Jun 2019

Integrating Environmental, Social and Governance (ESG) Policies and Practices into Investment Portfolios

Introduction

The potential for significant negative impacts on an investment portfolio from our changing climate, the dramatic loss of biodiversity in recent years, our emptying oceans, has been well documented but has not yet led private sector investors to act urgently to contain these risks. ADM Capital sees an opportunity to play a leadership role in facilitating portfolio companies to build resilience whilst helping transition to a more sustainable economy.

Being signatories to the United Nations' Principles of Responsible Investing (UN PRI) since 2008, sustainability is interwoven into various lines of business of the ADM Capital Group – whether they be the conventional investments investing responsibly by following robust ESG guidelines (Galleus, ASLF Funds), or those actively placing sustainability at their core (Cibus Fund, TLFF). A common thread is the knowledge base provided by the ADM Capital Foundation, which has been working on environmental solutions across Asia since 2006.

CORPORATE ADVISOR
ADM Capital works closely with portfolio companies to communicate the benefits of ESG, mitigating risk and delivering commercial advantage.

Our consistent approach has gradually worked to convince our portfolio companies of the tangible and intangible benefits of thorough ESG analysis, including improved business resilience, access to a wider pool of funds, and general recognition as leaders. We believe that looking forward, ESG factors will drive investment outcomes like never before, and will soon become a part of mainstream investing. Investors will increasingly view ESG considerations as "necessary" while portfolio companies will realise and seek to optimise the impact that ESG factors can have on the future of their businesses.

Background: The Risks We See

We know beyond reasonable doubt that increasingly erratic and warming climate is driven by human actions. This was made clear most recently in a report from the Intergovernmental Panel on Climate Change (IPCC) showing greenhouse gas (GHG) emissions at historically high levels and "extremely likely" to be the dominant cause of changes to the climate.

The report continues that, if left unchecked, the impact to our economy, environment and society may be significant, representing a global risk to markets and communities. Some news outlets have quite rightly opted to refer to "climate emergency" instead of global warming or climate change, which now seem too tame given the rapid loss of biodiversity and the climatic shifts we are experiencing.

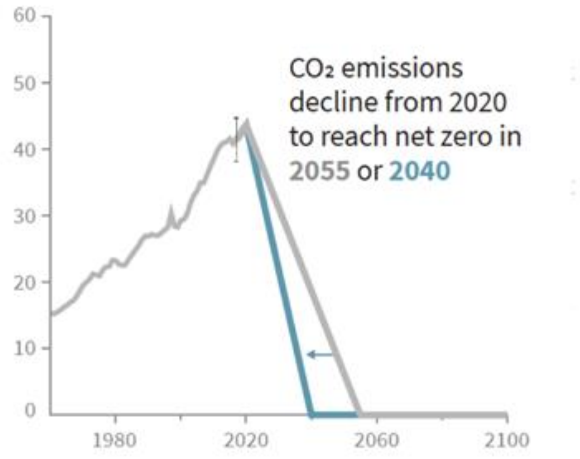
INCREASING EMISSIONS
Atmospheric carbon dioxide levels hit record highs in May 2019. Given population trends and the growth of the middle class demographic in emerging markets, this will only worsen without decisive action from the financial sector.

The economic transformation Asia in particular has experienced over the past two decades has strained our natural systems and pushed our planetary boundaries beyond anything deemed safe. For the first time in recorded human history, in mid-May atmospheric carbon dioxide levels hit 415 parts per million. The last time we saw these levels was estimated to have been 300 million years ago. The IPCC report estimates that emitting no more than 420 billion to 570 billion tons of carbon dioxide would give the world approximately a 66% chance of meeting the 1.5 C temperature goal. We are eating quickly into our carbon budget. That's only around 12 years' worth of current global greenhouse gas emissions. According to the Global Footprint Network, we are using the resources of 1.7 planets and given continuing population growth, expected to reach 9 billion by 2050, and the changing demands of burgeoning middle classes in India and China, that will only expand if we don't alter our consumption behaviour.

Yet there is a cognitive dissonance between our current stasis and what must be done to halve global emissions by 2030, achieve carbon neutrality by 2050 and, as the IPCC report suggests, bring the planet back within safe limits. What is required is a substantial and immediate change in the way we use energy, occupy buildings, produce food and transport ourselves. Yet far from recognising the risk and opportunity in this moment, the response of the financial sector – and elsewhere – to the need for dramatic change is by and large muted.

Stylised Net Global CO_2 Emission Pathways

Billion tonnes CO_2 per year ($GtCO_2$/yr)



Source: IPCC, Special Report 1.5

ACTION REQUIRED

~12.6m people die from environmental health risks annually. Outdoor air pollution contributes to the deaths of 5.5 million people each year, with an estimated annual global health cost of USD5 trillion.

ESG risks to society stretch beyond those directly caused by the climate emergency. According to the World Health Organization (WHO), an estimated 12.6 million people die from environmental health risks annually, about 95% of these in developing countries. Outdoor air pollution alone contributes to the premature deaths of 5.5 million people each year globally, according to the World Bank, which estimates the associated annual health costs to the global economy more than USD5 trillion annually. In all, global environmental damage and other costs of dirty production are estimated at USD 6.6 trillion. Clearly, given the stakes, the drivers of environmental regeneration should be priced into the real economy meaning there are several factors at play that should be factored into any investment thesis.

At the same time, as the middle classes grow rapidly across Asia, value for the majority is quickly being eroded by an inability of governments to keep up with the transformation. There is inadequate investment in infrastructure to build resilience and protect vulnerable populations in particular from drought, polluted air, water and soil degradation, as well as increased risk of food shortages. Not enough attention is being paid to make sure climate-appropriate housing, health care and education are in place. It quickly becomes clear, then, that inequality and environmental challenges threaten asset values and financial stability. Have we properly considered the risk and cost of tens of millions of climate refugees from low-lying areas?

Meanwhile, the financial system is being impacted by environmental stress from these increasing natural disasters, against which we have been forewarned by the scientific community. The last 19 years included 18 of the warmest years on record, which led to worsening food and water security risks.

We can see that water insecurity is already a significant global drag on growth—and a threat to financial assets where valuations rely on growth. According to a report from China Water Risk, an initiative of ADM Capital Foundation, 2 billion people rely on water from 10 River Basins in Asia. A total GDP of USD 4.3 trillion generated in these basins could be at risk from insufficient water.

The World Bank estimates that as a result of changing climate, water scarce regions such as the Middle East, the Sahel, Central Africa, and East Asia could see gross domestic product (GDP) declines of as much as 6% by 2050.

ADM Capital believes that, as investors, we need to promote an approach where our portfolio companies, particularly those owning real assets or engaged in food production, build resilience so that they are prepared as hurricanes, droughts and other severe weather events become more frequent and destructive.

OPPORTUNITIES
ADM Capital is delivering sustainable growth in private markets, acknowledging widespread changes in consumption and regulation.

But we see the changes we face not only as operational risks to be mitigated, but opportunity in terms of how we invest in what we see is the impending transformation. Major shifts in consumption patterns, in technologies and in regulation will be needed to drive the substantial and sustained reductions in GHG emissions and other dimensions of sustainability that will be required to deliver the 17 UN Sustainable Development Goals (SDGs), for example. We believe that we can play an important leadership role in supporting the inevitable transition to a low carbon and climate resilient economy, one that moves away from our current business-as-usual model of development, into one that promotes sustainable growth for our future.

So, integrated ESG management allows us to:

- Reduce risk;
- Drive better financial returns;
- Seek environmental and social returns that contribute towards the SDGs and a sustainable economy, more broadly; and
- Improve our understanding of emerging investment opportunities.

ADM Capital: Our History

20 YEAR TRACK RECORD
ADM Capital has been investing in private markets since 1998 and established the ADM Capital Foundation in 2006.

Established in 1998, ADM Capital has focused on private credit and special situations throughout developed and emerging Asia Pacific markets. ADM Capital's lending strategy primarily involves bi-laterally negotiated private loans, supporting companies in growth financing, bridge loans and other special situations where clients are unable to obtain financing via traditional banking channels. Most opportunities are sourced via proprietary networks. ADM Capital is a sector agnostic lender from a financial viewpoint. However, from an ESG perspective, we do maintain a restricted list of investments that eschews heavily polluting, environmentally destructive sectors as well as those considered to have a negative impact on our environment or society, for example, alcohol, mining, weapons and tobacco.

In 2006, the partners of ADM Capital established The ADM Capital Foundation (ADMCF), a non-profit initiative to help seed systemic change through research, education and action. ADMCF was a response to rapidly growing social and environmental challenges in the early 2000s as the world outsourced production and pollution to China, then beyond. Increasingly affluent Asian populations with new production jobs then looked to consume as the West has consumed, wanting, for the first time, refrigerators, air conditioning units, more and varied food, clothing and urban housing. In a race to help address this, ADMCF has built programmes focused on forest conservation finance, marine ecology, water, air quality and wildlife trade, and supported children at risk as families migrated internally for jobs.

For its part, ADM Capital became a market leader as early as 2006 by formulating and applying clear ESG principles in its sourcing, diligence and management of investments. In 2008, ADM Capital enhanced this approach becoming the first asset manager in Asia (ex-Japan) to sign up to the Principles for Responsible Investment (PRI). The growing networks and knowledge generated by ADMCF started to pay dividends beyond the impact of the Foundation's programmes. It became clear that as well as delivering on its mission, the Foundation was facilitating new insights, networks and enthusiasm for integrating ESG into the investment process.

This growing integration of ESG in private credit attracted attention from development focused investors such as the large European and Asian multilaterals throughout the 2000's, as well as many ESG focused US foundations and endowments. This interest was triggered not only by improved sustainable development outcomes, but also by an enhanced ability to understand downside risk, which is the foundation stone of private credit investment given its relatively illiquid nature and return profile. ADM Capital's private credit funds, ASLF 1 (2012) and ASLF II (2017), enjoyed support from IFC as a cornerstone investor and placed a high emphasis on investments in small and medium-sized enterprises (SMEs) that achieve sustainable environmental, social and governance outcomes. These investments follow due diligence and environmental, social and management systems based on the IFC Performance Standards and fill a gap in SME financing where credit was absent from local banks to sustain companies and jobs.

MULTILATERAL CORNERSTONE INVESTORS

ADM Capital was the first Asia (ex-Japan) manager to subscribe to UNPRI. ESG integration attracted investors such as IFC and OPIC.

IFC performance standards were integrated into ADM Capital ESG policy.

While IFC sustainability staff held training sessions for ADM Capital analysts and the IFC Performance Standards were integrated into the ADM Capital ESG Policy, ADMCF and China Water Risk's market leading research provided an important backdrop. Research conducted by both considered China's water scarcity and pollution challenges and the ramifications of water crisis in the world's most populous nation for global trade; the climate and broader sustainability implications of tropical forests converted for agriculture, in part as China imported virtual water largely in beef and soy; sustainable seafood and the consequences of overconsumption of fish; of climate change on our oceans; and the consequences of Asia's growing demand for protein.

In 2016, ADM Capital started marketing the Cibus Fund which invests in 'food for our future" and the Tropical Landscapes Finance Facility for Indonesia (a partnership among ADM Capital, BNP Paribas, UN Environment and ICRAF) led by ADM Capital partners Rob Appleby and Chris Botsford respectively. Both funds placed sustainability at their core.

The ADM Capital Approach to ESG

There is a growing recognition among investment leaders that it is part of their fiduciary duty to consider environmental and social factors as material risks (e.g. water, climate, other excessive resource depletion, human rights) and to push toward sustainable value creation. At ADM Capital, we believe that investment valuations in the future will be higher for companies that act more sustainably and that younger generations will demand corporate management take action in this area.

ADM Capital therefore started incorporating ESG into its investment process, honing its investment sectors by adopting a restricted list with a view to ensuring lending was not supporting activities that were detrimental to the environment or vulnerable populations and working to a continuously updated ESG policy. For investments where risk is identified, environmental and social due diligence assessments are undertaken as part of the overall due diligence process. Additionally, Environmental and Social Action Plans are established with portfolio companies to address any challenges and improve disclosure of non-financial risks. ESG analysis and updates provided to investors are an important part of ADM Capital's reporting metrics.

ESG INTEGRATION

ADM Capital analyses sustainability concerns and opportunities early in the investment process. Specialist DD providers are often engaged, and a Sustainability Advisor observes the Investment Advisory Committee.

ADM Capital's ESG analysis begins at the initiation of a transaction. Our concept notes include a mandatory ESG section for analysts to identify key environmental and social risks and these are elaborated in the Investment Committee Memorandum once these have been further investigated. ESG is fully a part of our due diligence process and involves ESG due diligence experts and consultants who provide reports detailing any key challenges and action plans for mitigation.

While ESG integration is often clearer in the context of private equity, in private credit this remains a developing field, but one we believe is highly complementary to the strategy, which at its core includes a focus on analysing and managing risk through establishing close relationships with borrowers. These close relationships often lead to board seats and an ability to influence a company's direction further. We actively seek these opportunities. In general, with each lending opportunity, key environmental and social aspects to be addressed for compliance purposes are written into loan covenants and other documents and monitored by consultants. These are in turn monitored as a key part of overall portfolio covenant compliance monitoring by ADM Capital's legal department.

ADM Capital In-House ESG Tool

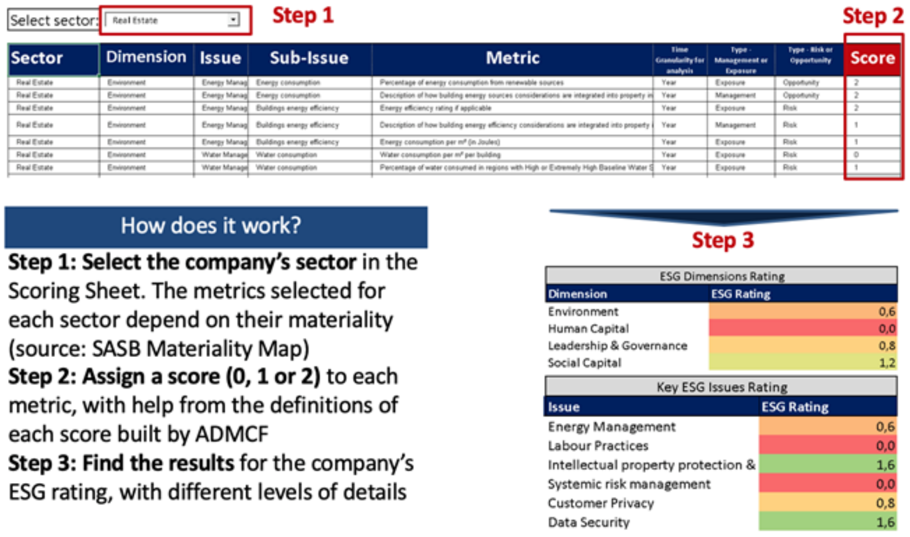
More recently, both the Cibus private equity fund and ADM Capital's Asian private credit funds have included the ADMCF CEO, Lisa Genasci, as an advisor on ESG matters. Lisa also sits on the ADM Capital Asian Investment Advisory Committee as an observer to support ESG integration across ADM Capital funds. In addition, the Foundation in 2018 designed for ADM Capital an in-house ESG tool that provides analysts with sector specific knowledge of ESG risk factors. The tool generates a simple rating system, providing appropriate due diligence questions to integrate and support the analyst through key performance indicator (KPI) setting with borrowers. Finally, integrating the key findings and ESG Action Plan, will allow the funds to capture ESG performance better over time. The tool is based on the Sustainability Accounting Standards Board's (SASB) industry standards and MSCI's ESG ratings methodology. KPIs are linked to the IFC Performance Standards and the SDGs.

In Summary:

- The ADM Capital ESG Metrics ("Metrics") will help analysts to identify key ESG risks and opportunities based on the company's current position and their sector's common sustainability-related business issues;
- The Metrics will also identify the company's management readiness for the related risks and opportunities;
- Through identifying the risks and opportunities, analysts can use the Metrics results to establish achievable KPIs with the company;
- When establishing the KPIs, analysts will use IFC's Performance Standards and/or UN's Sustainable Development Goals as a guide; and
- ADM Capital will systematically integrate ESG criteria into all their investment analysis.

ADM Capital ESG In-House ESG Tool Example

The tool generates a simple rating system, providing appropriate due diligence questions to integrate and support the analyst through key performance indicator (KPI) setting with borrowers



Benefits for Investors and Clients

ENHANCING RETURNS

Companies considering diversity, gender balance, clean energy, water sources and waste disposal are expected to outperform over the long-term.

There is growing empirical and anecdotal evidence to suggest that integrating ESG factors into investment analysis and portfolio construction offers investors potential long-term performance advantages. We believe that portfolio companies thinking longer term about diversity, gender balance in their work environment, clean energy and water sources, and issues relative to waste disposal will outperform. We believe that as a consequence they have stronger and more resilient business models. Given the increasing speed of disruption in today's economy, this is increasingly relevant for a firm providing private capital, even when much of our lending in Asia is short term by comparison to the private equity approach of the Cibus Fund.

In the Asian lending book, we have repeat borrowers who see value in the guidance and education that ADM Capital can bring around ESG issues. We have seen among our property investments that LEED certification, for example, has led to stronger exit prices and a broader pool of high-quality buyers for our investments. Our companies appreciate the perspective that we bring, an ESG service offered by our third-party ESG providers and our analysts, that others don't. Our ESG focus can give us an edge.

At the same time, we see we are not alone, that many investors are actively targeting investments that generate positive environmental or social outcomes. USD 90 trillion in assets now support the UN-backed Principles for Responsible Investment, and USD 30 trillion support the Climate Action 100+ Initiative (the implementation of the 2014 Global Investor Statement on Climate Change). Institutional investors are increasingly working to align their investment portfolios to the long-term interests of pension holders.

As the recent UN PRI report on private credit points out, among the biggest challenges faced by private credit funds integrating ESG is the lack of available data on private companies and hence the difficulty, for now, in benchmarking. A further challenge is the willingness of small businesses to accept ESG criteria in a competitive market where other investors and banks might not try to enforce similar clauses or compliance.

As we work through the challenges and opportunities of ESG integration, our focus remains on collateralised private lending generating strong risk-adjusted financial returns and this will always remain the core principle of our business. We prefer to think of ourselves as managing risk and our fiduciary duty as all managers should be: For our Future.

Case Study: Taking ESG from Theory to Practice: Rent-to-Own

ESG IN PRACTICE
ADM Capital designed a two stage ESG engagement programme, delivering social and environmental benefit, before being refinanced by a development bank at an attractive gross IRR of 45%.

In October 2016, ADM Capital provided debt and equity capital in a cornerstone financing of Rent-to-Own, a greenfield motorcycle leasing company in Myanmar focusing on low income customers in the regions outside of Yangon.

The Company rapidly grew its geographic footprint to the extent that after two years, the business covered over seven regions, including 34 branches, 300+ 'point of sales/dealers', 400 staff and with a track record of over 50,000 motorcycle contracts. This investment had a strong social benefit to Myanmar which suffers from poor credit penetration especially in the lower income segments. Of the company's clients, the average monthly income was equiv. USD230 and customers were largely manual workers, farmers/fishermen, shop owners/street vendors etc. By providing financial inclusion, the business helps support various Sustainable Development Goals including 9, 10, and 11.

As a start-up business, ADM Capital's approach to ESG differed from ordinary operating companies. ADM Capital designed a two stage ESG engagement programme with the first element being consultation between externally engaged ESG experts and Rent-to-Own's management to help formulate management and social policies and ESG impact agendas in connection with the Company's business plan. As a second stage, after the Company had commenced operations and grown to over 100 staff, ADM Capital's ESG consultants conducted a follow-up review to assess the business performance against previously identified objectives and IFC Performance Standards, including PS 1 and PS 2. ADM Capital, management and the external due diligence consultants agreed on a detailed Environmental and Social Action Plan with milestones for further actions to be monitored as part of ADM Capital's legal investment covenant compliance.

As a cornerstone investor, ADM Capital was entitled to board of directors representation, allowing it to actively monitor and provide input on environmental and social issues related to the business. As the Company grew, ADM Capital worked with the Board to design a more advanced E&S strategy involving a long-term plan for reforestation in northern Myanmar as part of a carbon sequestration programme to offset emissions from Rent-to-Own's motorcycle fleet. From a strategic and financial perspective, the board realised that the best possible growth and exit strategy would be based on ESG positioning to attract development investors.

This strategic plan succeeded, and ADM Capital was able to exit its investment in November 2018 in the context of a new round of financing by a German development bank and a Japanese financial institution. ADM Capital achieved a gross IRR of 45% and cash on cash of 1.68x.

*Should you have any questions, please contact **ADM Capital Investor Relations** at admir@admcap.com*