Arisaig Partners Climate Change Management Approach (Investment side)

January 2023

Contents

1. What does climate change mean to us and why does it matter?

Arisaig Partners' Investment Philosophy is founded on the belief that Purposeful Growth - taking a multi-stakeholder view of the world - generates superior long-term investment returns. Climate change and its most disruptive outcomes pose an existential threat to humanity itself and, therefore, all businesses.

Emerging markets are particularly vulnerable to these risks given their geographic positioning (many are located between the tropics, where many of the most extreme weather events are concentrated) and economic fragility (they tend to lack the infrastructure and fiscal resources to respond to and/or mitigate the effects of climate change).

In response to this, there are growing policy actions led by governments to limit global emissions to manageable levels. Nearly 200 countries[1] have pledged to limit global temperature rises to 1.5°C above pre-industrial levels. In addition to policy pressure, consumers and broader investor communities also demand companies to respond to climate change. If companies fail to do so, their business performance, asset prices and access to financing may be severely impacted in the future.

We believe the trend towards a low carbon economy is now firmly entrenched. Given our multi-decade investment outlook, it is imperative that we adequately manage climate change risks and opportunities over the coming years to preserve our clients' capital. To achieve this, we need to integrate climate risk management firmly within our processes and implement a targeted and proactive engagement approach, as set out in this document.

Climate risks

The effect of climate change on our investments can broadly be categorised into transition risk and physical risk[2]. Transition risk is the risk involved with a transition to a low-carbon economy, which is typically brought by policy, technology, and consumer behaviour. Physical risk refers to impacts from physical climate events, such as severe climate catastrophe or sea-level rise. Other climate-related risks that may impact our business include regulatory risks and reputational risks.

Category	Description	Time frame
Transition risk	Reduction in returns where companies are not taking appropriate action to transition to a low carbon economy (e.g., climate policy action, change in consumer preferences, technological innovation)	Short to medium-term
Physical risk	Reduction in returns where companies suffer property losses, supply chain disruption, workforce issues and other issues due to extreme weather events and chronic changes (e.g., change in precipitation patterns, rising sea levels).	Short, medium, and long-term
Regulatory risk	Increasing and more complex regulation and standards relating to what and how asset managers need to integrate and report in relation to climate and other ESG issues.	Short to medium-term
Reputational risk	Increased expectations of external stakeholders (including regulators, clients, the wider market) of how businesses act in relation to climate change. Greater scrutiny of businesses' commitments and impact.	Short to medium-term

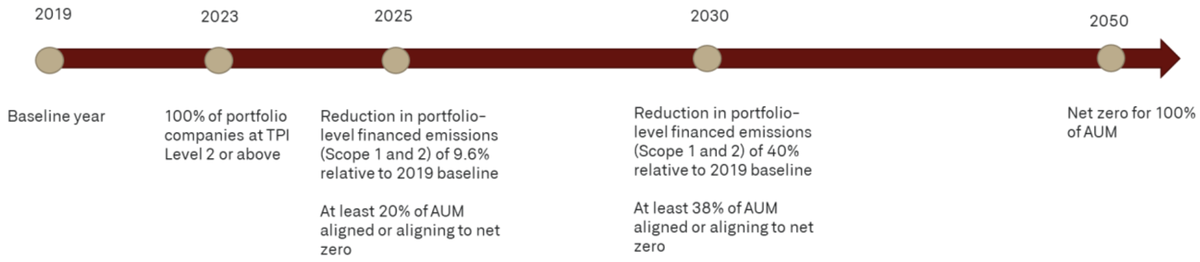
[1] 197 countries agreed to sign the Glasgow Climate Pact at the UN Climate Change Conference in November 2021 (COP 26)

[2] See the detailed definition of the two types of climate risks in annex.

Climate targets

Given the profound impact of climate change, we believe taking early actions to transition investments to 'Net Zero' is necessary to respond to climate risk. As one of 30 inaugural members of the Net Zero Asset Managers (NZAM) initiative in December 2020, we committed 100% of our assets under management to be managed in line with net-zero by 2050. We have set granular decarbonisation targets for the coming decades that will allow us to fulfil this commitment.

Figure 1: Targets supporting Arisaig's Net Zero Commitment[3]



Source: Arisaig Partners

Our targets are designed to be actionable, comparable, and suitable for emerging markets. Our portfolio-level financed emissions targets (1.6% annual reduction until 2025 and 6.1% annual reduction between 2025 and 2030) are derived from the International Energy Agency's 1.5°C aligned Net Zero 2050 Pathway for Emerging and Developing Markets[4]. This is one of the few 1.5°C pathways specific to emerging markets we are aware of.

To measure emissions reductions reliably, data gaps are a foremost issue to resolve. To address this, we set a target for 2023 relating to the Transition Pathway Initiative (TPI) Climate Risk Management Quality framework[5]. The framework lays out a useful roadmap via five clearly defined 'levels' of climate change integration. By reaching 'level 2' in 2023, our aim is for all portfolio companies to publish emission data, providing a sound foundation for assessing risks and monitoring progress. To achieve this, we have committed to engage with all companies ranked TPI Level 0 or 1 annually. If a company still fails to reach the target, an "explain or exit" escalation process will apply (see 3.2).

The asset-level target of 20% of AUM to be aligned or aligning to 'Net Zero' by 2025 and 38% by 2030 is based on a linear pathway from 0% in 2019 to 100% aligned in 2050. This pace is somewhat slower than what might be expected in developed markets, but we believe it is still ambitious for emerging market companies.

2. What are the underlying principles guiding our climate change management approach?

We have the following principles when designing the approach to managing climate change:

- Systematic due diligence: Climate risks and opportunities will be fully integrated into our investment analysis and decision-making processes. To support this, we will seek appropriate disclosure on climate issues from our holdings.

---

[3] Read more about our targets here: [Implementing Net Zero in emerging market public equities - Arisaig Partners]

[4] More information available at: https://www.iea.org/reports/net-zero-by-2050 (see Figure 2.2)

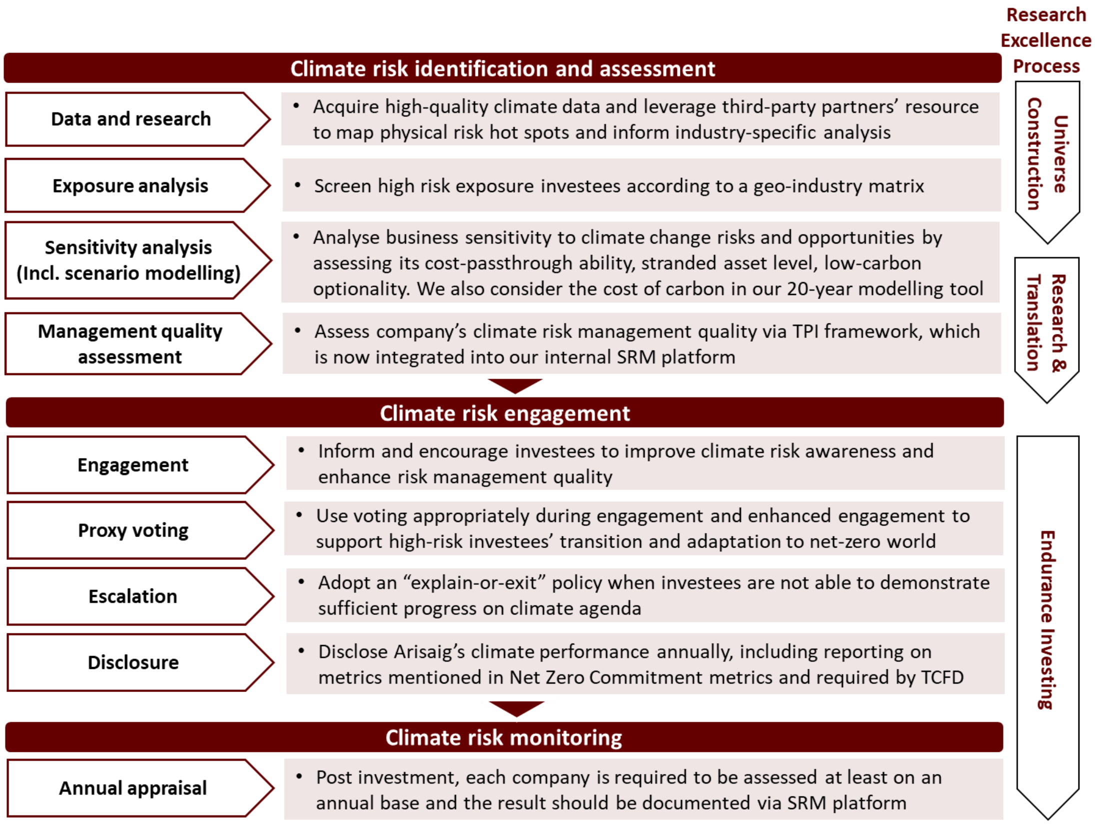
[5] The [Transition Pathway Initiative] (TPI) Management Quality Questionnaire is a set of 19 questions to assess companies' preparedness for low carbon transition. Supported by investors representing over USD 40 trillion assets, TPI was initially developed by an international group of asset owners initiated by Church of England, in partnership with the Grantham Research Institute on Climate Change and the Environment at the London School of Economics (LSE) in 2017.

- Endurance investing: We are long-term, active stewards of capital. We will meet our climate change commitments by proactively engaging and supporting our holdings to achieve the emissions reductions and other measures necessary to limit global warming to 1.5°C above pre-industrial levels.
- Continuous learning: We will monitor evolving best practice and update our climate approach annually to reflect this.

3. What is the process?

Climate risk is embedded within every asset we hold. Only by decarbonising at the asset level can we enhance asset climate resilience, and therefore societal resilience and financial resilience. To achieve this, climate risk is considered within every step of our investment research pathway (see Research Excellence Process document for more information).

Figure 2: Arisaig Climate Risk Management Process



Source: Arisaig Partners

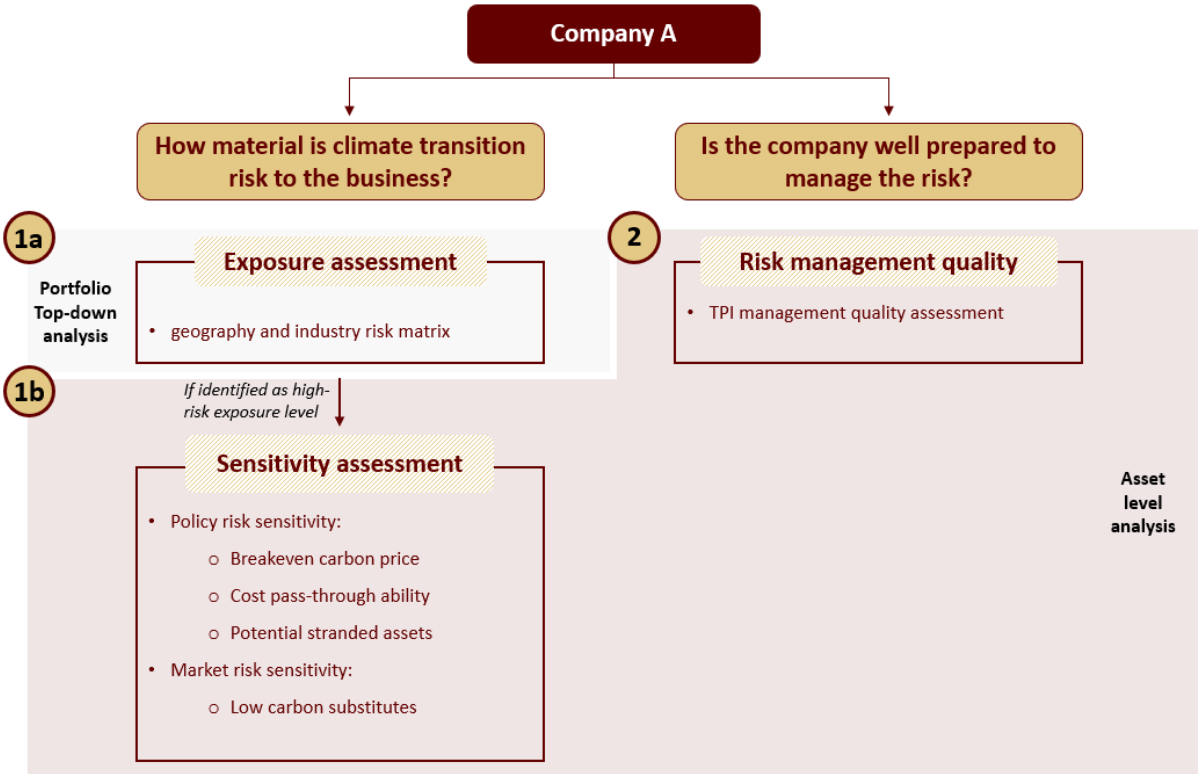
3.1 Climate risk research and assessment

Our climate risk research focuses on assessing investment-related transition and physical risks.

3.1.1 Asset-level transition risk assessment

To translate research into practice, we developed a climate risk assessment framework to apply during *Investment Case (IC) Draft* stage.

Figure 3: Arisaig Climate Transition Risk Assessment Methodology



Source: Arisaig Partners

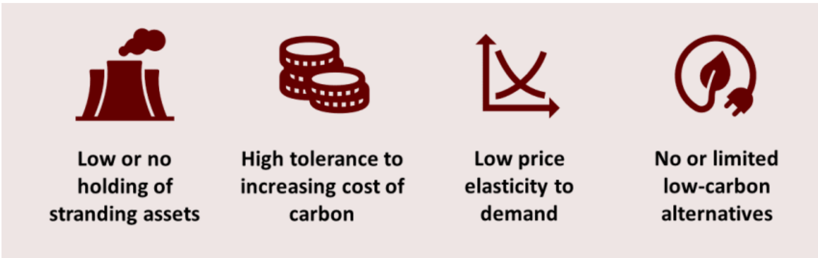
Step 1a. Exposure assessment

Risk exposure level is determined by the industry of the business and where it operates. We developed an industry-geography risk matrix to identify companies that are high risk. Industry is relevant as emission sources are similar within a sector. Geography is relevant because climate policy risk and market appetite are highly localised. For companies that operate across multiple markets and several business-lines, our analysis focuses on where most of the revenue is generated.

Step 1b. Sensitivity assessment

For companies identified as highly exposed to climate transition risk, we conduct 'sensitivity assessments' to investigate how financially sensitive these businesses are. Even where a company is highly exposed to transition risk, we believe having certain qualities make a company less financially sensitive, effectively mitigating the risk (see below).

Figure 4: Key indicators of low sensitivity companies



Source: Arisaig Partners

Step 2. Climate Risk Management Ability

All companies, regardless of risk exposure, need adequate climate change management abilities. Therefore, we applied the TPI framework[6] to measure the quality of companies' management of their GHG emissions and of risks and opportunities related to the low-carbon transition.

The Questionnaire is part of the Sustainability Risk Management (SRM) assessment, a proprietary web-based tool used to assess each company's management of material sustainability issues[7].

3.1.2 Portfolio-level transition risk assessment

We also price carbon in our 20-year discount cash flow model Arisaig Crystal Ball (ACB)[8]. Our approach focuses on the impact on margins. We firstly calculate the cost of carbon by taking (estimated) scope 1 & 2 emissions and multiply by a carbon price[9]. The cost of carbon will then be applied to operating costs, assuming a direct transfer over time. While the estimation of margin compression could be conservative, this straight-forward approach helps us easily understand and communicate the impact on return on investment.

In 2022, we conducted a firm-wide analysis to quantify the potential implications of carbon costs being internalised on productivity and indicative returns of our portfolios. Compared to the S&P Emerging Markets BMI Index, we found that our holdings have a lower carbon footprint than their sector peers, which translates into a lower margin compression in the event of carbon pricing. From a returns perspective we were also reassured by the modest predicted impact – an USD 75/tCO2e carbon tax on scope 1 and 2 emissions would only hit returns by 3%. On the downside, our holdings have poorer carbon disclosure than the broader market, likely due to our skewing to smaller companies and less developed countries.

Figure 6: Impact of carbon pricing - Arisaig holdings vs S&P EM BMI, by sector (green indicates better than the benchmark)

GICS Industry Group Level	Relative Avg Carbon Disclosure Score (%)	Relative Avg Scope 1+2 emissions intensity (tonnes CO2/USDm revenue)	Relative Median EBITDA Margin (bps)	Relative Median EBITDA Margin Compression through Carbon Tax (bps)
Retailing	-2	-740	70	-1
Media and Entertainment	-18	-278	-601	0
Food and Staples Retailing	-19	-438	309	21
Household and Personal Products	-7	-40	-7	1
Health Care Equipment and Services	-19	-322	1,441	2
Consumer Services	-13	-490	1,686	44
Food, Beverage and Tobacco	23	-667	332	6
Pharmaceuticals, Biotechnology and Life Sciences	-13	-429	1,071	5
Software and Services	-20	-983	1,556	4
Materials	51	-456	133	421
Utilities	30	-816	2,249	820
Telecommunication Services	-11	-370	1,967	10
Semiconductors and Semiconductor Equipment	77	-122	-297	-166
Banks	NA	NA	N/A	NA
Total	-2	-423	261	12

[6] See *Footnote 3*
[7] See more details about SRM in our ESG & Constructive Ownership Approach (available on our website).
[8] See more explanation about ACB in our ESG & Constructive Ownership Approach.
[9] Our model assumes emerging markets' carbon tax to reach USD 75 per ton in 20 years. This is adapted from the IMF's estimation of a global tax of USD 75 per ton by 2030 to effectively limit global warming to 2°C. With rising actions in emerging markets, we will increase modelled carbon price over time.

Source: S&P Global/Trucost, Arisaig Partners analysis, May 2022

3.1.3 Physical risk

Knowing our investments focus on asset-light consumer businesses and limited expansion plans beyond existing markets, we decided to lean our resources to assess and manage transition risks, which we believe will mitigate most physical risks if managed well.

That said, it is important to distinguish physical risk from transition risk as individual company exposure to them can be quite different. For example, a renewable hydroelectric plant in India will have little-to-no transition risk but significant physical risk as water shortages threaten future output.

In 2020 we employed a climate consultancy South Pole to conduct a portfolio-wide assessment that involved geo-tagging physical facilities and using catastrophe models to estimate specific risk exposure and potential loss (see Figure 7 below for summary). We used this to engage the companies identified to be at the highest risk to assess whether they have adequate mitigation measures in place. We have since divested in some of the highest risk companies, partly due to climate physical risk exposure.

As turnover in our portfolios is relatively low[10], we believe repeating this analysis at least every five years will be sufficient to manage the related risks.

Figure 7: Revenue at Risk from Physical Climate Change by Major Market*

Market	No. Companies	1° C Warming	2° C Warming	3° C Warming	4° C Warming
Bangladesh	1	0.4%	16%	80%	98%
Tanzania	1	0.4%	13%	75%	97%
Tunisia	1	0.4%	13%	75%	97%
Nigeria	1	0.4%	12%	73%	97%
Rwanda	1	0.3%	6%	54%	93%
Ghana	2	0.3%	8%	57%	93%
Pakistan	3	0.3%	9%	62%	92%
India	13	0.3%	4%	43%	88%
Egypt	2	0.3%	4%	38%	87%
Vietnam	1	0.3%	4%	40%	84%
Philippines	3	0.3%	3%	33%	78%
Peru	2	0.3%	2%	22%	73%
South Africa	3	0.3%	2%	17%	67%
Central America	1	0.3%	2%	17%	68%
China	4	0.3%	2%	16%	64%
Mexico	5	0.3%	2%	17%	63%
Brazil	8	0.3%	2%	14%	61%
Russia	1	0.3%	1%	7%	38%
Turkey	2	0.3%	1%	8%	44%
Total Average		**0.3%**	**4%**	**33%**	**76%**
Average - Top 10 Companies		**0.4%**	**10%**	**65%**	**94%**

**Market in which each company derives the majority of its revenues*

Source: South Pole, Arisaig analysis. Analysis conducted May 2020 based on holdings in Dec 2019

3.2 *Climate risk engagement*

We believe active engagement and the ability to build long-term, constructive partnerships with our holdings are essential. It is particularly crucial on climate issues – our goal is to encourage emissions

[10] Average holding period in our longest running fund is over 8 years

reduction in the real economy while divestment will not necessarily lead to so. Since climate awareness in emerging markets is still lagging, early engagement and capacity building will unlock huge decarbonisation potential. We have therefore set engagement targets within our Net Zero Commitment.

We will measure the success of our engagement strategies against the engagement targets set. Specifically, it will include:

- A company's climate risk management quality level assessed via TPI framework; and
- A company's decarbonisation performance against its climate target and net-zero pathway.

Proxy voting: We actively participate in proxy voting on all issues, including climate risks. Although climate-change-related shareholder resolutions are still rare in emerging markets, we will vote for supporting resolutions that will enhance investees' climate resilience and decrease climate risks. We also see proxy voting as a valuable tool for "enhanced engagement" (see Escalation section for more details). For example, we may vote against director appointments when a company has not made sufficient progress on climate-related issues in a reasonable timeline.

Escalation: Where we identify that a holding is not going to meet one or more of our asset-level Net Zero targets, we will launch an enhanced engagement. This includes but is not limited to voting against management. If the company still does not demonstrate sufficient progress after one year of enhanced engagement, we apply a 'divest or explain' approach where the relevant Strategy Research Head will need to recommend to the Investment Committee to divest from the company or give sufficient justification for not doing so.

Disclosure: We are a formal supporter of the TCFD[11] and disclose according to its recommendations. We disclose on the governance and strategy, targets, and risk management processes in this document. We disclose our carbon performance in our annual ESG Review. In addition, as a member of UNPRI, we also publish our climate transparency report on PRI's website, which is available to the public.

3.3 Climate risk monitoring

Consistent with the Constructive Ownership Approach, climate risk factor will be re-appraised annually with all other material ESG risk factors considered in our internal E&S assessment (SRM).

4 Governance and learning

The governance structure for managing climate risk is built around the Research Excellence Process.

Our Research Team is responsible for the day-to-day implementation of our climate change management approach. This includes engaging actively with our holdings to meet our engagement targets, and providing relevant analysis to the Investment Committee (e.g. view on whether each asset is likely to achieve our targets or not) at quarterly 'Strategy Townhall' meetings and Annual Strategy Review meetings.

The Research Analyst (Climate Change), with oversight from the Research Director (Impact and Engagement), is responsible for maintaining our Climate Change Approach, including updating this document at least annually, providing technical expertise to support the Research Team with respect

[11] Please see the annex for more about the TCFD.

to climate change engagements and management information to be reviewed at the relevant forums mentioned in this section.

Arisaig's **Investment Committee** is responsible for achieving our asset- and portfolio-level targets. The Committee makes the "exit or explain" decision with respect to any assets that are falling short of our targets.

The Fund Boards are responsible for ensuring the Strategy meets its mandate of generating sustainable long-term returns. Climate risk is an agenda item at all the board meetings of each Strategy. The management entity is responsible for updating the Board of each Strategy on progress against net zero targets and justifying any deviations from climate policy.

The Boards of the management entities (AP Asia and APRS UK) are responsible for ensuring that the firm meets its mandate of generating sustainable long-term returns across its strategies. The Research Department and Investment Committee are responsible for updating the Board on progress against net zero targets and justifying any deviations from climate policy.

5 Annex

A. Taskforce on Climate-Related Financial Disclosures (TCFD)

The table below summarises where TCFD recommendations are embedded into Arisaig's policies and disclosures.

Governance of climate-related risks and opportunities	
Describe board's oversight of climate-related risks and opportunities	Section 4
Describe management's role in assessing and managing climate-related risks and opportunities	Section 4
Strategy: actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material	
Describe the climate-related risks and opportunities the organisation has identified over the short, medium, and long term	Section 1
Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning	Section 1, Section 3 Operational climate change policy (available on request)
Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario	Section 3
Risk management:	
Describe the organization's processes for identifying and assessing climate-related risks	Section 3
Describe the organization's processes for managing climate-related risks	Section 3
Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management	Section 3
Metrics and targets	
Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process	ESG Review (available on our website: https://arisaig.com/about-us/responsibility/)
Disclose scope 1, scope 2 and, if appropriate, scope 3 greenhouse gas (GHG) emissions and the related risks	ESG Review (available on our website: https://arisaig.com/about-us/responsibility/)
Describe the targets used by the company to manage climate-related risks and opportunities and performance against targets	Section 1

B. External reference materials

- Recommendations from the Task Force on Climate Related Financial Disclosures[12]
- EU Sustainable Finance Disclosure Regulation[13]

[12] Source: Recommendations | Task Force on Climate-Related Financial Disclosures (fsb-tcfd.org)
[13] Source: Sustainability-related disclosure in the financial services sector | European Commission (europa.eu)

Disclaimer

This document is for Professional Investors only. The views expressed in this document are those of Arisaig Partners and should not be considered as advice or a recommendation to buy, sell or hold a particular investment. They reflect opinion and should not be taken as statements of fact, nor should any reliance be placed on them when making investment decisions.

This article contains information on investments which does not constitute independent research. Accordingly, it is not subject to the protections afforded to independent research.

Fund values can fall as well as rise, and investor losses may equal or exceed original investment. Past performance is not a guide to future returns.

The statements and views expressed herein are subject to change and may not express current views. Such views (i) may be historic or forward-looking in nature, (ii) may reflect significant assumptions and subjective judgments, and (iii) are subject to change without notice. Arisaig Partners makes no representation or warranty, express or implied, regarding future performance or events.

Any statements regarding future events constitute only the subjective views or beliefs of Arisaig Partners. Words like “believe,” “expect,” “anticipate,” “promise,” “plan,” and other expressions or words of similar meanings, as well as future or conditional verbs such as “will,” “would,” “should,” “could,” or “may” are generally intended to identify forward-looking assumptions. Certain assumptions have been made in the course of preparing this document. Arisaig Partners makes no representations or warranties that these assumptions are accurate. Any changes to assumptions made in the preparation of this document could have a material impact on the information presented. Additionally, information regarding the due diligence process with respect to portfolio investments is meant to be indicative of the general process that Arisaig Partners intends to follow and is not meant to be construed as a description of the process followed with respect to every portfolio investment. Furthermore, the content of this document is included as an example of the overall risk management process. Arisaig Partners may change this process without notice to investors in any manner that it deems appropriate.

Emerging markets are generally more sensitive to economic and political conditions than developed markets. Foreign and emerging markets investments may be more volatile and less liquid than other investments and are subject to the risks of currency fluctuations and adverse economic, social, or political developments. Emerging markets exposure may lead to a greater risk of loss because of volatile securities markets, adverse exchange rates and social, political, military, regulatory, economic, or environmental developments, or natural disasters that may occur in those emerging markets. Other factors include greater 'Liquidity Risk', restrictions on investment or transfer of assets and failed/delayed delivery of securities or payments to the Fund(s).

All information is sourced from Arisaig Partners and is current unless otherwise stated. The images used in this document are for illustrative purposes only and where applicable, the firm has requested the necessary permissions to reproduce the images within this document.

This document is issued by Arisaig Partners (Asia) Pte Ltd for information purposes only and is not intended for public use or distribution. Arisaig Partners (Asia) Pte Ltd is licensed and regulated by the Monetary Authority of Singapore to carry on business in the regulated activity of fund management under the Securities and Futures Act, Chapter 289 of Singapore and operates as an exempt financial adviser under section 23(1)(d) of the Financial Advisers Act, Chapter 110 of Singapore.

For information on how we use the personal information that we collect or generate in relation to the use of our website (at https://arisaig.com/) as well as our services, please visit www.arisaig.com/privacy-policy/.