DUFF & PHELPS

Protect, Restore and Maximise Value

Valuation Insights

Greater China Edition

SECOND QUARTER 2020

INSIDE

SFC Relaxes Regulations for LCs and LIs affected by COVID-19

Even as the COVID-19 pandemic and its effects were only just being felt in Hong Kong, the Securities and Futures Commission (SFC) was already issuing advice to licensed corporations. As the full scale of the pandemic became apparent, the SFC went a step further, offering concessions and other forms of regulatory relief.

Recognizing that licensed companies (LCs) and licensed individuals (LIs) may not be able to comply with all regulatory obligations during this time, the SFC is offering the following concessions:

- **Training and examinations:** LIs whose annual continuous professional training (CPT) hours are affected by the outbreak may carry their unfulfilled CPT hours forward until the end of 2021.

  LIs required to pass post-licensing regulatory examinations on or before September 30 will be given until December 30 to meet the requirements.[1] This is relevant in light of the Hong Kong Securities and Investment Institute suspending all regulatory examinations until May 21.[2]

- **Extended deadlines:** The SFC will extend by six months the deadline to implement three regulatory expectations, all formerly due in 2020: the use of external electronic data storage (moved from June 30 to December 31, 2020); new measures to protect client assets (moved from July 31, 2020 to January 31, 2021); and data standards for order life cycles (moved from October 31, 2020 to April 30, 2021).

- **Work-from-home arrangements:** These are permitted, even for premises that are not approved under s. 130 of the Securities and Futures Ordinance. Work-from-home staff are still expected to remotely access the LCs' authorized trading systems, with their activities captured in the systems' records and documents.

  For LCs whose compliance with order recording requirements (as per paragraph 3.9 of SFC Code of Conduct) may be compromised by remote working arrangements, can avail themselves of alternative order receiving and recording options.[3]

- **Back-up facilities:** In the event of the main office shutting down, LCs are still obliged to maintain a back-up office and have remote access to trading facilities. In the event that the back-up facilities fail and orders have to be routed to an overseas affiliate for execution, the SFC may allow the LC's unlicensed overseas affiliates to carry out such tasks for the LCs, subject to the relevant regulators' approval.

- **Deadline for audited accounts:** The outbreak may prevent LCs or their associated entities from making a required submission of audited accounts within four months after the end of the financial year. In such cases, they must immediately apply for a deadline extension, and the SFC will review applications on a case-by-case basis.

- **Notification requirements:** LCs should be mindful of changes to their business and operations resulting from the outbreak; certain changes may trigger a notification requirement to the SFC under the Securities and Futures (Licensing and Registration) (Information) Rules Section 4.[4]

The SFC concedes that delays in response time are inevitable in the course of the outbreak; longer lead times for licensing applications, product applications and the SFC's public complaints and enquiry service should be expected. Through it all, the SFC is expected to continue issuing guidance and provide additional relief to market participants as the need arises.

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Pilot Scheme for REITs in China Announced

On April 30, 2020, the National Development and Reform Commission (NDRC) and the China Securities Regulatory Commission (CSRC) launched a joint statement (“the statement”) formalizing a long-anticipated pilot scheme for real estate investment trusts (REITs) in China.[1]

A REIT is a company that owns, operates or finances a portfolio of income generating real estate. Like mutual funds, REITs pool the capital of a group of shareholders, who can earn dividends from the REIT without owning or managing the properties in the portfolio. Shares in REITs can be bought, held and sold like any other stock on China’s exchanges.

High Hopes for REITs

Singapore and Hong Kong have led the way in launching REITs in Asia outside of Japan. Singapore has seen 41 REIT IPOs since 2002, with a current total market capitalization of USD 81.1 billion (bn).[2] In Hong Kong, the REIT market covers many of the territory’s most popular shopping centers and has a market capitalization of USD 30.04 bn.[3]

Investors and asset managers have high hopes for China’s nascent REIT market. The statement recognizes REITs’ high liquidity, stable returns and strong security; and touts REITs’ ability to help reduce debt risk in the short term and convert savings into investment capital in the long term.

Analysts believe that China’s publicly funded REITs may reach a market capitalization of between CNY 4-12 trillion in the future.[4]

Focus on Infrastructure

The pilot scheme will allow qualified Chinese mutual fund houses to launch REITs investing in infrastructure projects, with a focus on logistics (warehouses , toll roads), municipal engineering (heat, water and electricity) and pollution control. Pilot projects for “new types of infrastructure,” including information networks and industrial parks, will be encouraged.[5]

Analyses from Peking University’s Guanghua School of Management cite two key advantages to starting with infrastructure:

- **Boosting the urgent need for reform in the area of infrastructure investment and financing:** REITs’ use of the capital market’s open and transparent pricing mechanisms can promote high-quality infrastructure development.[6]
- **Least costly and most effective pilot method available:** starting with infrastructure may reduce the complexity of the pilot, and mature market experience overseas can be used as data by Chinese regulators.[7]

Loosening Regulations on REITs

The statement marks a significant change in China’s approach to REITs. Real estate companies were held back by regulatory and tax obstacles.[8] The closest investors could get were “quasi-REITs” sold to qualified institutional investors: key examples include Penghua Qianhai Vanke Real Estate Investment Trust, launched in 2015 and Zhonglian Qianhai Kaiyuan, launched in 2017. The combined market capitalization of both quasi-REITs increased by 500% to about CNY 2.7 trillion by 2018 year-end.[9]

The announcement of the pilot program drove a stock surge in China’s mainland exchanges, with seven listed firms in the infrastructure construction business hitting the 10% daily gain when the market opened.[10]

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New Limited Partnership Regime for PE/VC Funds Proposed in Hong Kong

On March 20, 2020, the Limited Partnership Fund Bill ("the Bill") was issued by the Hong Kong government, creating a new limited partnership regime for onshore PE and VC funds.[1]

As Asia's second-largest PE market, Hong Kong is under pressure to update its laws to provide incentives for PE funds, especially as the rise of tech startups have channelled significant amounts of capital into corporate coffers.[2]

The Government expects the Bill to come into effect by late August 2020.

Minimum Eligibility Requirements

Under the new regime, any eligible fund may be constituted as a limited partnership fund (LPF), to be registered as such with the Companies Registry. To meet minimum eligibility requirements, an LPF must (among other things):

- Be constituted through a limited partnership agreement
- Have at least two partners, including at least one general partner (GP) and at least one limited partner (LP)
- Have a registered office in Hong Kong and a business registration certificate

The full eligibility requirements can be found on page C217 of the original Bill.

Partners' Rights and Responsibilities

The Bill imposes no minimum capital requirement and no restriction on the LPFs' investment scope and strategy; LPF partners will have freedom of contract with respect to the fund's operations.

Under the Bill, each LPF's GP assumes unlimited liability for all debts and obligations and holds ultimate responsibility for management and control. The Bill also specifies the GP's responsibilities, which include (but are not limited to):

- Appointing an investment manager, who can be an individual, a Hong Kong incorporated company or a registered non-Hong Kong company
- Appointing a "responsible person" to carry out anti-money laundering (AML)/counter-terrorist financing (CTF) checks
- Filing an annual return with the Registrar, and notifying the Registrar of certain changes with regards to the LPF

The full list of responsibilities can be found on page C233 of the original Bill.

LPs are granted the right under the Bill to participate in income and profits arising from the LPF's operations. However, LPs will not automatically be obliged to exercise day-to-day management rights or control over the fund's assets. LPs also enjoy exemption from profits tax, provided certain conditions are met under the existing funds exemption regime.

The LP's liabilities for the LPF's debts and obligations do not extend beyond the amount of its agreed contributions, unless the LP actively exercises a management role in the fund.

Shoring up Hong Kong's Leadership Role

The Limited Partnership Fund Bill is intended to address the shortcomings of Hong Kong's existing Limited Partnership Ordinance (LPO). Enacted in 1912, the LPO is widely seen as a disincentive to attracting private funds to domicile in Hong Kong. The LPO will still apply for non-fund limited partnerships after the Bill's implementation.

The Bill also responds to wider worldwide trends, such as new laws in the Cayman Islands that introduce requirements for local "economic substance" and subject locally incorporated PE/VC funds to regulation by the Cayman Islands Monetary Authority.[3]

Finally, the Bill is intended to shore up Hong Kong's position as a hub for asset and wealth management in the region, working in concert with proposed incentives. These incentives include a new domestic regime for open-ended fund companies as well as tax exemptions and concessions covering certain open-ended funds and offshore and onshore PE/VC funds.[4]

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Duff & Phelps Survey: Impact of COVID-19 on Investment Valuations

COVID-19 has brought an unprecedented crisis to global economies and financial markets. Unlike past economic shocks, which were often precipitated by predictable–if not familiar–factors, the source of the current turmoil is a pandemic with no recent historical precedent. So far, the defense against the virus has been through economic rather than pharmaceutical measures.

As a result, this has had a paralyzing effect on nearly all sectors with very few market participants unscathed. This poses a significant conundrum for the investment community in terms of how to navigate the crisis, protect investors and even identify opportunities.

In an effort to learn how investment professionals are approaching this challenge and specifically, the topic of valuation, we surveyed investment managers globally to gain an insightful, and at times surprising, look at the response.

The Respondents

The majority of respondents (64%) to the survey identify as being a general partner or investment fund manager. Of those, private equity and private debt fund managers accounted for nearly two thirds of those surveyed.

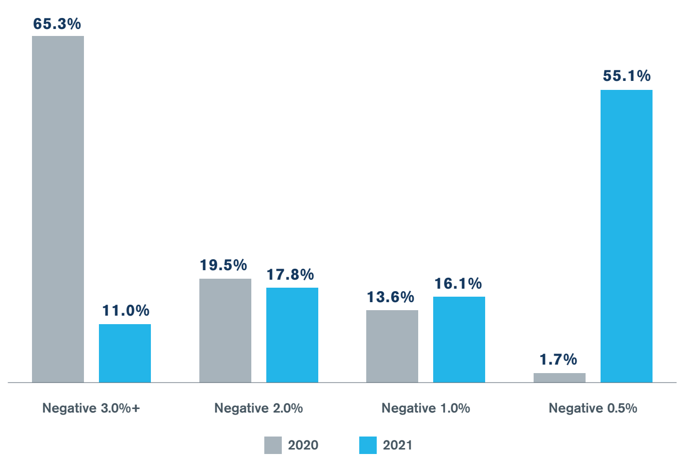
The perspective they offer is predominantly of developed markets, with 52% of respondents focused on the North American market and 41% focused on Western European markets. Approximately 19% of respondents identified themselves as investing globally.

A Negative 2020, but Sentiment Improves in the Long Run

With the coronavirus pandemic shutting down segments of global economies, many of the respondents expect the GDP growth of their focus market to contract this year. This is not a surprise since the majority of respondents focus their investments in the U.S. and European markets, which have both been severely impacted by the virus.

As a result, the majority of respondents (65%) expect COVID-19 to cause GDP growth in their key markets to shrink by 3% or more this year. Meanwhile, 33% of respondents expect contractions of 1% or 2%. Approximately 2% of respondents expect their market's GDP growth to contract by just 0.5%.

WHAT DO YOU EXPECT WILL BE THE MAGNITUDE OF THE IMPACT OF COVID-19 (AND THE RELATED ECONOMIC RESTRICTIONS) ON GDP GROWTH FOR 2020 IN YOUR FOCUS MARKET?



However, when viewed over a longer timeframe, this sentiment improves. When asked about how GDP growth could be impacted going into 2021, the majority of respondents (55%) expect the virus to have a negative impact of just 0.5%. However, 11% of respondents still expect the pandemic to have significant impacts next year with 3% or more contraction to GDP growth.

Value Considerations

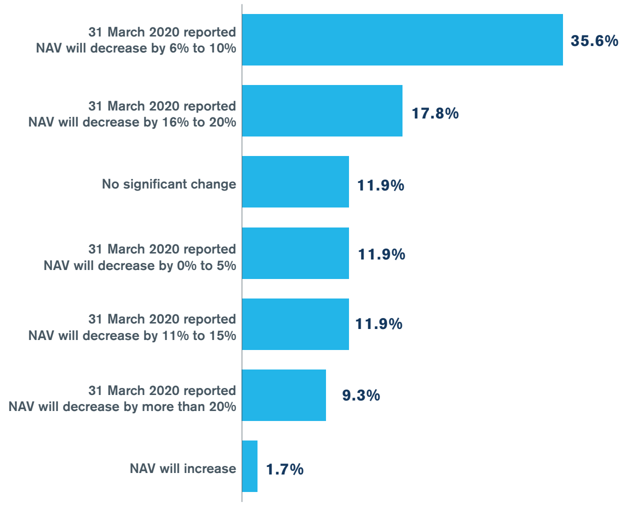
With this survey, we wanted to gauge investment mangers' perspectives on how the coronavirus pandemic has impacted value assessments. When respondents were asked to determine the most important factors for fair value assessment, the crisis' impact on Q1 and Q2 cashflows was the most notable (14%).

However, nearly half of respondents (47%) coupled this with quarter-to-quarter market capitalization changes, cash reserves running out and increases in credit spreads/shifts in credit quality. These issues are arguably knock-on effects from the immediate impacts governments' response to the coronavirus are having on cashflows for all kinds of businesses.

Sticking with value, the majority of those investing through close-ended funds still found net asset values (NAVs) useful in making investment decisions (87%). This was compared to 13% who regard NAVs as irrelevant due to close-ended funds being "locked up."

That said, a significant majority (86%) expect NAVs to meaningfully decrease between December 31, 2019 and March 31, 2020. Of this figure, nearly half expect NAVs to fall by up to 10% with most (36%) anticipating reductions between 6% to 10%. Worryingly, 9% of respondents are anticipating NAVs to decline by over 20%.

FROM A FUND NAV PERSPECTIVE, WHAT CHANGE WOULD YOU EXPECT TO SEE BETWEEN 31 DECEMBER 2019 AND 31 MARCH 2020?



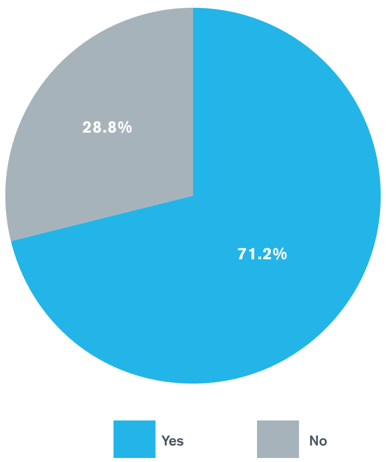
Even though this paints a gloomy picture for the outlook of many funds and their assets, our respondents had somewhat pragmatic views on corporate bankruptcies. When asked about investments where the potential outcome is binary (whether the investee will survive or not), 63% said they would still need to do scenario analysis to make a solid determination. Meanwhile, 10% admitted they wouldn't know either way, which suggests that a lot about this unprecedented crisis is still perplexing investors.

Overall, when asked about the fair value of their investments by the end of 2020, the majority of respondents were optimistic that these would be worth more than on March 31, 2020 (57%), but 47% do not expect values to recover to pre-crisis levels seen at the end of 2019. In terms of fair value, only 11% expect their investments to be worth more after the crisis than before, with 26% expecting values to be less overall. The group's forecasts for NAVs decreasing reveals concerns about the limited impact a post-crisis recovery could have on assets.

Looking Ahead to the New Normal

Both the U.S. Federal Reserve and the European Central Bank have unveiled unprecedented measures in response to the pandemic. Since the majority of the respondents have an investment focus on the U.S. and Europe, these measures have largely been welcomed, with 71% saying they feel enough economic support is being offered in their regions.

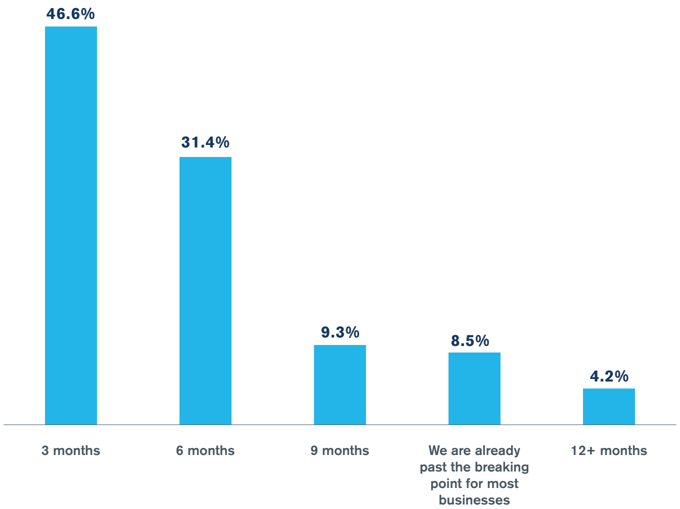
ARE GOVERNMENTS IN YOUR REGION DOING ENOUGH TO PROVIDE ECONOMIC SUPPORT TO BUSINESSES MOST IMPACTED BY COVID-19 TO COUNTER THE IMPACT OF ECONOMIC RESTRICTIONS BEING IMPOSED ON THOSE BUSINESSES?



Although there are encouraging signs with the virus potentially starting to abate in some countries, 71% of respondents expect social distancing to continue for at least the next three months in their country, with 21% expecting measures to last six months in total.

Worryingly, when asked about how long businesses have before reaching their breaking point under the current measures, 46% of respondents said three months. Another 31% think businesses have more time, with six months, but 8% of respondents feel that we are already past the point of no return for some businesses.

WHAT IS THE "BREAKING POINT" AT WHICH THE CURRENT ECONOMIC RESTRICTIONS IMPAIR THE ABILITY OF BUSINESSES TO RESUME BUSINESS AS USUAL?



However, in a positive turn of events, our respondents felt that private capital was embracing environmental, social and governance (ESG) qualities during this crisis. When asked about the extent to which this was true, 32% answered “mostly” while 30% agreed most private capital-backed businesses were acting in the best health and safety interests of their communities, even if it isn’t in their own financial interests to do so.

Why ESG is on the Rise in Asia

In today's socially-connected world, companies understand that their success rests not only on their business performance, but also on their relationship with society at large. This explains why environmental, social and governance (ESG) disclosures are on the rise, driven by both regulatory mandates and investor pressure.

Growing concern about climate change risk, for instance, fuelled the worldwide growth of socially responsible investments by 34% to US$30.7 trillion by 2019.[1] Even in East Asia, with only five percent of assets under management invested in sustainable projects,[2] regulators have begun mandating ESG disclosures for issuers listed in Shanghai and Hong Kong.[3]

Society's increasing interest in investing in ethical business practices and their outcomes has put pressure on investors and asset managers to integrate ESG into their investment decisions.

ESG: An Alternative Way of Assessing Performance

In addition to deflecting pressure from activists and regulators, ESG helps investors and other stakeholders flag opportunities or risks not identified by conventional financial analysis. ESG disclosures focus on the following key areas:

- Environmental data that shows the target company's efficiency at managing their resources and caring for the environment around them;
- Social data that reveals how well the target company treats their clients and workers, or how diverse the makeup is of its management; and
- Governance data that examines the target company's governance and share class structure.

ESG disclosures represent an alternative way of assessing a company's performance beyond its balance sheet, with a view to its effects on society at large. They also indicate an asset's potential for value that sustains momentum even in the "new normal" post-COVID-19; a Morningstar analysis found that funds integrating ESG factors registered record growth in Q1 2020, beating Q4 2019's previous record.[4]

ESG Indexes: Setting Sustainable Investing Benchmarks

More sophisticated research and increased reporting by public companies have cut through the lack of clear ESG standards worldwide, creating the potential for increased structure and standardization in the field.

Institutional, wealth management and personal investors demand clear, sustainable investing benchmarks. And millennial investors actively seek investment options that closely align with their values; this fast-growing group is "twice as likely to invest in companies or funds that target specific social or environmental outcomes."[5]

To all these demands, ESG indexes provide an answer. In the Asia-Pacific region, the MSCI AC Asia Pacific ESG Leaders Index is a prime example: it derives its financial indicators from a proprietary index methodology that utilises ESG ratings to highlight companies that are "in a better position to manage ESG-related opportunities or risks."[6]

By casting a spotlight on regional companies with high ESG performance relative to their sector peers, ESG indexes help Asia-Pacific investors integrate responsible investing into their investment decision-making processes.

ESG in M&A: Integrated Into Pre- and Post-Transaction Processes

ESG has also become an increasing factor in deciding M&A. PE firms that wish to avoid reputational risks and liability from compliance failures have begun integrating ESG in both due diligence and post-closing compliance.

In a 2019 IHS Markit survey, 90% of responding senior executives (representing PE firms, corporate entities and asset management firms) admitted they conducted ESG due diligence, "confirming that it has become a core element of the M&A process despite its relative newness." 83% in turn were confident ESG "will become increasingly critical to M&A decision-making in the next 12 to 24 months."7

Considering that many ESG benchmarks are far from established, creating due diligence and post-closing compliance standards for future M&As are a challenge for today's investors, including PE firms and regulators – while presenting an opportunity for ESG benchmarking and analysis specialists.

Investment research provider Morningstar just bet big on ESG ratings and research company Sustainalytics, paying €55 million initially with additional payments to be derived from the company's 2020 and 2021 fiscal year revenues.[8] They're confident that demand for ESG data, research and solutions will increase exponentially in the next few years – a bet they're sure to win!

ESG Practice in Hong Kong

Hong Kong leads East Asia in ESG practice. As early as 2015, the Hong Kong Stock Exchange (HKEX) changed its rules to shift from a "voluntary" ESG reporting regime to a stricter "comply or explain" requirement.

The revised HKEX rules also compel companies' boards of directors to assume responsibility for ESG, instead of delegating it to mid-level executives. Compliance will be mandatory starting on July 1 this year.[9]

The record is mixed where actual compliance from Hong Kong companies is concerned. While members of the Business Environment Council expressed support,[10] the business community at large has struggled to comply, with only 39% of 500 randomly-chosen ESG reports found to have fully disclosed their environmental performance indicators.[11]

ESG Practice in China

Despite its late start, ESG practice in China has entered a fast track. New ESG reporting guidelines have been promulgated by the China Securities Regulatory Commissions (CSRC) and the Shanghai Stock Exchange (SSE).[12] And this year, the CSRC and the Ministry of Environmental Protection will require listed companies and bond issuers to disclose ESG risks associated with their operations.[13]

Beyond simply offering compliance, China's financial sector has also taken some responsibility in formulating international reporting standards. Over 20 China-based asset management companies signed up to the United Nations Principles for Responsible Investment (UN PRI), including China Southern Asset Management and China Life Asset Management.[14]

Achieving Favourable Outcomes with ESG Due Diligence

ESG has never mattered more than in today's post-COVID new normal. With ESG-related stocks encountering surprisingly strong demand and a growing investor base that demands proof of ethics beyond mere performance, ESG due diligence has become an essential part of the investment process.

We, at Kroll, a division of Duff & Phelps, have also seen a steadily intensifying focus on ESG over the many years we have been assisting the financial industry. We have seen the financial industry adopt an increasingly positive attitude toward responsible investing. Within the last two years, our own firm has launched a formal ESG program and embarked on a path to becoming a Carbon Neutral® certified company. Not only do we believe it is the right thing to do, but our ESG initiatives have proven a source of pride among our employees.

Today, a majority of private equity firms, asset managers and funds now work to ensure that their present assets and/or future acquisitions all benefit from having ESG programs in place, each adjusted according to the standards set by each fund or their responsible regulators.

Today's investors know that integrating ESG factors into their investment processes will help them achieve favourable outcomes: mitigating portfolio risks, increasing shareholder value, broadening opportunities, and ensuring peace of mind borne from knowing your company's actions are in harmony with the world around it.

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