ASIAN INFRASTRUCTURE INVESTMENT BANK

Strategy on Investing in Equity
April 3, 2019

1. Objectives

1.1. The Strategy on Investing in Equity (the Strategy) establishes the principles of the equity program of the Asian Infrastructure Investment Bank (AIIB, or the Bank). Equity investment is an important tool to help AIIB realize its mandate to foster sustainable infrastructure and achieve development outcomes in its member countries, mainly by mobilizing private capital but also in other ways.

1.2. The Strategy covers instruments that provide ownership or clear profit participation features. The Strategy focuses on the infrastructure sector, broadly defined, but it generally applies to Other Productive Sectors that AIIB may invest in.

1.3. The Strategy should be considered in conjunction with other AIIB sectoral strategies and policies, including the Capital Adequacy and Stress Testing Policy, the Risk Limits Policy, the Risk Appetite Statement and the Accountability Framework.

2. Introduction

2.1. Equity investments provide returns generally through dividends and eventual sale of the investments. The return is uncertain at inception and is subject to factors specific to a company, sector and/or country, and regional or global economic and business cycles. In general, equity investments can be categorized as either direct equity, or indirect equity through externally managed funds. Equity can be the appropriate financing instrument in a range of circumstances. Notably, equity can provide the critical capital base in new initiatives in high growth environments where upside potential is high but expected cash flows are volatile or unpredictable.

2.2. AIIB's Articles of Agreement (AoA) specifically state that the Bank may carry out its operations by investing funds in the equity capital of an institution or enterprise, while mandating the Bank to follow certain limitations on the relationship between AIIB's equity position and its net worth, and the overall portfolio. It is also stipulated that AIIB will seek to achieve reasonable diversification in its equity investment portfolio, not to take a controlling interest in any entity, and to maintain appropriate provisions against possible losses.[1]

[1] Asian Infrastructure Investment Bank, Articles of Agreement, Article 11, Par. 2, Article 12, Par. 1 and 2, Article 13, Par. 11, Article 14, Par. 3 and Article 20, Par. 1.

2.3. Global trends show that investments in infrastructure are gradually shifting from the public sector to the private sector. Globally, private sector investors deploy a wide range of equity instruments and vehicles in infrastructure projects, which allow project sponsors to leverage additional debt or equity. However, in emerging Asia, the private sector still plays a relatively small role in financing infrastructure compared to other regions. Given the substantial gap between infrastructure financing need and available capital in emerging Asia, AIIB has significant scope to use equity investment to attract additional commercial capital for infrastructure. The non-controlling ownership, required by the AoA, means that AIIB's investments will mobilize other sources of long-term finance, one of the Bank's key themes. In those likely cases where AIIB is a relatively early and relatively large investor in an externally managed equity fund, the Bank has opportunities to leverage its position to attract other investors, as outlined in the Bank's Strategy on Mobilizing Private Capital for Infrastructure. AIIB's involvement as an equity investor can broaden the range of investment opportunities, notably among large and influential institutional investors. Given its mandate, substantial financial resources and sector focus, AIIB is in a unique position to bridge the public and private sectors, to offer specialized skills and knowledge, and to use its convening capability to mobilize private capital for infrastructure investment in Asia. In this way, AIIB serves as both a catalyst and an anchor.

2.4. Unlike debt, equity carries no legal obligation for repayment and has an unpredictable and variable cash flow for investors. Macroeconomic conditions, particularly the performance of local currencies, sector specific dynamics and the regulatory environment, have a large impact on financial returns. Equity also carries a larger measure of responsibility, as investors are more directly associated with investee company activities. Therefore, equity is broadly understood as a riskier investment than debt, and it consumes more economic capital. As a result, equity investors usually require a higher rate of return than lenders do. If executed effectively and in a disciplined way, equity investments can help AIIB realize its mandate and key thematic priorities through more direct involvement than is typical for other products, as well as meaningfully contributing to the growth of AIIB's balance sheet and its profitability.

2.5. Both debt and equity have roles to play in project financing packages. Equity investments offer a special opportunity for a "seat at the table" and they can provide AIIB with an early, constructive influence with investee companies. Equity investments can support AIIB's objectives through market signaling, institution building and the improvement of the enabling environment over time.

2.6. Equity can support a range of sustainability goals, such as improving Environmental and Social (E&S) policies and good corporate governance standards. Similar E&S policies, objectives and requirements apply to both equity and debt, but equity investment can have a more pronounced impact. As a shareholder, AIIB is in a better position to facilitate investees' adoption of target practices, which in turn will influence other providers of finance, investee companies and their peers. Equity investments can also support the creation of role model companies in terms of Environmental, Social and Governance (ESG).

2.7. Equity investments also serve as essential risk capital for small-scale and innovative projects in dynamic subsectors where technological innovation is pronounced. These projects require significant equity investment, often through new corporations, platforms, or even small investment "clubs" tailored to individual investors' return preferences, yields and exit plans. In these areas, private investments are often constrained due to the high-risk profile of such projects, especially for new companies with limited cash flow.

2.8. Given the inherent high-risk feature of equity investment, it is critically important to ensure that the Bank pursues such investments in a disciplined manner. The following guiding principles and implementation approach are intended to guide AIIB in developing a well-diversified equity portfolio composed of high-performing assets, supported by a sound institutional setup and a strong partnership network.

3. Guiding Principles

3.1. Disciplined

3.1.1. Equity investing requires detailed planning and careful implementation, with a clear direction and approach. Each equity investment will rigorously meet the twin goals of development outcomes and market financial returns commensurate with the economic capital it consumes.

3.1.2. The Bank's exposure to equity will be implemented through Annual Business Plans and subject to the risk limits set by the AIIB AoA, Board and Management, as modified from time to time.

3.1.3. AIIB will invest its equity in line with international best practices and ensure that its portfolio companies implement AIIB's key policies. AIIB will follow Global Forum on Transparency and Exchange of Information for Tax Purposes and Financial Action Task Force standards for funds that are domiciled in third jurisdictions and will diligently take measures required by its relevant Directives.[2]

3.2. Progressive

3.2.1. AIIB will progressively develop its equity program, in accordance with its financial position, in-house capacity and strategic priorities. In the near term, AIIB will prioritize investments that provide a combination of relatively low risk, high diversification and strong market learning, such as equity funds and platforms.

3.2.2. AIIB will also progressively establish its internal capacities to meet the growing needs for managing its equity portfolio. Those capacities will be tailored for equity but fully integrated with the existing systems and teams of the Bank (see Section 4 for the implementation approach).

[2] Including the Directive on Anti-Money Laundering and Combating the Financing of Terrorism.

3.3. Diversified

3.3.1. AIIB will achieve diversification within the equity portfolio so that it offers lower volatility and satisfactory returns over time. This approach will, in turn, limit AIIB’s risk exposure to business down cycles in any single market or sector and will require relatively small commitment sizes across a range of clients, sectors and geographies. By enabling the Bank to reach a broader set of clients, equity can also contribute to a well-diversified portfolio for AIIB.

3.4. Impactful

3.4.1. The equity program will focus on the quality of its investments, measured by development outcomes and applicable financial benchmarks rather than on commitment volumes.

3.4.2. AIIB will actively and effectively use the opportunities provided by equity to influence investee company policies as an engaged, knowledgeable partner. This includes provisions that are aimed at protecting AIIB’s investment and brand and creating lasting positive impact in E&S policies and corporate governance standards. Such provisions will be determined prior to the investment decision and be tailored to the specific circumstances of individual investments.

3.4.3. To reinforce its impact, AIIB will develop a program of active portfolio management, which will aim to improve the value of its investee companies and offer insights into market practice and trends. As a non-controlling investor, AIIB will implement this program by working with other investors.

4. Implementation Approach

4.1. AIIB has already made initial investments in equity funds. The Bank will move in a phased approach to more complex engagements: co-investments with funds where AIIB is an investor and direct equity investments, independently of funds. Internal capacity building will be the central element driving and shaping the phased approach.

4.2. AIIB will establish investment guidelines that will identify the critical capacities specifically required for each phase. These will include management procedures, business development capacities, tailor-made risk mitigation mechanisms middle and back office functionalities, specialized staffing and IT infrastructure.

4.3. In the current phase, AIIB will selectively invest in equity funds and platforms that are highly transparent, well managed and diversified and whose managers have ~~a~~ good reputation and track record. Benefiting from its experience from investing in funds, AIIB will build its comparative advantages and market presence. For this phase, the investment guidelines will emphasize how AIIB can protect its investment, proactively manage reputational risk, achieve intended development outcomes and leverage post-disbursement, through close monitoring, including active participation in the funds' Advisory Committees.

4.4. AIIB will move to co-investments with investee funds and direct equity investments phases when Management determines that the necessary internal capacities are in place. In these phases, AIIB will invest only in companies that have high integrity, significant potential for growth and good management capacity and comply with the Bank's E&S standards and other policy requirements. For co-investments with investee funds the investment guidelines will identify special procedures needed to ensure timely responsiveness. For direct equity investments, the investment guidelines will include explicit exit plans before an investment is made and key provisions for the selection of nominee Board Directors and their responsibilities.

4.5. To support the phased implementation approach, AIIB will build strong and specialized equity expertise needed for the deeper engagement that equity investments require by identifying and developing experts internally and also recruiting externally. Staff specializing in equity will be fully integrated into AIIB's existing operations and organized in a way to ensure continuity through the life cycle of the investment.

4.6. AIIB will also develop a network of preferred partners to gain project and market knowledge and to enhance its market analysis capacity. AIIB will tap into the knowledge of reputable sector experts and arrange trainings, internships and exchanges with key partners such as other international financial institutions, major institutional investors and selected fund managers.

4.7. AIIB will acquire or build IT systems to collect, manage and report on financial data specific to AIIB's equity portfolio. These systems will also track dividends, valuations, capital calls and other key variables. These systems will be integrated with AIIB's main financial and management capacity and accounting functions.

4.8. AIIB will periodically review its equity investment program in line with the Bank's priorities and the guiding principles above. The review process will monitor how well the twin goals set out for each equity investment are achieved. The process will also reflect on the performance of the equity portfolio against the indicative range of long term financial targets, the outlook in key markets and the progress achieved in building the Bank's internal capacity. Informed by the review process, the Bank will adjust the investment program and define resource needs going forward.

4.9. Summary results of the equity investment program review, including the progress of the phased implementation approach, will be reported to the Board of Directors as part of Annual Business Plans.

4.10. The Board of Directors will periodically review and, as appropriate, revise this Strategy. The timing of such reviews will be agreed with the Board of Directors in the context of Annual Business Plans.