

This case study provides a snapshot of the sorts of ESG issues one could commonly come across in private equity investment in Asian emerging markets. It comes from one of our client portfolios. Given the potential sensitivities, we have deliberately chosen a past event. An edited version of this case study is published in “The Guide to Responsible Investment” edited by Tom Rotherham of Hermes Equity Ownership Services (PEI Media, 2011).

Case study:

Investing responsibly in Asia – the governance turnaround of a Chinese portfolio company

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The reality of ESG integration in Asian private equity markets

In the context of the booming Asian private equity markets, the integration of environmental, social and governance (ESG) factors is rarely at the forefront of priorities for general partners (GPs) and their investee companies. This is particularly true of local country funds where it is not uncommon, when broaching the issue, to hear GPs responding: “What is ESG?” Larger, pan-Asian buyout funds do, however, have a higher level of awareness and their standards are often equal to those GPs based in developed markets.

Asian private equity has thus become somewhat of a victim of its own success. Fund managers are increasingly busy chasing deals, and limited partners (LPs) have enough difficulties gaining access to top-performing funds, so it takes a lot of conviction to impose additional conditions on a fund. There are even some well-known international LPs that have been known to turn a blind eye to governance irregularities, through fear of ‘rocking the boat’ while the fund is making money.

Active engagement: collaboration between LPs and GPs

Investors in funds often ask how much influence they can legitimately have when they are one level removed from the portfolio company.

The case discussed here is a rather unique one, taken from a Chinese growth capital fund in AddVenture’s client investment portfolio. It illustrates how a close-knit relationship between LPs and the GP enabled hands-on engagement with the investee company to successfully implement radical governance improvements. Due to the sensitivity of the subject, the case describes past events, with the identity of all those involved kept confidential.

The Fund is a small-sized fund with a number of European LPs having a prior working relationship and openness of dialogue between them. The Fund’s managing partner is a US-educated Chinese ‘returnee’ with awareness of ESG issues, and a strong sense of duty and responsibility towards the LPs. One of the European LPs has an advisory and investment committee role in the Fund. His close relationship with the managing partner meant that his support was solicited when difficult operational issues arose at the portfolio company level.

Within the context of ESG integration in developing Asia, many of the internal controls and checks and balances that one might take for granted in a developed market environment do not exist. It had to take a major disaster – a bribery case involving a government body – and a number of related side incidents to provoke the complete overhaul of the portfolio company's internal controls, financial management and governance.

A portfolio company in the high-growth healthcare sector

Company W was a high-growth SME with revenues of approximately €40 million at the time of the governance breaches. It was founded in 1998 by Dr Z, a Chinese scientist specialising in this field, and was a market leader in the design and manufacturing of medical devices in China. In a market experiencing explosive growth, and for a company of this size in China, ESG was simply not a priority.

The industry context: heavy dependence on regulatory authorities

The healthcare reform programme, orchestrated by the Chinese government, has massively boosted the medical device segment. In addition to the major business challenges of R&D and the production of competitive products, the industry is subject to a high level of regulation. Company W is heavily dependent on the obtaining of government approvals, usually a process that takes between 6 and 18 months, prior to commercial launch. In addition to granting approvals involving quality, safety and efficacy, the government also controls prices, through the use of centralised procurement tenders.

The bribery incident

In 2003, the founder and chairman of Company W, Dr Z, was involved in an incident where payments were made to an official of RegBod, an industry regulatory authority.

The signature of the approval certificate by the RegBod official is the culmination of a lengthy review process split into a technical portion – including pre-clinical and clinical trials, on-site inspection and independent third party technical review – and an administrative portion. The administrative stage and the issuance of the approval certificate cannot be achieved without first passing the technical reviews. Company W submitted a product which successfully passed the technical review but, upon reaching the administrative review, it was requested by the RegBod official to make payments for certain 'personal expenses'. Dr Z was anxious that a delay in approval might seriously harm the company as the product in question represented a significant portion of future revenues. Therefore, he paid the official Rmb 220,000¹ from his personal funds and Rmb 40,000 from the company's funds.

The incident was uncovered after the Fund invested in the company in 2005. Several RegBod officials had solicited bribes during the same period and were convicted. It should be noted here

¹ €24 000 at current exchange rates

that laws on anti-corruption are still in their infancy in China: a new anti-corruption law released in 2010 aims to crack down on widespread corruption in the public sector and state-owned enterprises, but it is relatively vague on the private sector. The law is still a long way from the US Foreign Corrupt Practices Act or the UK Anti-Bribery Act. At the personal level, it is not always clear, by Chinese moral standards, as to what constitutes a bribe and what is ethical or unethical.

Following investigation and a court case, the People's Republic of China (PRC) court pronounced its final judgement and closed the case in 2007. According to PRC criminal law, Dr Z did not commit bribery, because there was no intention to seek illegitimate gains or interest. Dr Z was cleared and was not pursued for any sanctions or disciplinary action.

However, the incident had a significant impact on the company and, subsequently, on the Fund's ability to exit. An IPO on NASDAQ planned for late 2006 was persistently delayed, with the underwriter pulling out. Other than the impact on its ability to satisfy regulatory and stock exchange rules necessary for a listing, the most notable impact was on the company's reputation.

Company W redoubled its efforts to demonstrate the safety and efficacy of the product, by conducting supplementary nationwide clinical trials beyond RegBod requirements. The product that was approved during the bribery incident has since not been subject to any claims, litigation or recalls and its approval certificate was not revoked. Following the dismissal of the RegBod official, and a general clean-up of the RegBod organisation, Company W has worked to exclude any bribery dealings. Its products have since successfully satisfied the requisite technical and safety reviews, and its business is growing at a rate of 15 to 20 percent p.a..

More importantly, from the ESG perspective, Company W, with the support of the Fund, took major steps to radically improve corporate governance procedures going forward.

Further governance incidents

There were two further incidents that surfaced during the holding period, which reinforced the stakeholders' belief that it was imperative to tighten up governance procedures. The first involved a fine being imposed on Company W in 2005 for granting Rmb 0.5 million in fees and rebates to hospitals in order to promote sales between 2003 and 2004.

The second concerned a string of anonymous complaint letters received in 2007. They alleged that Company W had falsified contracts and wired funds to pay kickbacks, and that there were accounting irregularities on purchase prices. The company engaged lawyers and auditors to conduct investigations of these allegations, which were not accompanied by supporting evidence. These investigations later concluded that the accusations were groundless. However, from the investor's perspective, even though these were unsubstantiated, such alerts were

important warning signs. Furthermore, they can be costly - not just financially - and divert management attention.

The following table illustrates the timeline of these events in relation to the Fund’s investment in Company W:

Governance at Company W: **timeline of events**

2003	Bribery incident occurs
2003–2004	Rebate incident occurs
2005	Fund invests in Company W
2005	Fines for rebate incident
2006	Internal investigations into compliance, internal controls and financial management
2007	Anonymous complaints incident. Further internal investigations undertaken.
2007	Initiation of improvements on internal controls and procedures. Appointment of two consulting firms. Specific implementation measures recommended.
2010	Listing of Company W on Hong Kong Stock Exchange (HKSE)
2010	Review of effectiveness of implementation of the measures.
Ongoing	Annual reviews of internal control systems, to be published in annual report

A radical overhaul of corporate governance

The Fund's managing partner was a director of Company W, an alternate board member and a member of the supervisory board. He therefore had a major role to play in the corporate governance overhaul. He helped to relay LP concerns and to impress upon the company that governance standards had to improve. His hands-on approach meant that he made himself available to provide advice as needed, and helped to closely track progress.

An extensive process of internal investigation was begun towards the end of 2006 to diagnose any deficiencies in the company's internal controls. PRC and US law firms, and the fraud investigation arm of a leading international accounting firm, were appointed to undertake both document reviews as well as interviews of current and former personnel. The use of external experts, highly supported by the Fund, enabled an objective third party investigation, which the company would not have been able to undertake on its own.

Many deficiencies were uncovered, including the absence of a system to monitor the connection between expense reimbursement and the business purpose of the expense. Another example was the absence of rules regarding the usage of company credit cards and the approval of expenses. A standard procedure that was not part of Company W's practices was a weekly management meeting of senior management and executive committee members.

From 2007, Company W began to address the deficiencies that had been identified. Two international consultancy groups were tasked with working with the company to improve internal controls, compliance and ethics. In addition to addressing the deficiencies cited above, some of the other measures implemented included:

- A workflow process for monthly accounting close (financial closing tasks)
- An authority delegation policy and approval hierarchy for transactions and processes
- Formal approval procedures for sales sample management – this prevents rogue sales of product samples to clients²
- Policies for monitoring meeting expenses – the company sponsors and participates in trade shows and conferences for marketing and promotional purposes
- A code of business conduct for personnel, including procedures for the anonymous reporting of concerns and irregularities³
- Clarification of signing authority for expenses
- Document management system for contracts and business documents; refining of contracts in compliance with applicable laws
- Compliance training for directors and all personnel having regular contact with regulatory authorities and customers

² It is quite possible, and common, in China to have a salesperson provide large quantities of samples to customers, which can result in a parallel market, with the salesperson keeping the proceeds of these rogue sales.

³ It is worth noting here that China currently has no clear law on whistleblowing.

Anti-corruption and compliance training is provided not only to the employees of the company – currently totalling more than 1,000 – but also (and especially) to Dr Z. With the listing of Company W on the Hong Kong Stock Exchange (HKSE) in 2010, Dr Z receives regular training on the fiduciary duties of directors of listed companies, in accordance with HKSE Listing Rules.

A progress assessment was conducted by one of the aforementioned consultancy groups in early 2010. The principal weaknesses identified in 2007 had been rectified, and further measures for ongoing improvement were recommended.

Environmental and social considerations

To conclude, it is appropriate to mention the other aspects of ESG practices in the company. In contrast to the regulatory and governance challenges facing the company and its industry, the “E” (environmental) aspect is relatively benign. The medical device industry is not a highly-polluting industry and Company W is in compliance with applicable environmental laws. Unlike jurisprudence on ethical issues, environmental laws are quite developed in China, with a host of regulatory bodies supervising different forms of waste and pollution.

Finally, on the “S” or social concerns, the provision of training has already been discussed. It is also noteworthy that employees have joined labour unions, although they may not function in the same way as in more developed markets.

Quality control is a very important issue: it is a “G” or governance issue insofar as deficiencies can lead to product liability claims and damage to company reputation. However, it is also very much a social issue as Company W’s products directly affect human health. The company has obtained ISO 13485 certification for its products, and is audited not only by Chinese inspection bodies, but also by Japanese and EU authorities as it exports a small proportion of its production.

Future outlook

In fast-developing emerging economies, it is natural that ESG imperfections exist. One will always be tempted to ask, was due diligence insufficient – could such issues have been uncovered prior to investment? Unfortunately, in the context of China they cannot always be easily identified at the time of investment. It would require a high degree of transparency and disclosure standards in the first place. Likewise there may be the question of whether a GP would decline to invest had it discovered the abnormalities prior to the investment. In general, funds based in China with international LPs would tend to be more cautious in such cases and may put a potential investment on hold until matters are clarified.

Suffice to say, in this particular case, once the issues surfaced, the LPs and the GP worked together to push for change. The small size of the Fund with a limited number of LPs, combined

with the Fund being an influential investor in the company, enabled an unbroken chain of positive engagement, which successfully paid off. Naturally this will be an ongoing process of constant improvement. The Fund has now exited its investment in the company, and is no longer involved in the board. Fortunately, a much stronger ESG culture has been installed and, with the requirements of the HKSE Listing Rules, the company will be motivated to maintain and enhance these higher standards.

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