

ENVIRONMENT AND SOCIAL MANAGEMENT SYSTEM: AUDIT FINDINGS AND DETAILS OF ARRANGEMENT

A. Introduction

1. The Asian Development Bank (ADB) is proposing an investment of up to \$40,000,000 in Northstar Equity Partners V Limited (NEP V). NEP V is a private equity fund established as a Cayman Islands exempted company incorporated with limited liability, with an expected size of \$500 million. Northstar Capital Group V Limited, a Cayman Islands limited liability company, is the managing director of NEP V. The investment manager, Northstar Advisors Pte. Ltd., is a Singapore limited liability company. The managing director along with its affiliates comprise Northstar Group (Northstar). Since its inception in 2006, Northstar has launched five funds (i.e., NEP I–V), having fully realized NEP I and partially realized the NEP II–IV portfolios.

2. NEP V aims to provide growth capital to 8-10 mid-sized Indonesian companies focusing primarily on consumers (including in the areas of education, health care, and agribusiness), financial services, and the digital economy.¹ The fund may invest up to [This information has been removed as it falls under the exception to disclosure in ADB's Access to Information Policy, para. 17.2.(v)] of the aggregate commitments in other countries in Southeast Asia.² While NEP V will focus primarily on significant minority and controlling interest investments in mature, growth companies, it may also invest up to [This information has been removed as it falls under the exception to disclosure in ADB's Access to Information Policy, para. 17.2.(v)] of aggregate commitments in six to eight early-stage opportunities.³

3. The project is classified as category FI for environment and involuntary resettlement and FI treated as category C for indigenous people under ADB's Safeguard Policy Statement (2009). ADB has assessed the investment's potential environment and social impacts, the risks associated with the existing and likely portfolio of NEP V, and Northstar's commitment to and capacity for environmental and social management in line with ADB's Safeguard Policy Statement requirements for a financial intermediary. The fund will be restricted from using funds for any activities that are classified category A for environment and involuntary resettlement, and A and B for indigenous peoples.

B. Findings and Recommendations

4. **Environmental and Social Policy.** Northstar adopted an environment, social and governance (ESG) policy in 2017 that it considered to be aligned with the United Nations'

¹ Indonesian companies are headquartered or have existing significant operations in Indonesia, or that the managing director reasonably believes will (within a 5-year period), either (i) derive at least 50% of their revenue, profit, or market value from Indonesia; or (ii) expand significantly into or source a significant amount of business from Indonesia.

² Southeast Asian companies are headquartered or have existing significant operations in Southeast Asia, or that the managing director reasonably believes will (within a 5-year period), either (i) derive at least 50% of their revenue, profit or market value from Southeast Asia; or (ii) expand significantly into or source a significant amount of business from Southeast Asia. Southeast Asia includes: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste, and Viet Nam. ADB will only participate in any investments by the fund in portfolio companies operating in Cambodia, Indonesia, Lao PDR, Malaysia, the Philippines, Thailand, Timor-Leste, and/or Viet Nam. Specifically, ADB will have excusal rights in relation to investments in Brunei Darussalam and Singapore (being graduated ADB developing member countries) and Myanmar. Based on discussions with Northstar, ADB considers that the likelihood of the fund investing in Myanmar is very low.

³ Early-stage opportunities include any investment opportunity in a portfolio company where the aggregate amount invested by the fund is \$15 million or less.

Principles of Responsible Investment.⁴ However, at the time of due diligence, there was no evidence of a discrete, documented ESG policy statement other than the reference in the 2018 ESG and Impact Report.⁵ The policy language in the 2018 ESG and Impact Report included statements regarding commitments to integrating responsible investment and ESG considerations into decision-making processes, and appropriate ESG-related disclosures and reporting. The ESG policy is stated to include a four-step decision-making process (para. 5) through which material environmental, health and safety, and social and governance issues are identified. The ESG policy process itself is not supported by any standard operations procedures, registers, or quantitative metrics or thresholds to determine material risk, and is therefore insufficient as an Environmental and Social Management System (ESMS) that would satisfy the ADB Safeguard Policy Statement's requirements for a financial intermediary.

5. **Screening, categorization, and decision-making procedures.** Under Northstar's existing ESG policy and philosophy statements, where Northstar is the lead investor, the prospective investee companies are reviewed through a four-step ESG process, which includes (i) a high-level ESG assessment by the investment team; (ii) determining if the ESG risk is low, medium or high; (iii) further investigating medium and high-risk investments (undertaken by third-party ESG specialists); and (iv) presenting ESG findings in an investment review committee (IRC) memorandum prior to making investment decisions, with approved investments incorporating ESG key performance indicators in transaction documents. Some previous fund investments were not processed in accordance with this process, in particular the Greenfield NEP V investment, for which ESG screening and processing was undertaken by the lead investor of the consortium, with Northstar accepting the findings prior to investment approval.

6. Northstar uses a standard ESG questionnaire for its pre-investment due diligence to identify specific ESG impacts and risks associated with the proposed investee company. Northstar has no (i) other tools or templates for conducting environmental and social assessments; (ii) metrics to gauge the categorization of a potential investment; or (iii) established, procedural guidance specifying additional requirements for environmental and social due diligence based on risk categorization. More comprehensive due diligence is carried out where there are material ESG risks, though it is not clear what constitutes material risks. Northstar's investment and portfolio operations teams, with support from its general counsel, review documents related to ESG risks and discuss remedial actions that may be implemented.

7. ESG findings are described in the IRC memorandum and are considered as part of the suitability analysis carried out for proposed investments. Northstar shared two cases that demonstrated how it incorporated ESG considerations in its decision-making. One concerns an investee that manufactures precision metal components from a previous fund. Northstar commissioned a third-party comprehensive review of the investee's production facilities. The review revealed several issues that required post-investment remedial actions, which the investee implemented to rectify the issues. In a second case Northstar considered that the prospective investee's approach to ESG risk was both socially irresponsible and indicative of poor governance, and Northstar declined the prospective investee on those grounds. The cases revealed that ESG due diligence was a part of Northstar's investment decision making processes but fell short of ADB's ESMS requirements.

8. **Organizational Structure and Capacity.** Northstar has no dedicated ESG personnel that have overall responsibility for ESG oversight, review and follow up. Currently, the firm's general

⁴ PRI. [Principles for Responsible Investment](#).

⁵ Northstar. 2018. *ESG & Impact Report*.

counsel provides oversight and guidance to the investments and portfolio operations teams on ESG matters. The investments team conducts ESG due diligence on prospective investments, and works with the Northstar portfolio operations team to manage any ESG issues post-investment. The current ESG capacity has insufficient dedicated resources to manage and implement an ESMS process that is ADB compliant for an FI categorized project.

9. Northstar's investment and portfolio operations teams are trained annually on compliance and ESG through the training session provided by its general counsel. The training does not include topics related to multilateral development bank environmental and social standards for FI transactions. No other specialized environment and social-related training plan was presented to ADB during due diligence.

10. **Monitoring and reporting.** Northstar does not have a mechanism to actively monitor the investees' compliance with applicable laws and regulations, and environmental and social mitigation measures. Northstar collects annual ESG data from each portfolio company that include environmental incidents and workplace injuries, but Northstar is only informed of the outcomes, and does not engage in handling and resolving ESG issues and incidents of portfolio companies.

11. Northstar prepares an annual ESG report that is distributed to all investors in its funds. The report includes information on portfolio-wide ESG metrics and company-specific ESG issues identified during the due diligence process. The focus is on environmental, health, and safety issues; and corporate social responsibility-related activities.

12. **Information disclosure and grievance redress mechanism.** Northstar discloses very limited information about exited and current portfolio companies on its website. No information on environmental and social risks and impacts associated with the business activity is shown.

13. Northstar does not have a formal grievance redress mechanism that enables stakeholders and the public to register their complaints.

C. Environmental and Social Management System Requirements

14. ADB's due diligence and review of Northstar's commitment and capacity for environmental and social management aim to promote compliance with ADB's Safeguard Policy Statement requirements. As a result of the ESMS audit, Northstar has been advised to undertake the following actions.

15. **Environmental and social policy.** Northstar will be required to establish and maintain an ESMS in accordance with ADB's Safeguard Policy Statement requirements and commensurate with the impacts and risks of NEP V's investments that will be funded by ADB. Northstar will adopt and apply ADB's environmental and social requirements to all future portfolio investees that will use ADB proceeds. The ESMS will be agreed by ADB prior to ADB's first disbursement.

16. **Screening, categorization, and decision-making procedures.** Northstar will be required to include within its ESMS an ADB Prohibited Investment Activity List screening procedure to be applied to all proposed investments using ADB proceeds. Each proposed investment will be screened and classified for its potential risks and impacts on the environment, involuntary resettlement, and indigenous peoples, guided by ADB's screening and categorization procedures. Northstar will engage with ADB during the investment appraisal process to provide early information and consult about the upcoming investments. Prior to any capital call, Northstar

will submit the environment and social screening and categorization reports and, as applicable, the environment and social due diligence reports in a format to be agreed with ADB. ADB will have the right to be excused from contributing capital to (i) any proposed investment classified as category A against all safeguard requirements, (ii) any investment classified as category B for indigenous peoples impacts, and (iii) any proposed investment that ADB assesses as being noncompliant with the ESMS.

17. **Organizational structure and capacity.** Northstar will be required to appoint a dedicated environment and social personnel to oversee overall ESMS implementation and ensure capacity building within the Northstar team and prospective investee companies, as applicable. The resource should be technically qualified and appropriately experienced in environmental and social matters such that it can (i) carry out the environmental and social due diligence in line with the requirements of the ESMS; (ii) review previous ESG-related work carried out by Northstar's investments or portfolio operations teams, independent consultants, or experts; (iii) establish terms of reference for additional due diligence; (iv) monitor portfolio company environmental and social performance; and (v) develop annual performance reports to be submitted to ADB.

18. Northstar will identify the ESMS training needs and develop a training plan for both the appointed environment and social resource and the investments and portfolio operations teams. Northstar will report annually to ADB on the implementation of the training plan, the topics covered, and participation by personnel, and include this information in its annual environmental and social reporting to ADB.

19. **Monitoring and reporting.** The ESMS will include procedures for supervision and performance reporting on compliance by investee companies with their contractual obligations in relation to environmental and social issues, including the status of any corrective action plan.

20. Northstar will be required to submit to ADB an annual environmental and social performance report covering its portfolio companies, in a format to be agreed with ADB. It will promptly report to ADB on environmental and social incidents and compliance breaches by portfolio companies.

21. **Information disclosure and grievance redress mechanism.** Northstar will establish a formal grievance redress mechanism to address any possible environmental and social concerns and dissatisfaction of stakeholder groups affected by the business activities of its portfolio companies. Statistics and summary information on environmental and social complaints will be required to be included in the annual environmental and social performance report submitted to ADB. On a best endeavor basis, Northstar will seek to ensure that the NEP V investee companies adopt the grievance redress mechanism, and will seek reporting updates for its annual reporting submissions to ADB.