

An aerial photograph of a city street. On the left is a tall, modern glass skyscraper. In the center is a brick building with a flat roof. To the right is a building with a green roof, featuring patches of green vegetation and a central skylight. The street below has a few cars and a crosswalk.

April 2022

Navigating Challenges,  
Seizing Opportunities

# Building ESG into Private Market Portfolios

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## Highlights

- Sustainably managed assets represent about 36% of total assets under management globally, the bulk of which is invested in public markets.
- Changing preferences, materiality and opportunities - reinforced by regulation - propelled ESG growth in public markets and are increasingly incentivising similar dynamics in private markets. As a result, investor interest in applying ESG to the private sphere is rapidly rising.
- In establishing a framework for ESG investing in private markets, having a robust foundation in fundamental analysis expertise in public markets can help inform best practices and decision-making.
- However, significant differences exist between ESG investing in private markets vs. public markets. These arise from factors such as the time horizon of investments, information availability, ownership structure and channels of influence.
- ESG data is generally sparse and inconsistent in private markets, making sustainability-aligned investments more challenging than in public markets. However, asset owners potentially have more time, control and influence to enact lasting changes.
- At Fidelity, we are leveraging our bottom-up research capabilities to apply an ESG lens across the investment cycle - sourcing, ownership and exit.
- We provide two examples of how Fidelity is putting this approach into practice through collateralised loan obligations (CLOs) and direct real estate strategies.

# Contents

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Private assets: The next frontier in ESG risks and opportunities	4
Double materiality materialising	4
Growth potential of ESG in private markets	5
Differences between public and private market ESG implementation	6
What private markets can learn from public markets	7
Applying ESG to loans and CLOs	8
Real estate: The path to net zero	9
Fidelity's proprietary ESG ratings	11
ESG engagement in private markets	11
The high road in private markets	13

## Private assets: The next frontier in ESG risks and opportunities

Environmental, social and governance (ESG) trends present investors with one of the most meaningful sets of challenges and opportunities across the world today. Sustainably managed assets have increased from US\$22.8 trillion in 2016 to US\$35.3 trillion in 2020, representing about 36% of total assets under management globally, according to the Global Sustainable Investment Alliance.

Reinforced by regulation, the reasons for this remarkable shift are threefold:

- 1. Changing preferences.** Consumer, investor and societal attitudes are creating demand to incorporate a stronger focus on sustainability in capital allocation, influencing investment decisions at every level. This trend accelerated during the COVID-19 Crisis, highlighting the relationship between business resilience and sustainable business practices. There is increasing recognition that investors have to think of ESG beyond the confines of individual portfolios towards a more outcomes-oriented view to drive real-world results, such as how asset allocation decisions align to the Paris Agreement.
- 2. Changing materiality.** The magnitude and likelihood that sustainability issues affect financial performance have become more apparent, increasing data transparency and new technology that enables analysis at a more granular level. Furthermore, the ramifications of ESG issues such as climate change are becoming more salient, changing how asset owners integrate sustainability. Previously, the emphasis may be on how ESG factors affect a particular company. While this remains relevant, a second dimension is being considered, looking at the environmental and social impact a business has on society. We explore how ESG materiality is developing in the next section.
- 3. Changing opportunities.** Evolving preferences and materiality of sustainability issues have helped foster the rapid development of ESG solutions, creating potentially attractive opportunities for investors. Witness the electric vehicle (EV) industry, with sales of cars more than doubling to 6.6 million in 2021, tripling their market share from two years earlier. In fact, all the net growth in global car sales in 2021 came from electric cars, accounting for about 9% of the global car market with tremendous room for growth, according to the International Energy Agency.<sup>1</sup>

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The rising tide hasn't lifted all boats equally. Rapid growth in sustainable investing has been concentrated in specific geographies and public markets, particularly listed equities. However, the drivers of change are spilling into private markets, and investors will need to prepare. The expected acceleration of ESG adoption in private assets is likely to meaningfully change risk-return characteristics, which may resemble the evolution in public markets but with significant differences.

In this paper, we consider why ESG is playing a more central role in private markets, what public markets can teach us about private markets and set out a framework to help investors be stewards of change in private markets while optimising portfolio returns. We also consider how to apply ESG to private asset classes, including real estate, collateralised loan obligations (CLOs) and direct lending.

## Double materiality materialising

Evidence that ESG has a material impact on an issuers' risk-adjusted return is mounting, with hundreds of research papers written on the topic. For example, in a recent paper examining over 1,600 stocks in the MSCI World Index universe between January 2007 and May 2017, the authors found higher ESG-rated companies tended to be more profitable, paid more dividends and experienced lower tail risk during extreme market downturns.<sup>2</sup>

Furthermore, ESG return drivers were transmitted through three key channels: cash flow (higher rated ESG companies may benefit from efficient use of resources, robust human capital development and innovation to support earnings growth); systematic risk (companies with higher ESG profiles tend to have lower cost of capital, which can translate to higher relative valuations); and idiosyncratic risk (companies with stronger risk management practices and/or regulatory preparedness may have more downside protection).<sup>3</sup>

However, it is important to note that the materiality of individual ESG issues is often dynamic and can change over time. This can be driven by ESG factors interacting with traditional return drivers or the salience and risk associated

with an issue shifting in response to varying external conditions. Russia's invasion of Ukraine, for example, could mark a moment of recalibration of sovereign ESG risk, and has even sparked a debate about the eligibility of defence spending to be classified as a sustainable economic activity. Furthermore, the degree that sustainability factors are material also differs by sector. Beverage manufacturers, for example, may be far more affected by water efficiency than a financial institution. Nevertheless, it is clear investors should not ignore ESG materiality.

The concept of 'double materiality' takes this a step further to examine materiality not only from an internal, corporate or sovereign perspective, but also externally to consider the impact a company, a country or a portfolio has on the environment, the community and broader society.

The recognition of this double materiality concept in ESG, combined with rapid growth in capital flows towards sustainable assets, contributes to an inflection point in ESG investing. Regulators are rapidly introducing a raft of policies, reporting guidelines and data frameworks to facilitate transparency and avoid misrepresentation of sustainability characteristics. For example, elements of double materiality are embedded in the European Union's Non-financial Reporting Directive.

For institutional investors such as pension funds and insurers, double materiality is an essential framework for making investment decisions if they are concerned about how their capital is being used. It allows more visibility to help meet outcomes-oriented ESG goals and evaluate longer-term risks and opportunities arising from an issuer's impact on a wider range of stakeholders.

## Growth potential of ESG in private markets

Advances in research linking ESG materiality and the investment decision-making process, supported by higher levels of sustainability disclosures and regulatory requirements, have helped create a positive feedback loop in ESG investing in public markets. There are signs that similar dynamics are beginning to occur in private markets, albeit from a low base. Private markets ESG-linked assets under management (AUM) doubled between 2017 and 2020 (see Figure 1), PwC estimates. And the total may reach between EUR776 billion and EUR1.2 trillion by 2025, accounting for 27% to 42% of the entire private markets sector.<sup>4</sup>

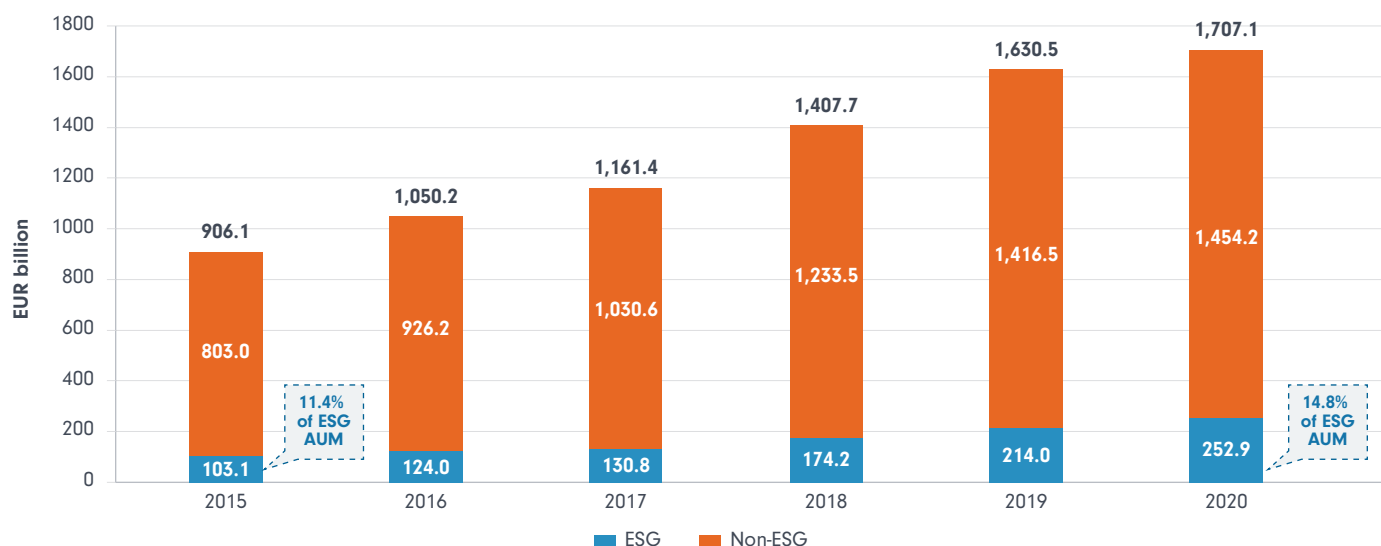
To better understand changing risks and opportunities, investors in private markets are increasingly considering ESG in their risk-reward analysis, recognising that the sustainability characteristics of an asset can influence asset valuation throughout the investment cycle and upon disposal.

Enhanced data availability are facilitating a more structured, quantitative analysis of sustainability issues and encourage broader adoption of sustainability considerations.

Institutional investors under fiduciary, regulatory and client pressure to consider ESG in investment decisions also are demanding more relevant disclosures.

Furthermore, new regulations such as the EU Taxonomy, the EU's Corporate Sustainability Reporting Directive (CSRD) and Sustainable Finance Reporting Directive (SFDR) will act

**Figure 1: European private markets AUM, ESG vs. non-ESG**



Source: PwC Global AWM Market Research Centre, Preqin, 2021.

as catalysts for increased data and transparency in both public and private markets. During COP26 in Glasgow, the International Financial Reporting Standards (IFRS) Foundation introduced the International Sustainability Standards Board (ISSB) initiative, which targets a more consistent, high-quality ESG reporting framework.

## Differences between public and private market ESG implementation

ESG investing should be applied across public and private markets, though it is also vital to keep in mind some crucial differences. First is the information environment. Private companies typically face fewer obligations to disclose information publicly, so direct engagement is often a critical source of data gathering. However, we note that the European Leveraged Finance Association (ELFA) recently published a paper to help private issuers meet SFDR requirements,<sup>5</sup> and increasingly, private companies are following best practices set in public markets.

Second, investments in private assets may involve larger ownership stakes or effective control, which is less common for investors in public markets. Therefore, investors in private assets may have more potential to influence change, even if they do not have the voting power of public market investors to make their voices heard. For an investor consortium with a direct stake in an office building, for example, the ability to demand ESG improvements will likely be far more consequential compared to an investor with a small minority stake in a listed real estate investment trust.

Third, longer holding periods, additional liquidity constraints and more complex exit strategies present private market investors with a different set of risk-return characteristics. Arguably, this makes ESG considerations even more relevant in the origination stage because ESG issues are typically more likely to impact business performance or valuations over longer time horizons. ESG considerations also can be significant during the exit process. There is a strong incentive to work with management and other stakeholders to demonstrate and report ESG characteristics and improvements at the end of the investment cycle. (See Figure 2)



**Figure 2: Fidelity's view of ESG in public markets vs. private markets**

	In practice – public markets	In practice – private markets
<b>Sourcing</b>	Forward-looking, materiality-driven analysis supported by proprietary ESG ratings and company meetings.	Limited publicly available ESG data. Longer investment horizon requires more rigorous ESG due diligence.
<b>Ownership</b>	Voting and engagement are the primary channels to improve ESG standards and trajectory.	Direct ownership and a larger stake can increase the potential to drive positive changes.
<b>Exit</b>	ESG improvements can result in potential for higher valuation. Holdings are typically very liquid.	ESG improvements may result in higher valuation and appeal to a wider buyer base. Responsible exit strategies and lower liquidity add complexity.

Source: Fidelity International, March 2022.



**Figure 3: Five pillars of ESG at Fidelity**



Source: Fidelity International, March 2022.

## What private markets can learn from public markets

Despite the differences, there are lessons from public markets that can be applied to private markets. A clear governance structure - grounded in qualitative and quantitative research backing ESG investment solutions and a consistent, active engagement strategy - has long supported our sustainability platform in public markets (see Figure 3). In this section, we demonstrate how this approach can advance sustainability processes in private markets.

A major barrier preventing the application of public market ESG methodology to private markets is the availability of material data. While the reliability of ESG disclosures is improving in public markets, it is still in early stages in the private sphere. Therefore, applying a robust process of complementing private company information with public company ESG indicators such as Fidelity's proprietary sustainability ratings or MSCI ESG Ratings can help improve investment decisions.

First, by using both public and private market data, investors can gain informational advantages relative to relying solely on private market data. Second, the insights, knowledge, expertise and best practices in public markets can be applied to help private companies to develop their ESG trajectory.

One recent example of how public markets expertise can help investors better understand a private issuer involves Breitling, a Swiss luxury watchmaker owned by private equity company CVC Capital. Since Breitling has no direct peers in the European leverage loans market, it is problematic to analyse its ESG credentials relative to peers if looking within private markets alone. However, by integrating Fidelity's proprietary ESG ratings and working closely with analysts covering public companies in the same sector, including Swatch, portfolio managers can delve deeper into ESG issues impacting Breitling's business.

Relative to Swatch, which aims to reduce CO2 emissions by 32% by 2030 relative to 2013, Breitling's environmental goals are viewed as more immediate, detailed and specific to its business. For instance, Breitling is targeting 100% renewable energy procurement and zero plastic waste across operations by 2025. The company also pledged to purchase all gold used in manufacturing from 'Swiss Better Gold' approved sources as early as this year.

In corporate social responsibility, Breitling is investing in programmes such as employee corporate volunteering and aiming to reduce the pay gap between men and women to zero - a far more ambitious goal than many public companies. In our view, having more precise knowledge of a company's ESG trajectory relative to its sector over the investment cycle supports a more informed decision and increases returns potential.

## Applying ESG to loans and CLOs

One of the most attractive opportunity sets in private markets is leveraged loans, and more specifically, collateralised loan obligations (CLOs). The structure of CLOs typically offers higher potential for returns, diversification and inflation protection due to an embedded floating rate component. However, manager expertise is also more relevant relative to public market equivalents due to the higher complexity, illiquidity and other idiosyncratic risks such as the potential for collateral deterioration.

CLOs also are appealing from an ESG perspective. Compared to US and public market counterparts, European CLOs traditionally have relatively lower ESG risk, with negligible exposure to the oil and gas, weaponry, and tobacco. For this reason, the adoption of values-based exclusion criteria is manageable within existing CLO investment frameworks.

However, as private markets take a page from public markets, investors are increasingly opting for an outcomes-based approach, applying a consistent ESG methodology across public and private assets to help gauge progress towards their sustainability goals. There are several steps in which Fidelity applies a consistent process of assessing borrowers - whether public or private - through an ESG lens as follows:

- **Determine eligibility.** A sustainable investing framework guides the qualitative and quantitative standards required for an investment to be considered sustainable. In general, the aim is to build a portfolio in which the majority of assets are as good or better than the weighted average ESG score of the investment universe, considering forward-looking 'E', 'S' and 'G' risks and incorporating these factors into their operations, decision-making and risk mitigation approach. For all borrowers, but particularly those who do not yet meet our sustainability framework standards, engaging with management teams and sponsors to integrate ESG thinking can help improve performance potential in the long term.
- **Select or exclude debt securities.** Our exclusion criteria remain a crucial part of ESG investing. For example, we apply an exclusion policy affecting issuers with material exposure to products or activities that are inherently harmful (tobacco), carry significant negative externalities (oil sands and coal mining) or breach international norms such as the UN Global Compact.



- **Integrate ESG as part of the investment process.** ESG integration in private markets differs from that in public markets. Nevertheless, we can learn from our methodology underpinning SFDR Article 8 requirements and Sustainable Family range of funds to help frame our approach for loan and CLO strategies. We follow the same Article 8 approach to manage loan and CLO strategies, which involve strict criteria and exclusion requirements, embedding ESG into the investment process and assessing every borrower's ESG trajectory. Portfolio construction also is aligned with our minimum standards to meet Article 8 requirements.
- **CLO portfolio reporting.** Basing the reporting methodology on the SFDR Article 8 framework can help increase visibility regarding ESG characteristics, even if the strategy itself is not labelled as such. For example, we have included an additional portfolio profile test overseen by an independent trustee to verify that the majority of our assets comply with our ESG commitment to be as good or better than the weighted average ESG score. In our trustee reports, we are publishing the weighted average ESG score along with significant ESG developments for borrowers so that investors can track the progression of the portfolio.





## Real estate: The path to net zero

Within ESG, climate change is perhaps the most urgent challenge facing the financial system, and this is particularly relevant for real estate investors. Building operational and construction emissions account for 38% of the world's energy-related emissions,<sup>6</sup> making it crucial for investors to address decarbonisation in their real estate portfolios.

Assets with higher ESG ratings may also add return potential and portfolio resilience. According to research by global property services provider JLL using sector BREEAM ratings or EPC certificates,<sup>7</sup> greener buildings commanded higher rental rates and stronger capital valuations. In central London, for example, rents for properties with higher BREEAM ratings were between 6% and 11% higher in the one-year and two-year periods after completion. In addition, they often benefitted from lower vacancy rates, operational costs and regulatory risks.

Therefore, having a clear decarbonisation plan is critical for asset owners, though just as important is the path taken to reach net zero. For example, an investor who simply offsets using carbon credits would theoretically reach net zero, but the reduction of actual greenhouse gases (GHGs) is limited.

Applying a hierarchy to decarbonise offers a structure to help investors deliver real-world impact. Based on best practices established in the Net Zero Carbon Pathway Framework produced by the Better Buildings Partnership, Fidelity's real estate GHG hierarchy (see Figure 4) begins by influencing business decisions to eliminate GHG emissions across the building lifecycle. For example, renovating rather than rebuilding an office building would cut the carbon footprint of delivering modern workspaces.

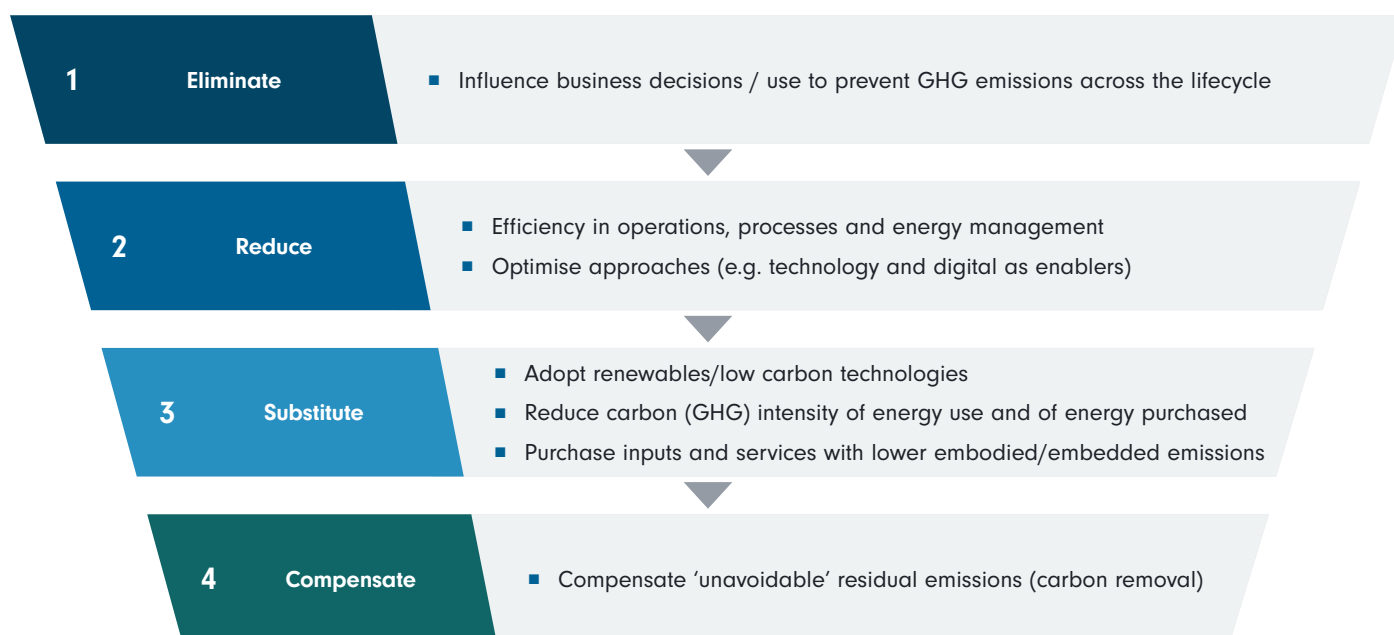
Second, reducing existing emissions by improving operational efficiency such as lowering energy usage can have a long-term impact on a property's carbon footprint. Technology has an important role in this step, including intelligent building management systems that save heating and cooling energy.

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**Building operational and construction emissions account for 38% of the world's energy-related emissions, making it crucial for investors to address decarbonisation in their real estate portfolios.**

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**Figure 4: Greenhouse Gas hierarchy in real estate**

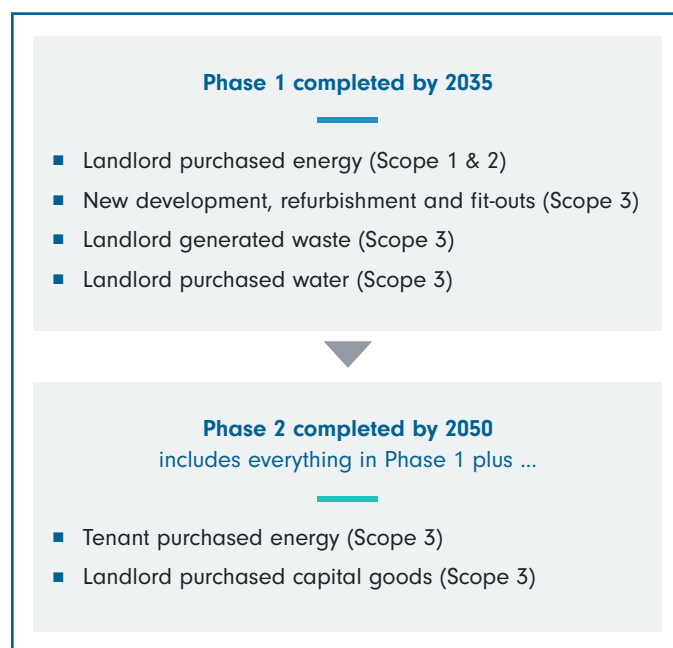


Source: Fidelity International, March 2022.

Third, the aim should be to substitute energy sources with those which have a smaller carbon footprint. For example, adopting on-site renewable energy generation or procuring 'green energy' will reduce the environmental impact of the consumption that is needed. However, there likely will be some unavoidable emissions after the previous methods have been exhausted. The residual, unavoidable emissions should be removed via nature-based carbon removal strategies. In common with Fidelity's corporate approach to our own operational emissions, we are exploring options to acquire or control assets that will contribute to carbon removal to verifiably offset against the residual emissions created in our real estate strategies.

Fidelity is committed to net-zero carbon emissions for all direct real estate funds by 2050 in a two-phase decarbonisation plan. (See Figure 5) In Phase One, we are committed to net zero carbon in Scopes 1 and 2 emissions, which account for the energy consumption under landlord control. In addition, some Scope 3 emissions, such as those linked to new developments and renovations, also will be included in the first phase. Phase Two will follow, covering all energy consumed under Scopes 1, 2 and 3.

**Figure 5: Two-phase net zero plan**



Source: Fidelity International, March 2022.

## Fidelity's proprietary ESG ratings

As the COVID-19 Crisis has demonstrated, ESG materiality is constantly evolving; just because a risk factor has not posed a material threat in the past does not mean it will not impact financial results in the future. Our sustainability ratings framework addresses this by capturing a forward-looking assessment of an issuer's management of key sustainability risks. Internally developed by the Sustainable Investing team and more than 200 investment analysts, the ratings enable comparability across sectors and geographies, public and private markets (See Figure 6). There are currently 4,200 companies covered, spanning equity and fixed income, and we are adding more.

Our dynamic, forward-looking ratings framework is designed to review and update specific indicators to reflect their materiality. For example, in the next iteration of ratings, named Sustainability Ratings 2.0, we are seeking to embed the double materiality concept and integrate other non-financial factors pertinent to investors' sustainability priorities. As climate change has become more urgent within ESG, we also introduced a separate set of proprietary Climate Ratings in 2021 to complement our broader Sustainability Ratings. Our Climate Ratings help assess the ambition and alignment of portfolio companies to a net-zero future.

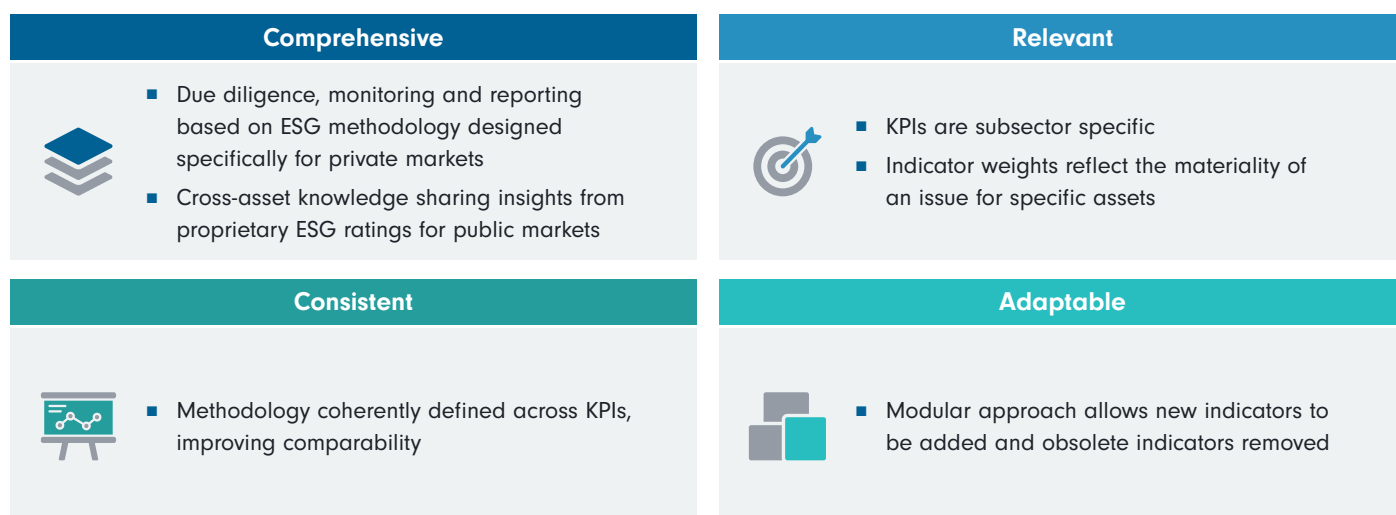
## ESG engagement in private markets

Another distinctive element of Fidelity's ESG platform is our active engagement process. Fidelity conducts more than 16,000 meetings annually to contribute to more granular and forward-looking issuer assessments. In 2021, we engaged with about 1,100 companies on issues including net zero pathway, supply chain sustainability and palm oil production.

We believe engagement is preferable to divestment, and our experience in public markets has helped us engage more effectively in private markets. (See Figure 7) First, establishing a dialogue with portfolio companies enhances investment insights to inform investment decisions. Second, it fosters constructive change aligned with best practices to protect and enhance long-term value for shareholders.

Whether public or private, engagement should be tailored to the individual issuer, region and asset class. Investors in CLO securities, for example, face different challenges relative to public equity owners. For example, the former has no voting power, so success in engagement will rely more heavily on the strength of relationships with issuers and borrowers. For the most part, the terms of the loans are fixed before they are offered to investors. Therefore, ESG due diligence is an especially crucial step.

Figure 6: Key attributes of an ESG assessment framework



Source: Fidelity International, March 2022.



**Figure 7: 1,100 company engagements in 2021**



Source: Fidelity International, March 2022.

In other private asset categories, however, asset managers may have more sway over the terms of the loans, offering opportunities to design ESG into the transaction. In direct lending, asset managers have an active role in the origination process and therefore control a larger percentage - if not the entirety - of the debt issuance, which usually involves smaller companies relative to CLOs. Differences in the structure of the debt securities, the controlling stake and the degree of direct access to management allow for more opportunities to add long-term ESG value to the company before exit.

Again, the ability to influence is different for direct real estate investors, who are essential owners of the asset. Their level of influence is often a product of the interrelationship between owner and asset occupier. Engagement centres on identifying personnel at occupier companies with similar values and ESG priorities, whilst having a clear idea about the investment objectives, the ESG priorities and the investment period. A critical advantage of direct real estate is the potential to have intentional, incremental and attributable impact by improving ESG standards on specific projects that align with investors' values.

Our heritage of bottom-up fundamental research, proprietary ESG ratings and extensive ability to engage with portfolio companies to bridge data gaps and influence change put us on a solid footing to manage the ESG transition in private assets.



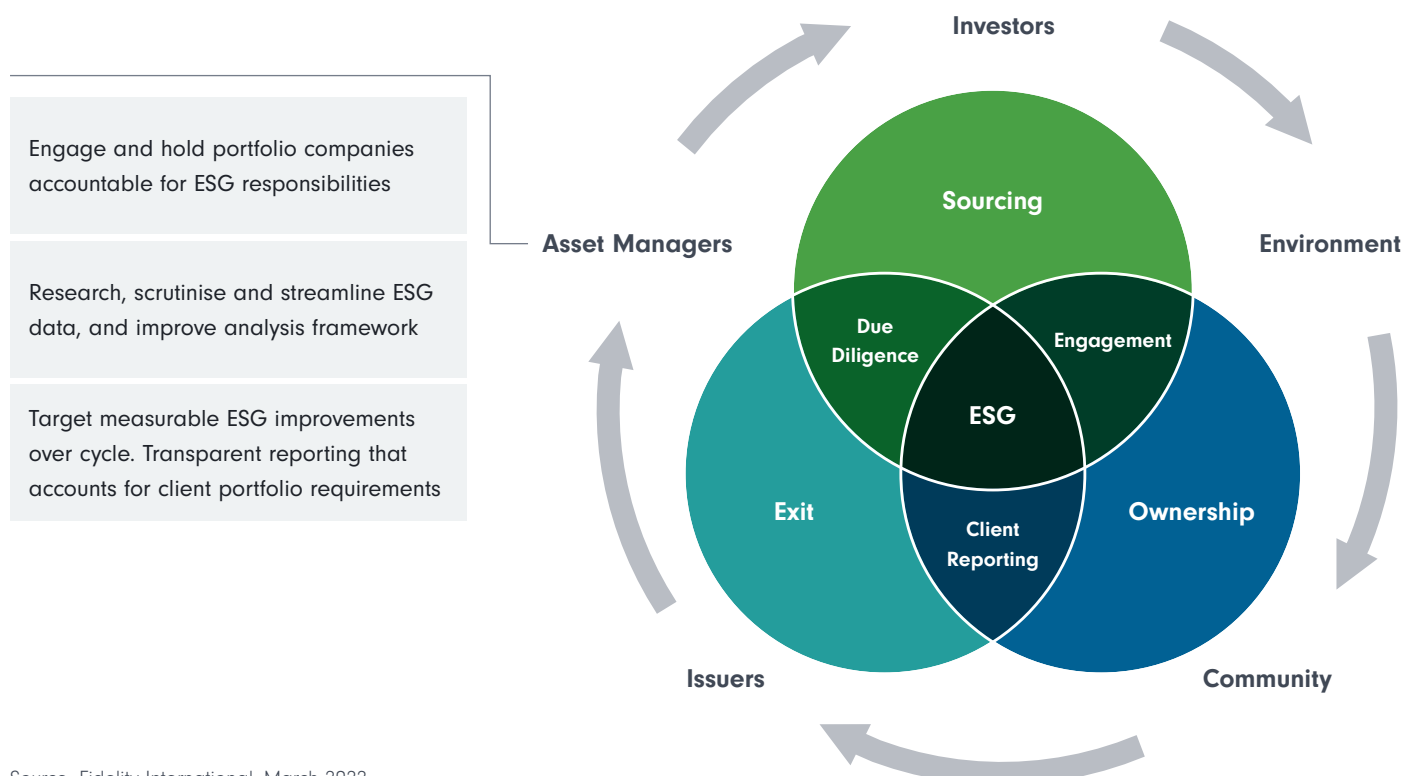
## The high road in private markets

ESG investing in private markets is expected to accelerate in the coming years. Some aspects of this evolution may appear similar to how ESG has developed in public markets, such as the mainstream adoption of ESG analysis for risk management and enhanced disclosure requirements. We know the pace of change will be swift, with a high level of uncertainty ahead. However, being early in building a robust foundation will help enhance the ability to quickly respond to changes, based on our public market experience and its practical application to private markets.

We also understand that effective implementation of ESG analysis in private markets will likely require a more tailored approach to deliver genuinely sustainable outcomes. And we will need to incorporate ESG considerations at every step of the investment cycle. (See Figure 8)

The transition towards a more sustainable economy must be managed carefully, so that ESG standards are just as rigorous whether assets are in the public or private sector. Otherwise, we risk regulatory arbitrage, whereby asset owners can sidestep public scrutiny by shifting into the private sphere - undermining investors' long-term sustainability goals along the way.

**Figure 8: Investment cycle of private assets through an ESG lens**



Source: Fidelity International, March 2022.

- <sup>1</sup> Leonardo Paoli and Timur Gül, [“Electric cars fend off supply challenges to more than double global sales,”](#) International Energy Agency, January 30, 2022.
- <sup>2</sup> Guido Giese, Linda-Eling Lee, Dimitris Melas et al., [“Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance,”](#) The Journal of Portfolio Management, July 2019.
- <sup>3</sup> Ibid, July 2019.
- <sup>4</sup> [“2022 EU Private Markets: ESG Reboot,”](#) PwC, 2021.
- <sup>5</sup> “SFDR’s Disclosure Challenges: How credit investors and corporate borrowers can prepare,” European Leveraged Finance Association, Hogan Lovells, November 8, 2021.
- <sup>6</sup> [“2020 Global Status Report for Buildings and Construction,”](#) UN Environment Programme and Global Alliance for Buildings and Construction, December 16, 2020.
- <sup>7</sup> [“The impact of sustainability on value,”](#) JLL, May 27, 2020.

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