the manager's ESG objectives.

- **Global Regulatory Landscape**: The global regulatory landscape regarding ESG is fast evolving and may impact at the asset level (e.g., setting benchmark industry standards), the fund level (e.g., setting data and reporting requirements) and/or the fund manager level (e.g., setting engagement policy and disclosure requirements). Keeping abreast of these changes and understanding how they may impact a manager's business and portfolio(s) is important, even when the jurisdictions in which portfolio assets are based are not subject to equivalent regulations. If an asset's clients/business partners are subject to certain standards they may expect, or indeed require, their business partners and suppliers to operate to similar standards. Similarly, for a manager, gaining access to a broad international investor base will be aided by an understanding of the standards and expectations of the target investors, based on the norms and requirements of their home jurisdiction.

- **Sanctions**: Sanctions regimes can change with little or no notice and have profound effects on where, and with whom, a company can do business. With the proliferation of global supply chains and international partnering, it is essential that sanctions regimes are monitored and their practical implications understood.
- **Exits**: Having broad exit options, whether on public or private markets, may assist a manager to maximise the value of an asset on exit. If a manager does not maintain its portfolio in line with developing international norms, the manager may find that its potential buyer pool is reduced and the asset's realisable value is limited as a result. In extreme circumstances, a manager may even find itself with stranded assets that cannot be effectively realised.

CONCLUSION

ESG will only grow in importance for the global investment management industry, but this is a challenge that the Asian investment management sector can, and will, raise itself to meet. ESG factors may affect all levels of a manager's business, not just its assets under management, but also its own staff and daily operations. Responding to these challenges will require managers to be proactive in identifying risks and learning to effectively navigate the ever-changing expectations and requirements of their consumers, business partners, investors and industry regulators.

Please reach out to your usual Clifford Chance contact if you would like to discuss how you can better respond to the current situation and take steps to prepare your business for the future.

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