# Are you ESG ready?

## How private equity can stay ahead of escalating ESG demands in Mainland China and Hong Kong SAR

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# Foreword

The international environmental, social and governance (ESG) landscape is evolving quickly, with Europe and the US leading the growth in responsible investment and capturing more than 80% of global market share. Compared to developed western countries, Asia still lags behind. However, Asian investors are catching up and increasingly looking to adopt and apply ESG factors in their investment and M&A decisions.

In China, interest and developments on the ESG front have also experienced a step change, with both government and social pressures fuelling the need for investors to systematically include ESG related performance considerations across their investment analysis and decision making. Over the past year, we have seen a surge in the number of Chinese signatories to the United Nations-supported Principles of Responsible Investment (PRI). This includes some of the most prominent Private Equity firms (PEs) and investment firms in China who have committed to integrating ESG factors into their investment decision making process.

Despite this, responsible investment and ESG integration still remain a novel idea in China, and investment firms are asking for more guidance on how they can factor ESG elements into their analysis.

This article provides the latest ESG trends in Mainland China and Hong Kong SAR, practical guidance on how General Partners (GPs) can integrate ESG factors into their investment lifecycles and ultimately how to successfully implement ESG factors into daily practice.

# 1 ESG trends in Mainland China and Hong Kong SAR

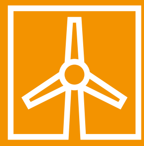
Responsible investment is an approach that aims to incorporate ESG factors along with traditional financial factors when making investment decisions. Responsible investment has progressed from a “nice to have” niche activity to a mainstream necessity. PwC’s *Private Equity Responsible Survey 2019* indicated that, out of 162 corporate respondents, 81% have already adopted a responsible investment policy. The same percentage report ESG matters to their Boards at least once a year[1]. In Mainland China and Hong Kong SAR, the rising demand for ESG can be divided into three buckets – government or regulatory body-mandated, investor or Limited Partner (LP)-required, and voluntary.

**81%**

corporate survey respondents adopted a responsible investment policy

**81%**

corporate survey respondents are reporting ESG matters to their Boards

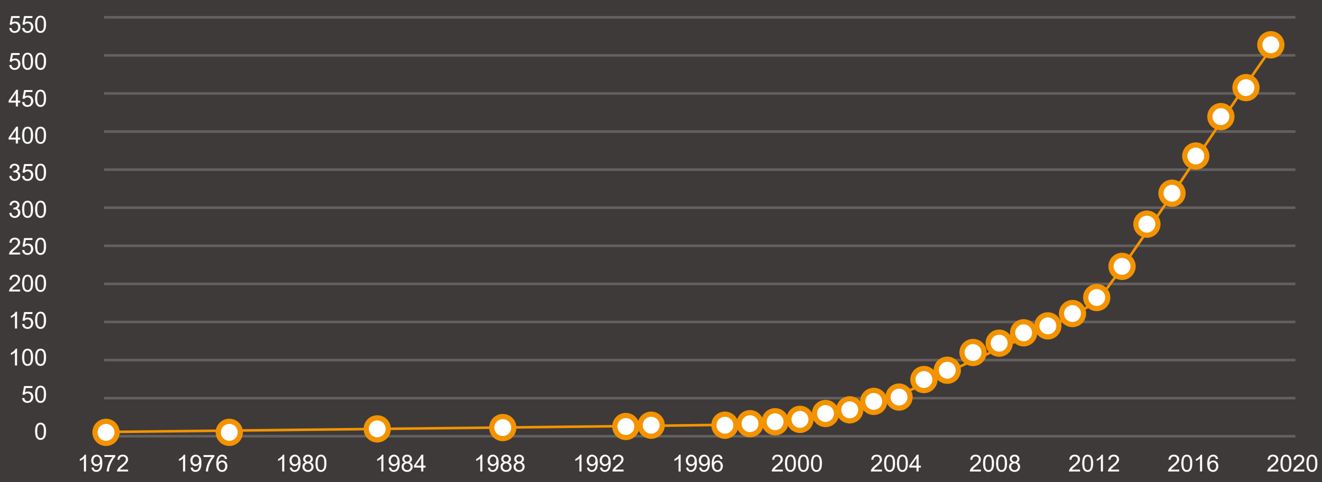


## Government or regulatory body-mandated

Globally, as outlined in Figure 1, the number of ESG regulations have increased more than tenfold over the last 15 years.

**Figure 1**

Cumulative number of policy interventions per year




Source: PRI responsible investment regulation database, PwC analysis

[1] https://www.pwc.com/gx/en/services/sustainability/assets/pwc-private-equity-responsible-investment-survey-2019.pdf

In China, environmental factors typically get greater attention and scrutiny relative to social and governance factors. Having committed to the Paris Agreement in 2016, China has imposed strict regulations to curb greenhouse gas emissions and pollution. At the same time, it is actively promoting renewable energy and electric vehicles through subsidies. In terms of ESG disclosure, China is still ranked low relative to other countries[2]. However, this is expected to change in the next few years. The China Securities Regulatory Commission announced in 2018 that it plans to require publically listed companies to make ESG disclosure by 2020. Both the Shanghai and Shenzhen exchanges have also issued guidance that demands better disclosure on ESG reporting by listed companies.

The Stock Exchange of Hong Kong upgraded its ESG reporting obligation to "comply or explain" back in 2016. In 2019, it issued further updates on gender diversity guidance and the Corporate Governance Code. In addition, the government-backed non-profit Hong Kong Green Finance Association has been established recently with the aim of establishing Hong Kong as a green finance hub.

For PEs considering IPO as an exit route, there is increased scrutiny on listing requirements in terms of ESG. As summarised in Figure 2, all three stock exchanges in Mainland China and Hong Kong SAR are active partners with the Sustainable Stock Exchanges (SSE) – an initiative launched in 2009 to promote responsible investment in stock exchanges and securities markets.

**In China, environmental factors typically get greater attention and scrutiny relative to social and governance factors.**

**Figure 2**

Mainland China and Hong Kong SAR IPO requirements (as at Oct 2019)

| | | SSE Partner Exchange | Has annual sustainability report | ESG reporting required as a listing rule | Has written guidance on ESG reporting | Offers ESG related training |
|---|---|---|---|---|---|---|
| Mainland China | Shanghai Stock Exchange | ✓ | ✓ | ✗ | ✓ | ✓ |
| Mainland China | Shenzhen Stock Exchange | ✓ | ✗ | ✗ | ✓ | ✓ |
| Hong Kong SAR | Hong Kong Exchanges and Clearing Limited | ✓ | ✓ | ✓ | ✓ | ✓ |
| | | | | Note 1 | | |

Source: https://sseinitiative.org/, PwC analysis

Note 1: Latest development of HKEX's ESG requirements

2019:

- An update to the Guidance Letter (HKEX-GL86-16) sets out expected disclosure on ESG matters and requiring disclosures on gender diversity in the listing documents of new applicants; and
- Changes to the Corporate Governance Code made to strengthen the transparency and accountability of the board and / or nomination committee and election of directors, including Independent Non-Executive Directors (INEDs); improve transparency of INEDs' relationship with issuers; enhance criteria for assessing independence of potential INED candidates; promote board diversity, including gender diversity; and require greater dividend policy transparency.

2016:

- "Comply or explain" on ESG. If the issuer does not report on one or more of the provisions, it must provide reasons in its ESG report.

[2] https://www.bloomberg.com/news/articles/2019-06-20/china-set-to-lead-esg-disclosures-to-lure-foreign-investments

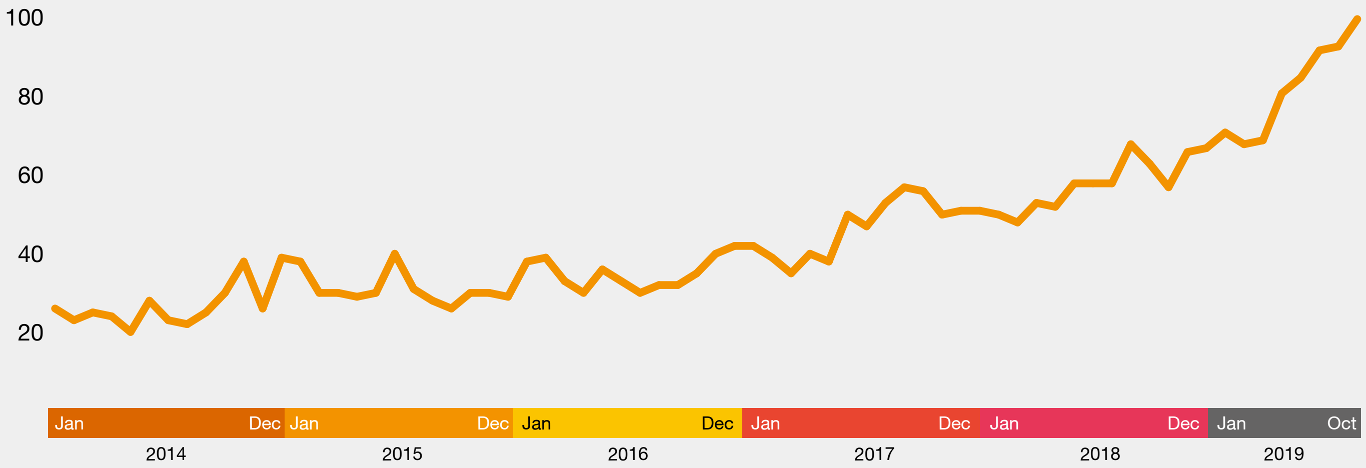
Investors are increasingly stressing the importance of having their investments managed responsibly. LPs are therefore expecting higher levels of ESG standards when selecting GPs.

## Investor or LP-required

Numerous corporate failures and growing environmental concerns have raised overall awareness of ESG in society, as shown in Figure 3. Investors are increasingly stressing the importance of having their investments managed responsibly. LPs are therefore expecting higher levels of ESG standards when selecting GPs. Of course, the ESG areas that the LPs are interested in will depend on how they define fiduciary duty and investment priorities.

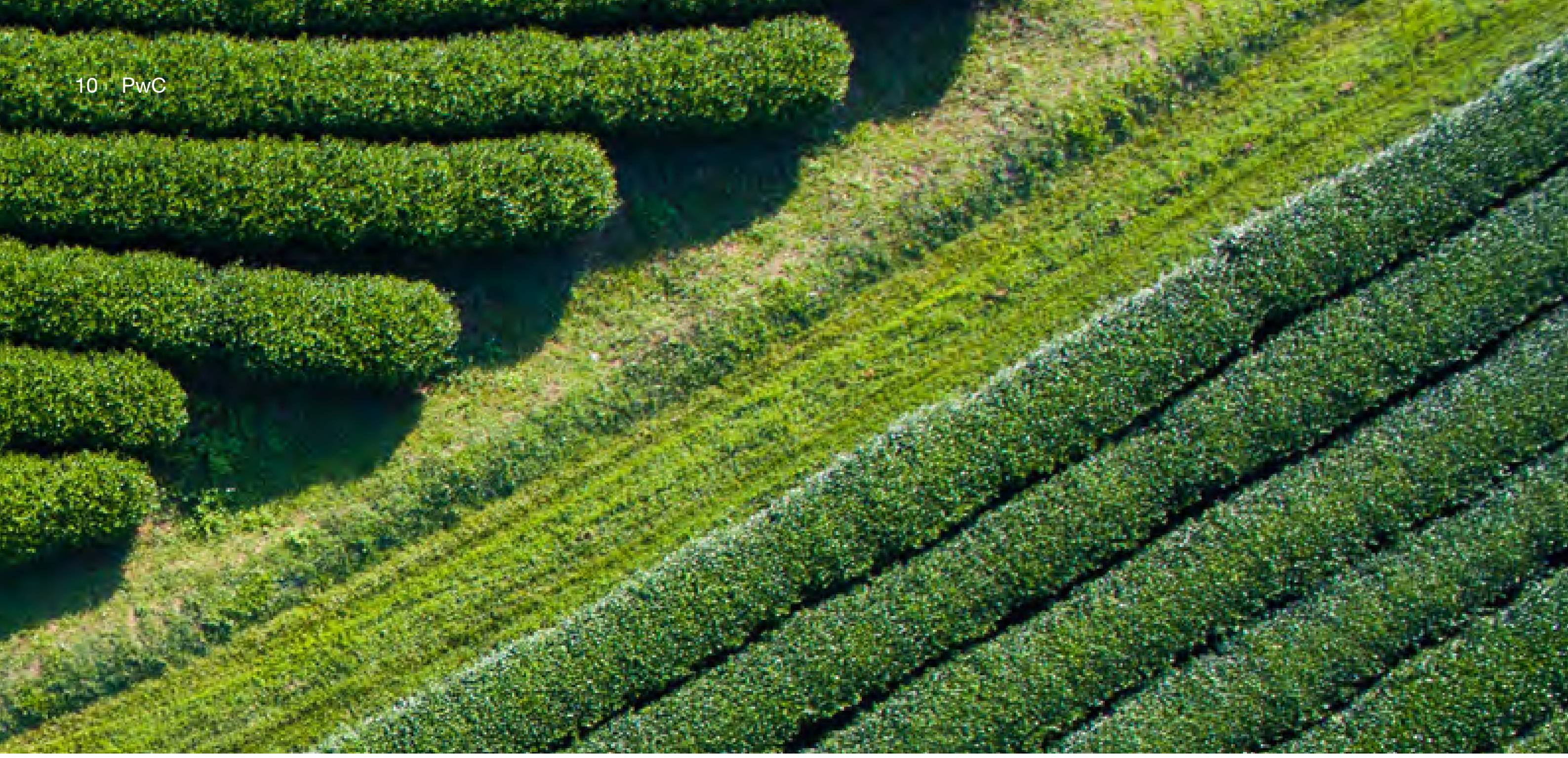
**Figure 3**

Relative interest in Google Search on “ESG”




Source: Google Trends (Oct 2019), PwC analysis

Note: Relative interest in Google Search on “ESG” in the context of finance since Jan 2014; A value of 100 is the peak popularity for the term and a value of 50 means that the term is half as popular.



## Voluntary

In terms of the adoption of RI and integration of ESG across the investment process, PEs can be categorised into three groups: front-runners, middle tier and laggards. Each will have different views on ESG and, therefore, different action plans.

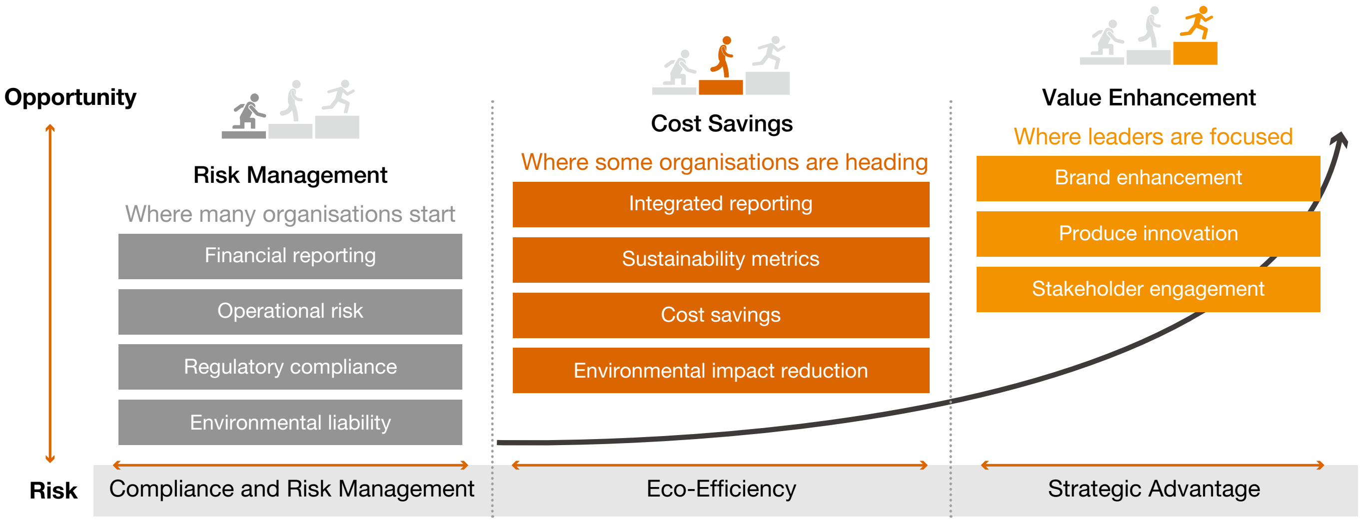
The front-runners understand that ESG factors can be a strategic value driver for their Portfolio Companies (PCs) and therefore lead to value creation and enhanced returns. These forward-thinking groups are already integrating ESG values, goals and metrics into their investment strategies to seize related opportunities for value creation.

The middle tier players typically have an integrated ESG framework in place for their PCs' management processes. Some of these players have started to view ESG as a lever for value creation from a cost saving and an environmental impact reduction perspective. However, a number of these players' ESG frameworks still lack the depth or data points to support more strategic ESG-driven value creation.

The laggards are just beginning to understand and adopt the integration of ESG factors across their investment processes. They will typically focus on financial reporting and management of operational risks and regulatory compliance, with minimal to no ESG related monitoring or reporting.

Depending on the ESG maturity of the PEs, they will tackle ESG matters in different ways, as summarised in Figure 4.

**Figure 4**



# How can GPs integrate ESG factors throughout their investment lifecycle?

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By integrating ESG factors across the investment decision making process, GPs can identify, manage and report risks to create value and generate sustainable, long term returns. Full ESG integration requires both a structural and cultural change across the GP organisation over time. At the outset, GPs must first create an 'ESG mind-set' across their organisation before diving into the integration of ESG factors across the different phases of their investment cycle.

The approach to embedding an organisational 'ESG mind-set' may differ for each GP and can be influenced by many factors including regional nuances, GP organisation's ESG maturity level, size of the GP portfolio and varying level of LP requirements for the GP. However, on an overarching basis, this typically involves:

- **Commitment from the top** – ESG must be considered a long term investment rather than a cost. This can be demonstrated by senior leadership through the inclusion of ESG as a critical component of their long term investment strategy, and clearly articulating the organisation's ESG objectives;
- **Definition of measurable goals and targets** – Setting and communicating clear goals and targets reconfirm the leadership's commitment towards the ESG agenda;
- **Assignment of clear accountabilities** – Notwithstanding compartmentalising ESG integration, this can take the form of establishing a formal ESG committee, or an informal working group led by a senior leader to champion and drive key initiatives with support from selected representatives across the rest of the organisation;
- **Plan and budget** – Developing a detailed plan for ESG integration with clear milestones, accountabilities and timeline will ensure your team remains focused throughout this journey. Moreover, having an approved budget provides the team with required investment dollars to drive outcomes; and
- **Proactive ongoing internal and external communications** – Communication is key to genuinely embed the 'ESG mind-set' across the organisation and engage external stakeholders such as LPs and industry bodies. Internally, this could be achieved through several forms of communication ranging from classroom training for staff, embedding an ESG agenda item into your monthly team meetings, newsletters, visual communications such as posters, sharing of success stories, 1:1 communications with key influencers within the organisation. Externally, this could take the form of the ESG team members directly engaging with LPs, joining industry led ESG working groups, contributing at speaking events or external publications.

Developing an 'ESG mind-set' must equally be supported by a structured ESG framework that integrates ESG factors throughout a GP's investment lifecycle, starting from targeting (due diligence) to taking control of the investment, operating & monitoring, and exiting an investment.

## Targeting (due diligence)

Identifying ESG risks and spotting opportunities for value creation should start early in an investment lifecycle, even as early as the targeting (due diligence) phase. Depending on the findings, the GP may seek formal commitment for future value creation from the PCs during the investment negotiation. To achieve this, the GP can:

- **Tailor the due diligence approach** based on the Target's industry, geographical footprint and operating model;
- **Perform high level due diligence** on the Target against the GP's bespoke checklist;
- **Engage an external advisor** to conduct detailed ESG due diligence and to develop a value creation (or protection) business case. Based on our experience in China, a self-performed ESG due diligence is typically high level and may not uncover the full range of ESG related risks or quantify the financial implications of such risks which are useful for investment valuation purposes. Depending on the nature of an investment, the benefits of engaging an external advisor may far outweigh the exposure an investor may take if the underlying ESG risks remain undiscovered in their target investment;
- **Present the key ESG findings** from the due diligence as part of your investment assessment paper to the investment committees for decision making; and
- **Seek formal commitment** from the Target's management on mitigation of ESG risks and potential value creation initiatives as part of your deal negotiation process.

## Taking control

Depending on the GP's investment strategy, governance model and other factors – such as controlling interest – the way a GP engages with the management of PCs during ownership may differ. For instance, GPs with controlling interest (such as majority shareholding or active board positions) may be better positioned to more holistically influence the PCs' management, whereas GPs with minority interest may adopt a more 'light touch' approach by engaging with the PCs' management focusing only on a few priority aspects of ESG which more closely align with their sustainability goals.

To achieve this, the GP can:

- **Collaborate, develop and implement** an ESG strategy and 100 day plan to mitigate priority ESG risks, whilst agreeing a longer term ESG integration roadmap with the PCs' management;
- **Agree the priority ESG areas** and **align on specific KPIs** for ongoing monitoring over the short or medium term;
- **Collect information from PCs** using structured reporting templates to develop a baseline for future comparison; and
- **Provide tools or support to PCs in monitoring and measuring** ESG performance against agreed KPIs.

## Operating & monitoring

Ongoing monitoring is a critical step for GPs to identify and minimise risk during the investment period, and to gather performance data on the PCs. On top of this ongoing monitoring, the GPs should actively report the overall portfolio's ESG performance to the LPs and other key stakeholders. To achieve this, the GP can:

- **Perform periodic non-financial KPI** assessment either by a dedicated internal team or by an external advisor;
- **Conduct periodic site visits** to verify the PCs' reported information and to demonstrate the GP's commitment to ESG initiatives;
- **Integrate ESG developments into the annual performance review** of the PCs; and
- **Report to LPs** on PCs' performances and other ESG matters.

There is an inherent risk of reporting bias for ESG data, as they are generally self-reported by the PCs without third party assurance and are backward looking which makes decisions more reactive in nature. Therefore, it is crucial for GPs and PCs to align on the timely reporting of ESG data and issues for proactive risk management and value creation, instead of just focusing on managing compliance and operational risks.

## Exiting

Conducting a thorough pre-exit ESG due diligence to identify and mitigate potential ESG risks and operational issues can ensure a smoother exit process. To avoid a negative impact on investment valuation or post-deal exposure upon exit, a GP can:

- **Perform high level due diligence** on the PC; and / or
- **Engage an external advisor** to conduct detailed ESG vendor due diligence on the PC and to provide potential ESG exposure identification.

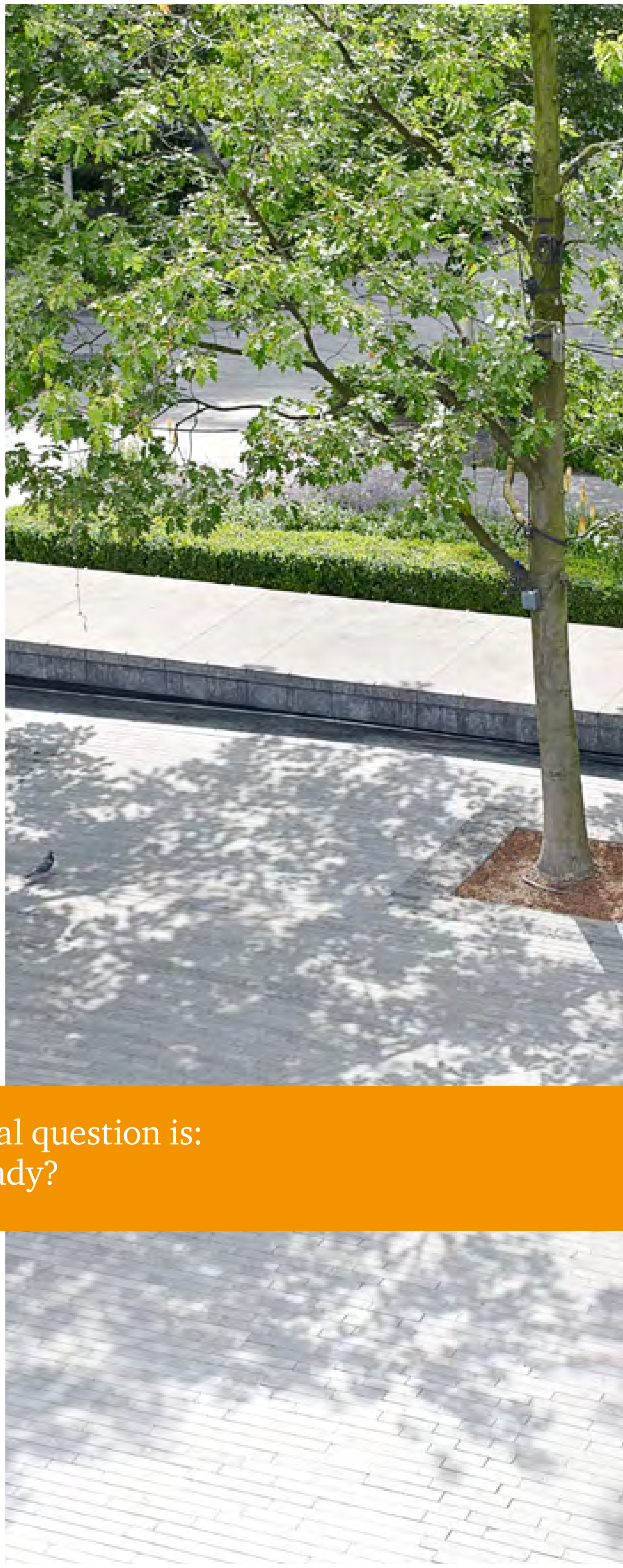
# 3 Looking ahead

Responsible investment covers a wide range of potential environmental, social and governance issues. The relative importance of each individual ESG factor may be subject to external factors and is constantly evolving over time.

Nonetheless, ESG issues are here to stay and will continue to define the role of companies in society. In Mainland China and Hong Kong SAR, we expect a rising trend of rapid development in the investment community's appetite to integrate ESG factors into their investment decision making process. This will continue to be driven by the further evolving ESG related regulatory environment and inclusion of an increasing number of Chinese stocks in the MSCI indices that are likely to be invested in by foreign investors. Specifically for the PE industry, the integration of ESG factors into the investment decision making is imperative, be it for the mitigation of risks or the creation of value.

The fundamental question is: are you ESG ready? For many investment firms in China, there is certainly a long way to go, but firms that invest and accelerate the integration of ESG factors across their investment process will remain ahead of the pack and are likely to create more value from their portfolio of investments.

Regardless of where you are in your responsible investment and ESG integration journey, please contact our team to have a more in-depth discussion about how this issue could impact your investments, and how we can assist you.



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