Private Equity International

Responsible Investment 2021

February 2021 • privateequityinternational.com


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Private Equity International
Published 10 times a year by PEI Media. To find out more about PEI Media visit **thisisPEI.com**

Printed by Stephens & George Ltd
stephensandgeorge.co.uk

FSC
www.fsc.org
MIX
Paper from responsible sources
FSC® C013417

Editor's letter

Investors stand firm on ESG

Louise Fordham
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Over the last year, limited partners have adapted to virtual meetings with general partners, conducted fund due diligence remotely and even committed to new managers without meeting in person. Yet there is one issue the majority of investors were unwilling to provide flexibility on in the wake of covid-19: their commitment to environmental, social and governance issues. According to *Private Equity International's LP Perspectives 2021 Study*, only 12 percent of LP respondents were open to relaxing their ESG policies as they relate to private markets fund investments in light of the pandemic.

Rather than stymying ESG initiatives, covid-19 and the tumultuous events of 2020 galvanised many industry stakeholders to act, or at least reassess their approaches to responsible investment and ESG risks. Examples of this can be found in *PEI's* inaugural *30 Big Ideas Shaping ESG* list – such as Vital Capital's Impact Relief Facility, an emergency debt facility to help businesses in sub-Saharan Africa weather the pandemic; or Partners Group's Portfolio Employee Support Fund, established to help portfolio company employees affected by the virus and which included contributions from the firm's staff, co-CEOs, chairman and founders.

> **"Rather than stymying ESG initiatives… the tumultuous events of 2020 galvanised many industry stakeholders to act"**

Of course, there were examples of innovation in this space long before the outbreak of covid. In this report, you can learn more about some of the 'big ideas' in ESG and impact investing, and read a cross-section of industry perspectives on the future direction of travel for responsible investment in private equity.

Louise Fordham

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Private Equity International

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ISSN 1474-8800 • FEBRUARY 2021

Innovators in ESG and impact investing

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Insight

Key trends The past 12 months have shone a new light on what it means to be a responsible investor. Here are the ESG themes set to pick up steam in 2021

LPs pump up the pressure

From the social and economic fallout of covid-19, to the inequalities highlighted by the Black Lives Matter movement and the devastation caused by wildfires in Australia and the US, 2020 laid bare the pressing need for action around environmental, social and governance issues, ***writes Louise Fordham***.

Already on an upward trajectory, ESG has taken an even stronger foothold in the private equity industry over the past year as firms took steps to mitigate the immediate effects of the coronavirus pandemic and paid increasing attention to how climate risks may impact portfolios moving forward. In Q3 2020 alone, 262 firms – including 43 asset owners – signed up to the UN Principles for Responsible Investment, which encourages investors to incorporate ESG factors into investment and ownership decisions, increasing the PRI's signatory base to over 3,300 firms worldwide.

In line with this, ESG is taking on greater weight in limited partners' due diligence processes – 88 percent take a manager's consideration of ESG factors into account when conducting due diligence, according to *Private Equity International's LP Perspectives 2021 Study*, up from 81 percent the previous year. Meanwhile, sister title *Private Funds CFO's* recent *Insights Survey*, found that almost three-quarters of LPs either always or sometimes ask whether funds have an ESG consultant in place to advise on responsible investing across their portfolios.

Julia Wikmark, sustainability manager at global private markets firm EQT, tells *PEI* that demand for climate-related information is on the rise. "The level of detail and number of questions has rapidly increased over the past two years, both in terms of EQT's own operations and portfolio performance," she says.

> “We can expect significant developments and innovation in technology”
>
> Paul Davies
> Latham & Watkins

12%

Percentage of LPs that do not consider ESG during due diligence

37%

Percentage of LPs that somewhat agree GPs are taking climate change risks seriously enough

Source: Private Equity International's LP Perspectives 2021 Study

And while questions on climate risks ramp up, the latest *LP Perspectives Study* suggests not all investors believe general partners are paying enough heed to climate change. Forty-one percent of respondents either somewhat or strongly agree GPs are taking climate risks seriously enough in their own investment policies and practices, yet 22 percent either disagree or strongly disagree and a further 37 percent remain ambivalent.

It has been almost a year since three of the asset class's biggest LPs – the California State Teachers' Retirement System, the UK's USS Investment Management and Japan's Government Pension Investment Fund – issued a joint statement calling for a greater focus on long-term sustainability-related risks, rather than short-term returns at the potential expense of other stakeholders "including the environment, workers and communities". The statement warned: "Asset managers that only focus on short-term, explicitly financial measures, and ignore longer-term sustainability-related risks and opportunities are not attractive partners for us."

USS Investment Management's head of responsible investment, David Russell, tells *PEI* that an additional 12 global funds have joined as co-signatories to the 'partnership for sustainable capital markets' statement since its release in March 2020. Russell says: "It is for each signatory to decide how to respond to address the challenges and opportunities highlighted in the statement. For our part, we hope that the support for the statement will send a strong signal to the market that asset owners now see long-term sustainability risks as a core component of investment and stewardship processes."

Collaborations flourish

The statement by CalSTRS, GPIF and USS is just one example of how industry players are working together to address climate risk.

In October, a new private sector-focused initiative backed by 16 institutional investors launched to support emissions reduction in Australia – Climate League 2030. Supporters, which include superannuation funds such as Aware Super and Cbus, will be asked to pledge at least one new action a year to help drive down greenhouse gas emissions under three themes: the integration of Paris-aligned emissions reduction goals into investment policies or business strategies; collaboration between investors, clients and companies to deliver emission reductions; and investment in new clean energy, clean technology and other projects and measures that reduce Australian emissions.

In a statement announcing Climate League 2030's launch, Aware Super chief executive Deanne Stewart said: "To really shift the dial and achieve lasting action to halt the potentially devastating impacts of climate change, it is critical businesses, investors and governments alike set and deliver on transparent, meaningful and measurable targets and goals. We can do this individually but collaboratively we have the power to do so much more."

The following month, Ardian, The Carlyle Group, Macquarie Infrastructure and Real Assets, Global Infrastructure Partners and SoftBank Investment Advisers formed the One Planet Private Equity Funds initiative. Their goal is to "advance the understanding of climate-related risks and opportunities within our investment portfolios so that we can build better and more sustainable businesses".

The six founding members will engage with members of the previously established One Planet Sovereign Wealth Funds and One Planet Asset Managers and collaborate on the One Planet Sovereign Wealth Fund Framework. This framework sets out three principles – alignment, ownership and integration – "to accelerate the integration of climate change analysis into the management of large, long-term and diversified asset pools".

Two heads, as they say, are better than one, and given the scale of the climate challenge it makes sense for stakeholders from within the private equity industry and beyond to work together. It is hoped that by sharing key learnings, expertise and best practices across responsible investing themes and through initiatives such as those outlined above, more progress can be achieved at a faster pace.

> "We can do this individually but collaboratively we have the power to do so much more"
>
> Deanne Stewart
> Aware Super

A greater focus on diversity

Another area where the industry is increasingly coming together is diversity and inclusion. In December, the Institutional Limited Partners Association announced the Diversity in Action initiative for GPs and LPs, which requires signatories to meet four core diversity, equality and inclusion criteria and at least two optional DEI criteria.

Signatories must: have in place a DEI statement or strategy communicated publicly, or a DEI policy communicated to employees and investment partners, that addresses recruitment and retention; track internal hiring and promotion statistics by gender and race/ethnicity; have in place organisational goals that result in demonstrable practices to make recruitment and retention more inclusive; request (if an LP) or provide (if a GP) DEI demographic data for any new commitments or new fundraises. Examples of optional criteria include assigning senior-level DEI accountability and providing unconscious bias training for staff.

Diversity in Action comes on the heels of ILPA's Diversity and Inclusion Roadmap, which launched in February last year to provide LPs and GPs with access to online resources and best practices.

Some private equity firms are also taking steps to support initiatives dedicated to advancing groups that are particularly under-represented in the investment industry, such as black women. Last month, for example, Blackstone, KKR, Clayton Dubilier & Rice and Livingbridge became the latest members of London-based organisation Black Women in Asset Management.

It seems investors have begun to take greater note of the role they can play in making progress on diversity and inclusion. In late 2020, ILPA managing director of industry affairs Jennifer Choi told *PEI* that LPs had started taking a more direct approach to D&I.

"The focus for our members seems to be around transparency and ensuring they have access to information they deem important to their organisation, such as specific metrics on gender and ethnicity at the manager, and how recruitment and retention efforts support broader D&I goals," said Choi. "Members have shared that there is an expectation GPs will improve their D&I efforts over time, with the understanding that, at the time of investment, diversity metrics may fall short or D&I practices may be more nascent."

And as LPs probe GPs further, emerging managers are seeking to build in diversity from the outset, Gabrielle Joseph, head of due diligence and client development at Rede Partners, tells *PEI*.

As Guy Townsend, joint chief executive at Walker Hamill, notes: "LPs may be forgiving of a firm that has been around for decades and needs time to adjust, but they are not going to support a brand new manager with a line-up of 10 middle-aged, white males."

> "There is an expectation GPs will improve their D&I efforts over time"
>
> Jennifer Choi
> ILPA

Disclosure demands increase

A pressing issue for managers is the EU Sustainable Finance Disclosure Regulation, taking effect in March. SFDR requires managers doing business in the EU to disclose how sustainability risks are integrated into investment decisions and ensure remuneration policies are consistent with the integration of sustainability risks. While the UK will not be implementing SFDR, it plans to develop its own disclosure regime.

Paul Davies, partner and co-chair of the ESG taskforce at Latham & Watkins, says: "International private equity houses may find themselves subject to EU regulatory requirements and/or other regulatory developments concerning ESG disclosure, including those that emerge in the UK. As such, the ability to obtain the necessary information and data from portfolio companies will be an important consideration.

"We can expect significant developments and innovation in technology, as the ESG data lake grows and resources are needed to enable a quick, simple and cost-effective means to analyse ESG performance and benchmark performance against peer companies."

Data standardisation has been particularly challenging, yet GPs appear relatively optimistic progress is being made. Three-quarters of fund managers in Intertrust's *Global Private Equity Outlook 2020* report expect ESG data across portfolio companies to be fully standardised within five years. ■

KEYNOTE INTERVIEW

Think big and be bold on ESG

Private equity must set itself ambitious targets if it is to move the needle in areas such as gender equality, says Jun Tsusaka, founding partner at Japan's NSSK

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NSSK

Q Why is responsible investment so important to NSSK and how has that manifested itself in the firm's structure and approach?
Our firm is relatively young. NSSK was established just over five years ago, when the pursuit of responsible investment was in the ascendancy. In many ways, it was a question of being in the right place at the right time. We launched NSSK with the express purpose of helping to revitalise Japan through private equity and we incorporated environmental, social and governance principles into our mission statement from the outset. We are focused on generating superior outcomes for society and for the environment, just as much as we are focused on generating superior financial returns. NSSK was created with that big and bold ambition.

Q NSSK has placed a heavy focus on diversity and inclusion in its ESG goals. What is the driver behind that?
Of the 153 countries included in the World Economic Forum's latest *Global Gender Gap Report*, which looks at economic, educational, health and political disparities between the sexes, Japan is ranked at number 121. We do not fare well at all. Of course, if nothing is done about that, the situation will only deteriorate. It was important for us to set big and bold objectives in this area, because without that you simply will not move the needle.

We are proud of the success we have already been able to achieve. NSSK now has a portfolio of 17 different companies with over 9,000 employees, and around 80 percent of those employees are women. Meanwhile, 49 percent of management positions are held by women and 40 percent of our CEOs and COOs are either women or people from minority backgrounds. Those are startling numbers when compared to the Japanese benchmark. In fact, we do not use Japan as a benchmark because the numbers are simply too low. We look to regions such as the Nordics for best practice and set our targets against what we see happening there.

Q What is holding private markets back when it comes to gender equality?

There is a lingering sense that prioritising responsible investment targets can negatively impact returns. There is still a feeling that there is a trade-off there somewhere, and yet there have been numerous studies showing precisely the opposite. Certainly, our funds generate top-quartile performance whilst also exhibiting year-on-year improvements in terms of the gender gap. People are economically rational animals, so once they fully buy into the fact that responsible investment is positively correlated with returns, that will go a long way towards helping the cause.

Q NSSK raised an impact vehicle at the same time as its first institutional private equity fund. Why did you decide to make that move?

It is consistent with our overall mission. We worked with private investors and government-related entities to establish our first impact fund in 2017, which was one of the first impact funds in Japan at that time. Today, we are in the process of raising four additional impact funds, each focused on community engagement, employment growth, improving social outcomes and gender diversity, which will mean we manage five out of the 10 impact funds that currently exist in Japan.

Q What is your strategy for resourcing responsible investment?

Responsible investment is the responsibility of every individual in our firm, and once we have invested in a company, it becomes the responsibility of every employee in that business as well. But it was also important to us to set up an infrastructure that could support

"It is vital that these things start from the top. ESG is not something to be delegated"

our aims and help turn them into reality. Part of that has involved the appointment of a chief philosophy officer.

Some of the companies we back have had their mission statements in place for 100 years. You would be hard pressed to find any corporate mission statement from 100 years ago that included ESG principles. Our chief philosophy officer helps businesses think about their attitudes, behaviours and codes of conduct – what it means to be a responsible corporate citizen and to be responsible members of society – and to distil that into a mission statement fit for the modern world. We then start by educating small groups, who pass the message on. It becomes, in many ways, a missionary activity.

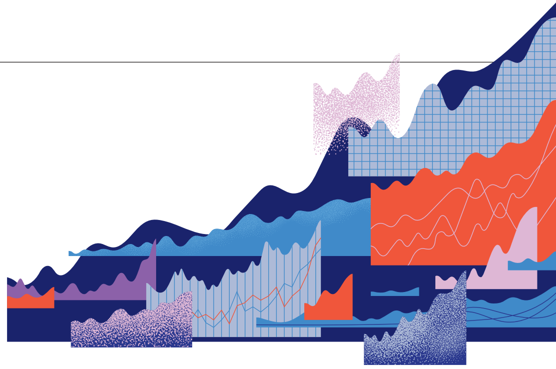
We also have a full-time ESG auditor whose job it is to look at NSSK and its portfolio companies to ensure we are doing what we say we are doing, and to offer advice on how to make improvements. Finally, I chair the ESG committee. That is because we believe it is vital that these things start from the top. ESG is not something to be delegated.

Q Employee wellbeing is crucial to your approach. How do you measure that and why do you believe happiness is so important in a business context?

There was a time when ESG initiatives were hampered by a lack of data. Now we have the data but are finding that those numbers do not necessarily tell the full story. We employ something called the Happiness Index to fill that gap. Fundamentally, we believe that you must have happy employees to create customer satisfaction. We are convinced there is a direct correlation between happiness and performance. Part of the philosophy officer's job is to ensure that happiness is top priority in our portfolio companies.

We have identified three variables that we believe are critical to success, both in business but also in life. The first is hard work. The second is ability – because we know that with hard work ability levels can be raised. The third variable can be directly translated from the Japanese as 'way of thinking'. We see the success formula for life as a mathematical equation – hard work, multiplied by ability, multiplied by way of thinking. Even if the first two are at 100 percent, a way of thinking that is even slightly negative will produce an overall negative result, which just shows the importance of having a positive frame of mind.

Of course, we want our portfolio companies to have the latest technology – the very best in hardware and software. But equally, we place great importance on what we call 'heartware' – being sympathetic, kind and respectful. We believe these attributes can go a long way towards making a company better. ■



The pipe dream: ESG data in 'real time'

The technology and expertise exist to communicate non-financial KPIs to LPs with regularity, but don't expect it to happen any time soon. Toby Mitchenall reports

How many jobs did your private equity portfolio create this month? How much closer is it to net-zero emissions? Right now, private equity investors cannot easily answer such questions.

The environmental, social and governance information that limited partners currently receive tends to be gathered at the point of due diligence – via an ESG-focused due diligence questionnaire – and sometimes appended through periodic (often annual) questioning of general partners.

"In our ESG due diligence we are still 'nice guys'," a senior private equity investor at one Scandinavian pension tells *Private Equity International*. It is a reference to the fact that even managers that come out with the lowest possible score from their ESG assessment process could still win themselves a commitment.

The head of private capital for a large European private bank tells *PEI* that the organisation has not yet created an ESG due diligence questionnaire for its private markets managers. The executive adds that the bank is in the process of adapting an established ESG scoring system for traditional liquid funds to its PE programme.

According to our *LP Perspectives 2021 Study*, these examples are representative. For 50 percent of investors, ESG forms only a minor part of due diligence, while for 12 percent it is not covered at all. Thirty-eight percent of LPs say it forms a major part of due diligence. Two other investors *PEI* has spoken to – a consultant in the US and a state-owned investor in Scandinavia – gather ESG data at the due diligence stage and subsequently through recurring annual surveys of all their partners.

All the investors note that 'best practice' in reporting ESG data to LPs is being formulated and driven by forward-looking GPs.

With its historical connection to development finance, private fund manager Actis is progressive when it comes to integrating and reporting ESG. As part of its quarterly reporting, the firm includes asset-by-asset responsible investing reports, which sit alongside the businesses' operational updates, financial metrics and team news. This has been part of the firm's standard reporting for around a decade, says Daniel Price, a principal in the EMEA investor coverage team, but "the detail has increased over the last couple of years".

James Magor is a director in Actis's four-strong responsible investment team. "We see ESG and responsible investment as being fully integrated into our investment approach, so our house view is that our reporting to our LPs should reflect that," he tells *PEI*.

Magor points out that Actis has started including sustainability highlights at the front end of quarterly reports alongside the executive summary of the fund performance. "It is a standalone section, which includes things like, for example, the CO2 offsets for our infrastructure funds," he explains. The section also includes some of the "softer" activities, like ESG-focused media articles that Actis has participated in or panels it has contributed to. The aim, says Magor, is to "show our investors that this is truly authentic to Actis. It is about our leadership in the market and not just some sort of glossy bolt-on".

Stories behind the data

In a conversation about gathering and imparting quantitative ESG data, the subject turns to the more familiar territory of qualitative information. Magor says feedback from investors suggests they are interested as much in the qualitative information as the hard data. "It's not just pulling down numbers and figures – jobs created, tons of CO2 avoided," he says. "It's the human-interest stories."

He refers to building properties for the Masai community around a wind farm in Kenya, and stresses the importance of communicating this story in a meaningful, "non-trite way" – with "really great imagery" – about how private capital is improving lives. "We know our investors really enjoy that, because if you're sitting in an office in New York, you feel disconnected from a wind farm in Kenya."

That is not to say the firm eschews hard numbers. Actis developed and launched its own impact scoring system – based on the work of the Impact Management Project – which it has made available to any other managers wishing to use it. In the same way that investors will be given an idea of the financial return they should receive from a fund, they will also have an idea of the impact expected to be generated and whether the fund is on track to achieve this.

It is not easy to collect consistent, relevant data from across an entire portfolio when investments are in different sectors. The impact score was created to allow effective comparison between the impacts of otherwise

> *"It's not just pulling down numbers and figures – jobs created, tons of CO2 avoided. It's the human-interest stories"*
>
> **JAMES MAGOR**
> **Actis**

incomparable assets in different sectors and geographies.

Actis does its reporting through the conventional PE route of secure data rooms, slick presentations and high-touch investor relations. Like most firms, it has not yet made use of the budding market for high-tech investor communications on ESG.

As and when Actis and its GP peers decide to automate or streamline ESG reporting, tech providers and consultants will be ready. One such service provider, Apex Group, has launched a product – a combination of a software platform, data methodology and consultancy – that facilitates the regular collection of ESG data from portfolio companies, benchmarks each company against its peers and allows the sponsor to aggregate data and present them to investors in a dashboard format. It will also produce gap analyses on each portfolio company, identifying how it scores on each of the criteria against the global standard.

Andy Pitts-Tucker, a long-time banker (and sometime conservationist) who joined Apex to help shape its ESG offering, says the firm spent "about a year" working out the methodology and exactly what data should be included in the platform: "We tried to work out what is best in class; what do all the LPs generally want; what is going to satisfy legislation; what do stock exchanges require if you are thinking of IPOing?"

There is an 80-page report "which defines how every single data point is matched to a global standard", he adds. "We have sought to collect data that helps investors understand the alignment of their underlying investments to the major global standards, to regulation and to organisations and associations like the Sustainable Development Goals and the UN Principles for Responsible Investment, which seem to be significant driving forces at the moment."

The firm has onboarded "dozens" of clients from across private markets, says Pitts-Tucker. He expects that, having conducted the exercise once – establishing the baseline for each of the portfolio companies – GPs will repeat it on an annual basis. He notes, however, that some LPs are looking for very specific metrics relating to emissions to be updated and communicated quarterly.

IQ-EQ, an investor services group, officially launched a product to "identify and mitigate ESG-related risks" in January this year. The product – called IQ-EQ Compass – is an ESG-focused module that operates alongside its existing portfolio performance reporting platform, IQ-EQ Cosmos.

So, while Cosmos delivers an investor dashboard covering the likes of net asset value, internal rate of return, and funded vs unfunded comparisons, Compass delivers data based on the set of Core Metrics outlined by the World Economic Forum.

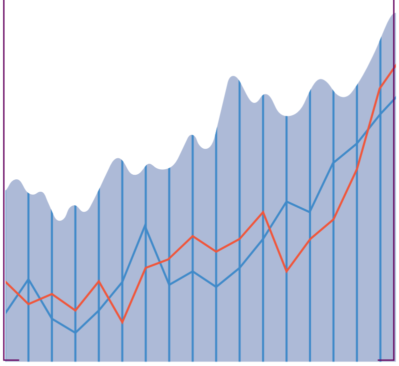
The WEF's Core Metrics are a set of 21 data points – grouped under 'principles of governance', 'planet', 'people' and 'prosperity'. The core metrics are described by the organisation as being "more-established or critically important", and "primarily quantitative metrics for which information is already being reported by many firms (albeit in different formats) or can be obtained with reasonable effort".

Why go for the WEF's metrics? Hugh Stacey, the executive director in IQ-EQ's investor solutions team responsible for the Compass launch, says one factor was the impending arrival of EU rules around sustainability. The Sustainable Finance Disclosure Regulation will require asset managers doing business in the EU to make detailed disclosures about the sustainability of their investment approaches and portfolios. "With the SFDR regulation coming into play in March 2021, we wanted to use metrics that are accessible, useful and more standardised," says Stacey.

Regulation is likely to be a significant driver for improved ESG reporting

"With the SFDR regulation coming into play in March 2021, we wanted to use metrics that are accessible, useful and more standardised"

HUGH STACEY
IQ-EQ



and, in turn, adoption of products like those from Apex and IQ-EQ. "We have a product that helps investment managers collect data on themselves, which is going to help them align with SFDR," says Apex's Pitts-Tucker, who anticipates a "scramble for the line" reminiscent of the rush to comply with the EU's General Data Protection Regulation as March approaches.

Looking for commitment

Impending European regulation aside, we should not get ahead of ourselves. The private capital industry may have a penchant for investing in tech companies, but GPs are not noted for being early adopters of tech when it comes to their own operations. Many are still wrestling with their conventional investment data and wondering how to bring automation to bear on that. At the same time, ESG policies, let alone data, are not yet standard practice among GPs.

A world in which an LP pulls up a dashboard to check for substantial movements in its private equity portfolio's carbon footprint, or whether there has been a reduction in health and safety incidents, is still a long way off.

To focus too much at this stage on data may – to some extent – miss the point. As Actis's Magor notes, LPs value narrative. And as the private bank PE head puts it: "Our clients are not very interested in the data. They are more concerned about generally making sure that whoever is managing their wealth is going to be a good steward of their capital, full stop. They are much more interested in selecting managers based on a commitment to ESG than measuring a tangible impact."

That said, service providers in this space are confident that demand for their products is only going in one direction. "Every day we are demoing our product multiple times a day and we have a huge number of discussions going on," says one service provider. "People are signing up very actively. It's great." ■

KEYNOTE INTERVIEW

ESG: The end of the beginning

While engagement remains patchy in some regions, Aberdeen Standard Investments' Alistair Watson, Alan Gauld and Stephanie Kempton expect ESG integration to soon become the industry norm

GPs had plenty to keep them occupied in 2020, including the move to remote working and the need to work closely with portfolio companies impacted by lockdowns. Despite these challenges, many have also spent time improving their environmental, social and governance performance.

This is a finding of a recent survey conducted by Aberdeen Standard Investments. A snapshot of private equity's progress in ESG undertaken annually since 2015, the survey comprises responses from 104 private equity managers and 40 of ASI's co-investment portfolio companies. We caught up with members of ASI's private equity team, senior investment director Alistair Watson, investment director Alan Gauld, and investment manager Stephanie Kempton, to find out more about the survey results and how the industry is addressing ESG.

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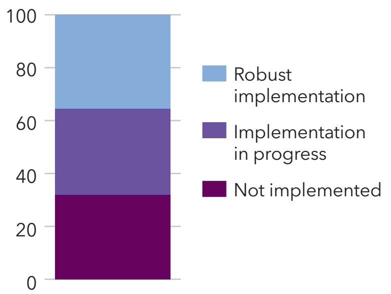
Q Why is ESG important to you as an LP?

Stephanie Kempton: Fundamentally, ESG is important to ensure we are good custodians of the money we manage on behalf of our clients. We see ESG integration as a hallmark of quality both at a GP level and when assessing co-investments. Strong ESG management is essential to running good businesses and generating returns.

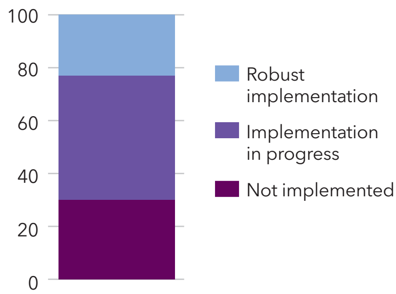
Alan Gauld: If you have a firm grasp of ESG in a business you can mitigate risks effectively, but we also see value creation stemming from this. ESG provides insight during the due diligence phase, protects downside and creates value during the investment. Research suggests that ESG leaders are more marketable on exit and are attractive to a broader set of buyers.

ESG is not new to us and responsible investment has been a longstanding

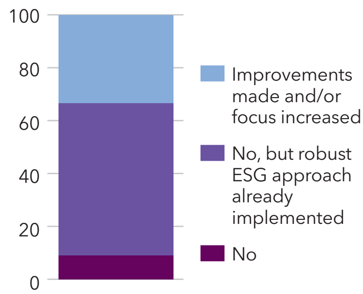
Describe how you identify, assess and manage climate related risks within portfolio companies: (%)



What diversity-related targets do you set for your portfolio companies? How do you monitor progress? (%)



Has covid-19 changed your approach to ESG? (%)



Source: Aberdeen Standard Investment's 2020 Private Equity Responsible Investment Survey

focus of ours. Aberdeen Standard Investments has been a PRI signatory for over 10 years and became carbon neutral in 2019. Yet, we do see some who remain sceptical of ESG. They are entitled to be, but they cannot deny the $30 trillion capital shift that is underway towards millennials and younger generations. These are generations that care much more about sustainability factors than their predecessors. There is also regulatory pressure – for example, the UK government recently announced that climate-related disclosures will become mandatory for large private companies by 2025. You can put your head in the sand if you like, but ESG regulation is coming.

Alistair Watson: There is sometimes an allegation that ESG is just cosmetic – we want to get beyond that by starting with reporting and metrics and then demonstrating how change and value builds over time. We are looking for managers that make changes rather than just report on metrics. Companies that are performing resiliently despite the covid-19 disruption, often companies that are anticipating shifts in the way we work and live, also tend to score well on ESG measures. Importantly we are seeing a requirement for increased ESG action and transparency from our own institutional investors, particularly in Europe. Asset owners recognise the positive impact they can have in climate change and the drive towards net zero.

Q Why do you conduct the responsible investment survey?

AG: When we started the survey in 2015, it was becoming clear that ESG was going to be a major factor in the success of private equity investments. Yet we were getting inconsistent or little information from managers and portfolio companies, so it was designed to understand what was happening within private equity firms and their portfolios. When we analyse managers, we need to cut through the marketing around ESG and try to benchmark ESG performance with the aim to eventually help drive tangible improvement.

SK: The survey has an important role in our fund and co-investment decision-making and we have incorporated it into our investment processes. It is a good bellwether for how managers look at ESG and helps us analyse trends, such as the increasing importance of the UN Sustainable Development Goals, as well as how managers are progressing and what challenges they face.

Over the years, we have seen GPs continually improving, especially in Europe. Even with the pandemic in the background, GPs have continued to make progress in integrating ESG. In the latest survey, we also looked at the difference in ESG performance between small, mid-sized and large managers. Larger managers have generally invested more capital in ESG systems and people, which is resulting in better ESG data. However, we don't believe that larger managers have a greater ESG cultural buy-in than smaller managers, it's more a factor of resource.

AW: In our co-investments, we can have a strong influence and get live data on how companies are managing ESG. In the latest survey, we included co-investments for the first time. We had a 95 percent response rate, so it provides useful ESG information across the portfolio: whether companies have an ESG policy in place and are tracking ESG key performance indicators, as well as ongoing ESG initiatives and important more specific topics, such as employee engagement and cybersecurity. In addition, it highlights areas of weakness and potential improvement – here, I would point to female board representation and measurement of carbon footprint.

Q Can you provide some examples of where you have seen progress?

AG: In 2018, 59 percent of respondents had an ESG policy; now that figure is 73 percent. Half of respondents are now PRI signatories, while in 2019, it was just 38 percent. The survey helps us with benchmarking and identifying who the leaders and laggards are. Those making most progress are not always the ones that are best resourced. By picking the right battles and having real buy-in, smaller managers can make a significant difference on ESG.

AW: A third of managers say their ESG plans are accelerating as a result of covid-19. Firms are aligning their investment theses with the SDGs, and some are becoming B-Corps or joining Initiative Climat International. The penny appears to have dropped, and we are now seeing real cultural emphasis.

Q Another key finding is that European managers have embraced ESG much more than those in the US or Asia. Why do you think this is?

AG: There is real momentum in Europe, and, while we are seeing encouraging signs, the US and Asia are behind Europe. Some of this is cultural, but it is also because Europe has been the genesis of ESG. Europe benefits from the political will of the EU and local governments to act on ESG issues and so the region has a head start. It just means we must engage more with some US and Asian funds – we do not screen out all investment opportunities that are not perfect on ESG grounds. We are happy to invest and work with GPs that are open and show a desire to improve their ESG credentials and are seeing definite improvements resulting from this engagement.

Q Where else is there room for improvement?

SK: The response to our question on diversity-related targets continues to be underwhelming. Only 23 percent were able to articulate the diversity targets in their portfolio companies, although 47 percent are intending to incorporate these in the near term. This will become more front of mind, especially as ILPA has launched its Diversity in Action initiative. Some GPs are running projects to help people of all backgrounds enter private equity or finance, but it must be a cultural shift, not just target-driven.

AW: Private equity-backed companies tend to have GP representatives on boards and since (reflecting the current make up of GPs) these are mostly male, that presents a challenge when you look at female board representation. Of course, we also want to see increased female representation in senior management teams.

Q How can you help GPs improve?

AG: Engagement is key. We invested a few years back, for example, with three smaller European GPs where ESG was not a major consideration but senior partners were open to implementing ESG and engaging with us. We supported them on areas such as ESG policy and what good implementation looks like. We can help support GPs because we bring a holistic view from across the market. The ESG practices of these GPs today compared with a few years ago are like night and day. As an LP, you should never underestimate the impact you can have just by asking the right questions.

"As an LP, you should never underestimate the impact you can have just by asking the right questions"

ALAN GAULD

AW: It can also help to talk about examples of best practice and positive change in our portfolio. We are not just looking to invest in 'ESG perfect' businesses, but also businesses that have a propensity to drive positive change in ESG matters. Industrials businesses are not always associated with positive ESG credentials, but, for example, we are encouraged by progress at investee company, Sulo (lead sponsor Latour Capital), a French-headquartered waste container manufacturer. Under current ownership Sulo was the first French company to be awarded the Circular Economy certification, due to its success producing waste containers made from 100 percent recycled and recyclable materials. Latour and management are striving to further increase the use of recycled materials from what is already a market leadership position. ■

Q How will ESG develop in private equity over the medium term?

AG: I believe that we are at the end of the beginning of the journey towards ESG being truly integrated. The last five years have been about firms developing their ESG policies and processes, setting the foundations in place. If we were to look at the European market five years from now, I am confident that ESG will be largely integrated into reporting and into LP-GP and GP-portfolio company discussions. This will be the way private equity does business and LPs will receive ESG metrics alongside the usual financial data. Regulation will accelerate change and we will likely see a more consistent approach to ESG reporting than at present.

AW: Over the next few years, private equity will move from a catch-up phase to one where ESG is measured and reported and the impact becomes more evident – with the increased cultural buy-in to ESG we are experiencing amongst private equity managers, we will see tangible results as well as the metrics.

Climate: What investors want

Investors are starting to ask more of their managers when it comes to climate strategy, writes Toby Mitchenall

Last November, *Private Equity International's* Responsible Investment Forum: Europe opened with a sobering keynote. Emily Shuckburgh OBE, a climate scientist and director of the University of Cambridge's climate initiative Cambridge Zero, delivered a lightning quick overview of the current state of our planet.

Among the many alarming revelations – versions of which you might have been hit with before – was her reading of how 2020, a year in which the pandemic had all but halted global travel, affected global carbon emissions. "It is likely that 2020 will see a dip as a consequence of the global lockdown," she said. "But the sort of dip we will see is only the scale of change that we need to see year-on-year-on-year for the next 20 years or so. That highlights the scale of the transition required."

How are institutional investors addressing the risks and opportunities associated with climate change? And what does that mean for private markets managers?

Nest is the UK's national defined contribution system for savers who are auto-enrolled into workplace pension schemes. Established in 2010, it is now the largest UK pension by number of members and manages more than £13 billion ($18 billion; €15 billion) in assets. It currently invests in private credit, but not PE, and is predicted to be managing £100 billion by the end of the decade. As a young scheme – half of its savers are under 35 – its priorities reflect the horizons of its members.

"We believe we have a social responsibility to contribute to a world which is fit for our members to retire into and enjoy their savings," said Diandra Soobiah, head of responsible investment for the pension, at the Forum. To that end, Nest established a climate policy in 2020 that aims to halve its portfolio emissions by 2030 and reach net zero by 2030. "We are working very closely with our fund managers in setting out targets and expectations on how we expect them to evolve over time," said Soobiah. "We are asking them to think about how to evolve their strategies towards a 1.5C target in the long term."

> *"The level of detail and number of questions has rapidly increased over the past two years"*
>
> **JULIA WIKMARK**
> **EQT**

The pension also expects its managers to report against the Task Force on Climate-related Financial Disclosures by the end of 2021, and is divesting from sectors with high climate risk, such as thermal coal, oil sands and arctic drilling.

The Office of New York City Comptroller, which manages $229 billion of assets across five public pension funds, is at an earlier stage in its move to sustainable investing. However, Cristian Norambuena, a senior investment officer at the pension system, said at the Forum that it had already been actively exploring commitments to buyout and growth fund managers whose "investment strategies are related to climate change or usually back companies within the energy transition trend".

He added that the pension system's two main climate change initiatives – as announced in 2018 – involve doubling its investment in climate change solutions from around $2 billion to $4 billion across public and private assets, and evaluating divestments in fossil fuel-related investments. Norambuena said that, along with energy transition-focused GPs in its $14 billion PE portfolio, the investor is also spending a lot of time on impact funds dedicated to climate change and goals such as financial inclusion and healthcare.

Climate risk and opportunity is "an

important part" of the ESG agenda for Argentum Asset Management, a private equity investor owned by the Norwegian government, says Jon Fredrik Vassengen, a manager at the investor who covers ESG. Part of its due diligence covers climate, but its expectations for new managers also take into account where they operate and in what sector. "It is not a one-size-fits-all approach," says Vassengen.

Argentum, which has €1.6 billion under management, asks GPs for portfolio company emissions data. It does not receive data for all the circa 700 companies, "but we get a good view of the most relevant companies in the portfolio", says Vassengen. His colleague, senior associate Christoffer Gundersen, notes that, in 2019, the LP received carbon emissions reports on twice as many companies as in 2018, confirming that an increasing number of companies have this data available.

Getting into the detail

From the fund manager's perspective, the demand for climate-related information is on the rise, says Julia Wikmark, sustainability manager for global private markets firm EQT. "The level of detail and number of questions has rapidly increased over the past two years, both in terms of EQT's own operations and portfolio performance," she tells *PEI* in January. Examples of frequently asked questions relate to greenhouse gas emissions (reductions or target setting), fossil fuel exposure and disclosures in line with the TCFD recommendations.

When it comes to climate-related reporting, the TCFD has proved to be a framework around which organisations have coalesced. PAI Partners, a European private equity firm with €13.9 billion in AUM, used it to formulate its own climate strategy, according to Cornelia Gomez, its head of ESG and sustainability.

"You start by calculating the carbon footprint, but when you have to act on it you don't have the strategy or the framework to do so" she told the Forum in November. "That's where the TCFD comes in super useful." She recommended it as a "very well written scenario" to GPs currently thinking about how to approach climate.

If you are a GP that has yet to formulate a climate strategy, you are not alone, according to Suzanne Tavill, managing director and head of responsible investing for StepStone Group. She told delegates that there is a broad range of preparedness on this topic that, to some extent, is drawn along geographical lines.

"Europe and the UK are definitely leading," she said. "We see it when we conduct due diligence… who's got ESG policies, climate policies. Asia is quite mixed in terms of geography – there is certainly increased awareness in Japan and parts of China.

"The unfortunate laggard is the US. [However,] we are certainly seeing signs of that changing: both from a number of GPs and the LP universe becoming more vocal on the topic and adopting climate change policies." ■

Carmela Mendoza contributed to this report

KEYNOTE INTERVIEW

Opening up access to private equity

LPs have a vital role to play in driving meaningful progress on diversity and inclusion in the industry, say HarbourVest's Craig Fowler, Amanda Outerbridge and Sanjiv Shah

Diversity and inclusion has moved further up the agenda at most organisations as the pandemic and murder of George Floyd last year highlighted social and racial inequalities. Many in the private equity industry are now in listening and learning mode so they can work out how and where they can make changes.

The influence of limited partners can be key here, from pushing for change among their existing relationships to allocating much-needed capital to funds managed by people from diverse backgrounds. We caught up with HarbourVest managing directors Craig Fowler, Amanda Outerbridge and Sanjiv Shah, to discuss how the industry can move forward and why investors ignoring emerging and diverse GPs are missing out.

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Q Why is D&I important to your firm?

Amanda Outerbridge: We believe every business that wants to succeed in the long term must constantly evolve to reflect the world in which it operates. D&I is vital for innovation and growth and is important across all our touchpoints – our firm, our investments and our clients.

A third of our senior professionals are female, which is around three times the industry average, and 27 percent of our global workforce are from ethnic minorities. However, we recognise there is always more we can do across all aspects of diversity. We established a D&I council in 2019 and one of its key workstreams is around recruitment – attracting a diverse workforce is a top priority and we are working with recruiters to find ways of expanding the talent pool. It is also important to focus on the inclusion part of D&I, so we work hard to ensure candidates succeed beyond the recruitment and interview process.

Q How do you see your role as an LP in this regard?

Sanjiv Shah: As an LP, we play a vital role because we can influence how our clients' capital is deployed. Capital is not infinite and so focusing on D&I cannot just be a nice thing to do. If we want to be at the forefront of change, we must succeed so that others want to participate and allocate capital in a way that is different from the historical focus. Last year we became a founding signatory to ILPA's Diversity in Action initiative. This is an important initiative for private equity because it is not just aspirational, it requires evidence of action in order to sign.

We also support organisations that are focused on education and training for diverse students to help them get into private equity and we take active leadership roles in strategic organisations. Craig has been a board member of the National Association of Investment Companies, the largest US network of diverse-owned private equity and hedge funds, and I am co-chair of the Association of Asian American Investment Managers, for example.

Q Do you have a D&I investment strategy? Or is your focus on improving D&I among GPs?

SS: We do both. Through our emerging and diverse manager investment programme, we have supported E&D teams for many years. Private equity is a long-term asset class, so you need to build relationships with the next generation of talent. There has been a lot of research around why diverse teams make better decisions and our own data shows that E&D teams, when you have the right screening process in place, do as well as – if not better than – other private equity teams even though they often struggle to raise capital.

We have an open-door policy to provide timely and honest feedback to GPs. This is often lacking in the industry and yet is so valuable. We also run an annual GP forum, bringing together leaders and founders from well-known firms and our newer relationships, which offer the opportunity to have candid conversations about how to get more diverse talent into the industry.

Private equity is an opportunity business, which is why we try and partner with talented, ambitious people who may not traditionally have had access to capital but who we believe are going to bring something new to the table. Yet it is also about having conversations with our more established GPs to ask them what they are doing to diversify their own intellectual capital. There is no one-size-fits-all approach to this, but as an LP we can use our influence to encourage change.

Q How do you measure progress on D&I in GPs that are not part of your emerging and diverse manager investment programme?

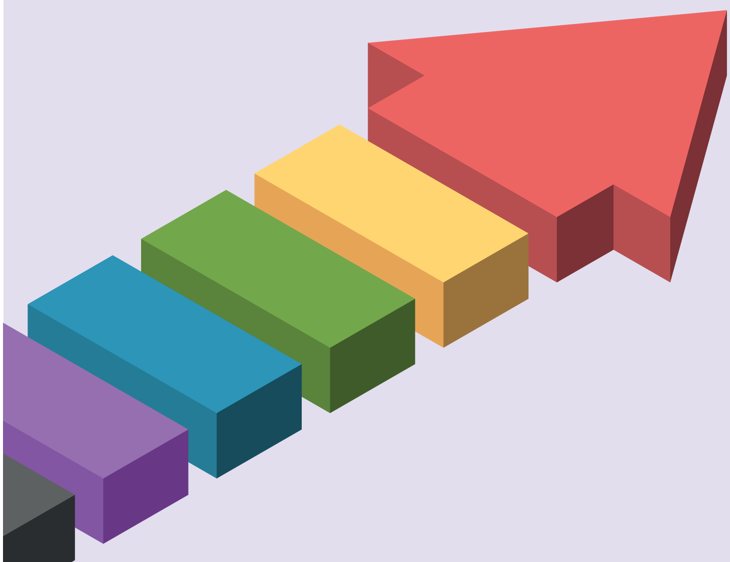
AO: We have developed an ESG scorecard that we use to assess GPs, from the evaluation stage and throughout the investment process to monitor progress. We benchmark GPs across 26 process-based ESG criteria, and D&I ratings are an integral part of this.

Our scorecard covers the management company level, including the policies a firm may have in place, governance and culture. It looks at the investments made, the due diligence process, best practice through the investments and then exit. It also covers reporting. Overall, it looks at the GP's capabilities for managing ESG-related risks and opportunities – it is a highly

Q Where can private equity improve on D&I?

Craig Fowler: Industry leaders have become much more aware of the need for D&I and have made public statements about their concerns. This acknowledgment is an important first step that must be followed up with action for change to take place. Private equity can make corrective actions within their own firms by recruiting and developing more diverse talent. The industry can also address head-on the significant gap of investment dollars going to firms owned and managed by ethnically diverse and female individuals. Without specifically designed programmes little will be accomplished.

There is a relatively small group of public pension funds that have been leaders in this regard and set the standard to be followed. I am hopeful that other investors follow up on their public statements with concrete actions inside and outside their organisations.



engaging process because it cannot just be a checklist.

We can use these results as a way into discussions with GPs around diversity, as the GP's efforts on D&I at firm and portfolio level are also taken into account. Some issues are tough to talk about, but we are here to be a sounding board and help them adopt best practices. We have also been able to show that firms that take D&I seriously are offering strong returns.

Q How receptive are GPs to those conversations?

Craig Fowler: As part of our process, we engage with GPs on their scores and overall, we have found most tend to be open to guidance to make improvements and strengthen their policies. Most managers the emerging and diverse team works with have meaningful levels of diversity and understand how diversity can improve performance.

The non-diverse managers appreciate that we are sharing information with them to drive improvements – and it sends a message when a key investor shows that it cares about this. Working with each manager, we've been able to show them how their results compare to their peers. Firms like to hear what their competitors are doing and usually want to be at the forefront of change.

AO: I have seen folks that have been in the industry for three decades really embrace change – they are open to it and are putting resources into it. This has been accelerated since the events of 2020. Many more firms have now established D&I councils and appointed heads of diversity. We are starting to see meaningful progress here.

Q How can the industry help address systemic racism?

CF: The industry must be engaged. The starting point is to look internally. Our firm, for example, now observes Juneteenth, a day which commemorates the end of slavery in the US, as one of our firm-wide holidays. This is

> *"Fostering the right culture in organisations is crucial"*
>
> **AMANDA OUTERBRIDGE**

not just a symbolic gesture; rather, we encourage our employees to use the day for reflection and education. Clearly, there can be change at a corporate level, but individual minds need to be behind this if we are to help drive societal change.

One of the results of systemic racism is a wealth gap that has persisted through history, as diverse managers have been historically excluded and under-represented. Our emerging and diverse programme strives to help bridge that gap by providing these managers with access to capital. These managers not only produce successful firms, but also usually have broad and diverse networks. They are more likely to invest capital in their network of diverse entrepreneurs – there is a flow-through effect.

We also took public action by signing the Diverse Alternative Investment Industry Statement, put forward by the National Association of Investment Companies. This commits our firm and the other signatories to helping create permanent, structural and perennial investments by investing into neglected communities. ILPA's Diversity in Action initiative is also important here, as it commits LPs and GPs to a foundational set of actions that help advance diversity, equity and inclusion, both internally and within the industry more broadly.

Q In terms of D&I, where do you think the industry will be in five years' time?

SS: I would like to think that in the next five to 10 years we will not be having this kind of conversation. I expect we will continue to see push and pull factors that will drive change in the industry. Nasdaq, for example, recently proposed a new listing requirement that companies have more diverse boards, among other things, and I suspect other exchanges could consider similar changes. Private equity will not be immune to these kinds of external pressures.

There is also growing awareness that those who provide capital – those who pay into pension funds, for example – are not as well represented by the investment managers who receive the vast majority of allocations from these plans. I can see the pressure for change and creating more opportunity for funds which are managed by diverse individuals coming from here, too. Finally, there will be greater recognition of the potential for outperformance that diversity can bring – there's already published data in this regard, and I suspect we'll see more such research and even more success from diverse led teams. I am hopeful that we are at a point where a lot of positive things can happen in the industry.

AO: We will see product innovation and greater capital directed towards increasing diversity in the industry. The inclusion part of D&I will gain more focus because we must set our teams up for the long term. There will need to be initiatives, such as mentoring, to ensure candidates from diverse backgrounds continue to grow and succeed. Fostering the right culture in organisations is crucial – without this, any progress made would just be short term.

CF: I am encouraged by what is happening industry-wide, in light of the events of last year. D&I is not a new topic, but 2020 provided a much-needed push for the industry and we have to use that urgency and momentum to push us forward. ■

A generational shift

Amy Carroll asks if a new generation of private equity leader is poised to revolutionise the industry's approach to responsible investment

The proportion of general partners planning retirement as their next career move leapt by almost 13 percentage points in the wake of the covid-19 outbreak in March last year, according to Investec's annual *GP Trends* report. The survey captured sentiment both immediately before and after the pandemic struck. It is not hard to see why. Faced with one of the most unpredictable and potentially catastrophic economic downturns in memory, those who have already amassed their fortunes may feel they no longer have the stomach for the fight.

As senior managing partners prepare to bow out gracefully, their junior colleagues, spanning the later years of Gen X and the early millennials, remain both bright eyed and ambitious. Unbruised by the fallout of the financial crisis, they know only that market disruption brings opportunity. Whether they are in line for succession at their existing franchise or see the chance to set up shop on their own, they are excited at the prospect of taking the reins. Critically, however, their ambitions are not restricted to monetary gain. They are also looking to wield their power as a force for environmental and social good.

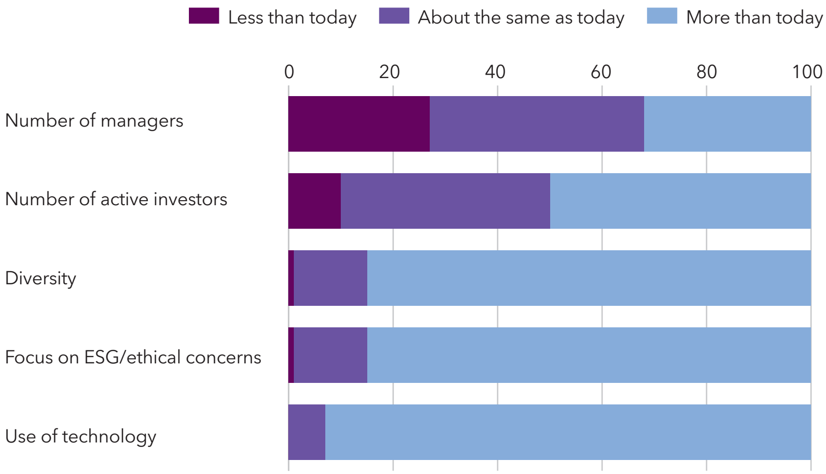
Of course, these are wild generalisations that will have riled those on both sides of the generational divide. There are baby boomers that remain as hungry as the day they completed their MBA and who are vehemently committed to improving the world in which we live through the power of private markets. Equally, not all those born after arbitrarily imposed cut-off dates have been imbued with the natural sense of beneficence the media has bestowed upon them.

That does not detract, however, from the fact we are living at a pivotal moment in history. A surge in social and environmental consciousness that has embraced everything from climate change to racial and gender inequality has coincided with a devastating global pandemic. Add to that a potential changing of the guard, and it is clear private equity has a unique opportunity to step up its approach to responsible investment.

"Succession planning is underway at many alternatives firms where current leaders have been in longstanding roles," says Russell Reynolds Associates private equity consultant Jeff Warren. "The emphasis on hiring leaders who embrace responsible investing will only accelerate over the next few years."

"For those who are coming up through the ranks, it is not all about capital gain. It is about being responsible and being sustainable," adds Guy Townsend, joint chief executive at Walker Hamill. "That will ultimately translate into a driving force, shaping the industry."

Relative to the industry today, how will the private equity industry look in 10 years' time? (%)



Source: Investec's GP Trends 2020 Report

A gradual process

Shaping an industry, however, takes time. There can be no doubt the process has begun. The proliferation of chief ESG officers, rigorous management and reporting methodologies and the creation of impact arms at the biggest firms are just some of the manifestations of this journey. "It started with a few groups becoming UN PRI signatories but has since gone wider and deeper, so that most firms have at least a responsible investing policy and many have a framework that embeds ESG across the deal cycle and allows them to monitor and report on progress against benchmarks," says Janet Brooks, partner at Monument Group.

> *"A greater emphasis on responsible investing has undoubtedly been influenced by a generational changing of the guard"*
>
> **ANTOINE DRÉAN**
> **Triago**

Russell Reynolds consultant Kurt Harrison agrees: "Private equity firms are well beyond the stage of waking up to this new reality. It is embedded into their capital raising, investment and portfolio management processes.

"The largest alternatives firms, in particular, are keen to hire professionals in all three of those functions that have held core beliefs in environmental or social concerns before they were interested in private equity as a potential career."

It seems inevitable covid will accelerate this process. "Adherence to responsible investment best practice has really picked up steam since the onset of the global covid-19 crisis," says Antoine Dréan, founder and chairman of Triago. "Social impact was a bit of a poor cousin to governance and environmental best practice, arguably right up to the outbreak of the pandemic. But it's really moved to the fore as both LPs and GPs have inevitably focused on the heightened suffering tied to the coronavirus. It's turning what was previously lukewarm commitment to doing well by doing good into something intense."

Nonetheless, truly changing the culture and ethos of an existing manager is, almost always, a gradual process. There have been firms, in the venture world in particular, that have taken concrete steps to redefine themselves as providers of solutions to global problems, whether that involves saving lives through healthcare investment or feeding the hungry with sustainable farming.

"These are traditional managers that have reorientated themselves, almost changing their mission statement, which is quite new," says Gabrielle Joseph, head of due diligence and client development at Rede Partners.

It is, however, far easier to make those kinds of bold, responsible investment statements when starting from scratch. According to Joseph, for example, the new groups that Rede works with are invariably looking to build diversity in at the highest level from the outset. "That has been a complete change in the past few years," she says.

This is largely in response to LP demands. Emerging managers must differentiate to succeed, and they must excel on ESG.

Townsend agrees. "LPs may be forgiving of a firm that has been around for decades and needs time to adjust, but they are not going to support a brand new manager with a lineup of 10 middle-aged, white males."

That is not to say there have been a stampede of new managers holding themselves up as ESG exemplars, but there are a growing number of such firms entering the fray. Summa Equity Partners launched in 2016 with the stated strategy of aligning investments with the UN Sustainable Development Goals in the mainstream Nordic lower mid-market, a philosophy that quickly gained traction with LPs.

"Private Equity 1.0 created value through financial engineering in the 80s, moving to Private Equity 2.0 and operational improvements in the 90s. Then Private Equity 3.0 in the 2000s saw firms become institutionalised and start to add value, expanding into different asset classes and new areas of expertise," explains Summa's head of IR, Hannah Gunvor Jacobsen.

"However, in recent years, we have seen externalities start to matter, as firms realise that companies that create a negative impact, or which are at higher risk of being impacted, will see their profitability and market values fall accordingly – and vice versa with those that are positively correlated with externalities. Consequently, the future lies in transitioning to Private Equity 4.0, where value is created through having a positive influence, environmentally or socially, while reducing risk through management of ESG factors."

Other notable examples of firms created with a distinct sense of purpose in mind include healthcare specialist ArchiMed Partners, which launched a dedicated philanthropic arm, the Eurêka Foundation, alongside its main business from the start.

"One of our principal goals in launching ArchiMed was to leverage our network and experience as business builders to improve people's lives in sustainable ways," says ArchiMed managing partner Vincent Guillaumot, who also chairs the Eurêka Foundation. "We do that initially by supporting companies operating in medical industries, both financially and strategically. Then through Eurêka, we commit a significant portion of our capital gains to philanthropic projects."

In Japan, mid-market firm NSSK was founded with ESG embedded into its mission statement, including the aim of tackling the country's gender inequality problem, while also launching impact funds alongside its core product; hiring a chief philosophy officer to ensure good corporate citizenship; and using an employee happiness index to help drive financial and social outcomes at portfolio companies.

Still in the launch phase, meanwhile, two consumer investors – Vish Srivastava, formerly of Bluegem Capital Partners, and Tracey Huggett, formerly of MidOcean Partners, Terra Firma and NEO Investment Partners – have left their legacy firms to create Future Business Partnership, which is currently in the market raising funds to back ethically attuned brands, offering "growth without compromise and sustainability without sacrifice".

It is not only the GP community that is experiencing this generational shift. The motivation behind private equity's ultimate client base is changing rapidly. Today's millennials – which account for around a third of the global population – stand at the threshold of their peak saving years and maintain a strong belief the companies they invest in should be part of providing solutions. Indeed, in a recent survey conducted by the deVere Group, 77 percent of millennial investors said ESG issues are their top priority when assessing investment opportunities. Pressure to enhance responsible investment emanating from limited partners is only going to increase.

31%

Percentage of GPs who believe their next career move will be retirement

Source: Investec

77%

Percentage of millennials who cite ESG investing as their top priority when considering investment opportunities

Source: deVere Group

Ideals as well as profit

Meanwhile, the entrepreneurs that private equity firms are backing often fall firmly in the idealistic millennial bracket, not least in the technology and consumer brand sectors that are proving so popular with the asset class today. "Responsible investment is a vitally important topic for management teams, particularly in start-ups," says Townsend. "These companies are being run by younger and younger people and there is no doubt that a strong and visible ESG angle could make the difference in which firm wins a deal."

It seems inevitable, therefore, that we will begin to see a virtuous circle emerging, that will transform the face of the industry. "Young talent are demanding more meaning from their careers and want to do more than just earning money," says Jacobsen. "As these young professionals move through the ranks and start to set up their own firms, taking a more responsible approach to investing will become a much more natural part of private equity."

"A greater emphasis on responsible investing has undoubtedly been influenced by a generational changing of the guard," adds Dréan. "The brash pioneers of what was a freewheeling investment fringe have given way to a new generation that's much more aware of private equity's image and its potential to be a significant force for good – even as it makes double-digit annual returns." ■

KEYNOTE INTERVIEW

Calculating climate risk

Understanding business and sector-specific exposure to climate change can help identify risks and opportunities in the transition to a low carbon economy, says Permira's head of ESG, Adinah Shackleton

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Q The conversation around climate change is becoming louder and more urgent. How do you get a foothold on such a broad and complex issue?

As you say, climate change is a very broad and complex issue. We are constantly reviewing and adapting our approach, considering how we integrate climate considerations in the investment process, respond to our investors and focus our engagement with portfolio companies on climate change.

Recently we completed a climate risk screening across the Permira private equity funds and the PDM funds (including the direct lending and the CLO strategies advised by Permira Debt Managers). Together with consultants we screened more than 200 companies. This has helped us understand which companies demonstrate higher physical risk in terms of exposure to extreme weather events, such as wildfires, water scarcity or flooding, and whether business models may be impacted – positively or negatively – by the transition to a low carbon economy.

Q What will you do with the results?

With the private equity funds, we will use the results of this risk assessment to identify which portfolio companies require further assessment, such as a more detailed climate scenario analysis, and then engage with management teams around their approach to respond to climate-related issues. For example, whether physical or transition risks from climate change have been considered as part of their risk management processes, strategy and board discussions.

On the private debt side, the PDM funds are supportive lenders, often behind an equity sponsor, which means that we are generally one step removed from the asset. At PDM, we want to use the results to understand the climate profile of companies in the portfolio and engage with the sponsors on businesses we deem to be at higher risk from the impacts of climate change.

Q Where does tracking your carbon footprint fit into this?

Our carbon footprint project is undertaken alongside the climate risk screening and has been an important aspect when looking at climate risk. We have requested carbon footprint data from the private equity portfolio companies since 2016 and have also undertaken a top-down carbon footprint estimate across the portfolio for 2018 onwards to address the gaps in the reporting.

However, out of all the ESG key performance indicators we collect across the portfolio, the carbon footprint is the hardest to obtain. We have seen an increase in reporting of carbon footprint data from portfolio companies. However, for some companies there are other ESG areas which are seen as more of a priority, especially where the carbon footprint is calculated on a voluntary basis, or they don't yet have the systems and processes in place to collate the data. This will be an area of focus this year as we look to actively engage with the portfolio on climate change more broadly, including on the benefits of carbon footprinting, such as identifying opportunities for energy savings or supporting them in defining a path to net zero.

Q What opportunities are there for collaboration on climate change and ESG?

Most recently, we joined Initiative Climat International, which is supported by the Principles for Responsible Investment. This initiative provides the opportunity for signatories to get together and address a significant challenge. Firms are very open in terms of their approaches and what has worked for them, so others can learn from their experiences. Such collaborative initiatives are important for advancing ESG within the private equity industry.

The other area for collaboration is on ESG reporting. We are coming to a point where different ESG standard setters are starting to speak with one voice about their expectations for investors and portfolio companies on ESG reporting. This year we have been participating in a collaborative initiative run by the European Leveraged Finance Association, which is working with PRI to encourage alignment on ESG monitoring and engagement in direct lending. Having broader industry consensus on the ESG factors which should be reported for this asset class will be very useful.

Q On the private debt side, how do you exert ESG influence as a firm?

Since 2015, we have integrated ESG into the pre-investment process, leveraging the due diligence conducted by the sponsor and using our own questions and advisors. At PDM we have formed a specific ESG group and are

Engaging with portfolio company Teraco on ESG

'When I joined Permira in 2015, the data centre business was the first company I engaged with,' says Adinah Shackleton, head of ESG at Permira.

"We conducted an ESG review with external consultants, and the support of Teraco's chief financial officer. The Permira portfolio monitoring team were also involved in the engagement and helped elevate the recommendations with the management team and at board level. One of the opportunities identified related to energy efficiency and renewable installations. Since then, the business has installed a solar renewable energy system at one of its main sites covering the roof, car park and other spaces. The installation feeds energy into the data centre generating renewable energy, cost savings and energy security advantages.

"The company also set up a Social and Ethics Committee. These structures are important as it means that when the Permira funds exit this investment, those ESG processes will remain in place, enabling further development of the company's sustainability approach, strategy and performance."

Pierre Pozzo, principal at Permira and board member at Teraco, says: "ESG engagement has been key to our value creation plan and how we have worked with the Teraco management team. We have seen a real positive impact of ESG on company performance, particularly for the renewables and energy efficiency programmes, but also for areas such as governance and community engagement. Having strong buy-in from the company management team really helped to drive forward these initiatives."

looking at what more we can do to engage with investments and sponsors during the investment period.

In businesses where there is no sponsor or where the PDM funds have equity, we can get quite involved and have undertaken site visits and joined management meetings to discuss ESG topics. Where there is a sponsor, they lead on engagement with portfolio companies.

However, we believe there is also an important role for a private credit investor to ensure there is a focus on ESG within the underlying portfolio companies.

Q Do you think the industry is thinking about ESG in an increasingly strategic way?

Yes, I do, and I can also see a step change underway. With regard to climate change, ultimately, we want the funds' portfolio to be resilient. That means looking at potential impacts before the funds actually make an investment. In the past, we have walked away from potential investments if we felt those businesses were not sufficiently aligned with a transition to a lower carbon economy. Going forward, we want to develop this approach further so that climate change is better integrated into our investment strategy. This will assist the investment teams in identifying both climate-related risks or opportunities as part of the origination and deal process.

We also plan to engage with our sector teams on climate change to help them think through what physical and transition risks mean for their specific sectors and markets, encourage them to reflect on their strategy and identify where the opportunities are. This is a big project for 2021. Climate change is clearly increasingly going to become another lens to look at potential deals and will influence how and where we invest.

Q How will you conduct this sector strategy review?

"Collaborative initiatives are important for advancing ESG within the private equity industry"

Our plan is to start with one sector and take it from there. We will work with the sector head and a small team. We will provide training on the climate science and implications for key subsectors and work with them to understand where the key risks or opportunities may be for their strategy. During this first review we are not going to come up with all the answers, but our approach should evolve as we become more sophisticated in thinking about physical and transition risk.

Q Are portfolio companies giving the same level of attention to climate change priorities?

Generally, companies are really interested in climate change, particularly high energy users. Some of the portfolio companies have done great work on climate-related initiatives and we want to start sharing more of what they have learned, for instance around carbon footprinting and installing renewable sources of energy.

For example, the South African data centre business Teraco has installed solar panels at its main site and is looking to use that as a blueprint for its other data centres. Dr Martens and LegalZoom – which have very different business profiles – also have solar panels on their buildings. We are also looking at applying those lessons to other portfolio companies in other geographies.

Q Beyond climate change, what new themes do you expect to come into focus this year?

The EU is launching new regulations on reporting and disclosure in sustainable finance, which we are watching closely while reflecting on our monitoring and reporting approach in general. We are also working on our first publicly available ESG report, which we will publish this year. We have provided an ESG report to our investors since 2015, and now we recognise that we should be sharing more of what we are doing as a firm in terms of sustainability and how we engage with portfolio companies on ESG. Over time we think there will be an expectation that private equity firms disclose more about their ESG approach. It is part of the trend toward improved transparency in the sector.

Q How important is ESG within the firm?

ESG is extremely important within the firm, including from senior management. Everyone across the firm takes ownership of ESG and everyone has a role to play. Each deal team has an ESG lead, the monitoring teams engage with companies on these topics and I tend to get involved with higher risk companies or where we believe there is more room for improvement on the ESG side. There really is a recognition that companies which manage these issues well will be more successful and sustainable in the longer term.

It's also really important to us to lead by example on ESG. For example, through the CarbonNeutral® company certification (which we've had since 2018), the diversity and inclusion initiatives and the work of the Permira Relief Fund, which was set up in response to covid and provides financial support to charities through the Permira Foundation. ■

INVESTOR

Q&A

Close partnerships with management teams are key to building more sustainable business practices, says Katharine Preston, vice-president, sustainable investing at OMERS

Q In November, OMERS was among eight Canadian pension plan investment managers that called for improved ESG data reporting by companies and investors. What progress is required in this area?

We believe integrating ESG factors into our investment approach is not a trade-off for strong returns. Instead, it is a key element of our fiduciary duty that will safeguard our portfolio and drive value for our members over the long term. We know that while companies face a myriad of disclosure frameworks and requests, it is vital they report relevant ESG data in a standardised way to provide clarity and improve data flow. Markets around the world are beginning to mandate and regulate disclosure requirements, so having a standardised approach is necessary.

Q How do OMERS Private Equity and other OMERS business units integrate sustainability considerations into investment decisions?

OMERS believes that well-run organisations with sound ESG practices will perform better, particularly over the long term. When looking at what ESG means for OMERS, we start with broad principles, and then we integrate specific factors into investment decision-making, across all investment teams and asset classes. We integrate these in a number of ways, including through ESG assessments of potential

"Our approach continues to evolve as more data becomes available"

new investments and ongoing oversight and influence of ESG issues in our investee companies. For each ESG assessment, we seek to evaluate a range of material ESG factors, including climate change, inclusion and diversity and board structure.

Q The events of 2020 have brought ESG risks to the fore. Has this impacted your approach?

Investing responsibly to deliver sustainable returns to our members over the long term has always been in our DNA as an organisation. The events of 2020 have highlighted urgent challenges facing our global community, and the need for more inclusive economic growth.

Our approach continues to evolve as more data becomes available, as tools develop to better measure these factors and as our portfolio companies respond to, manage and anticipate material ESG factors. Our internal Sustainable Investing Committee reviews our approach to ESG integration across the portfolio on an annual basis to ensure we employ best practices.

Q How do you engage with OMERS portfolio companies in private equity and other spaces on ESG?

We engage directly with portfolio companies in various ways. When investing in private assets, we typically acquire governance rights, including board seats. We exert our board-level influence to encourage the investee company to maintain and build on sustainable business practices and long-term thinking. Through this active governance, OMERS can influence material ESG-related practices in our investees' strategies and operations.

Having close partnerships with the management teams of our portfolio companies is central to our investment philosophy. We partner with our portfolio companies to find opportunities to evolve sustainable business practices and grow sustainably. ■

INVESTOR

Q&A

The UK's largest private pension scheme is divesting from certain sectors in its bid to invest responsibly for the long term. David Russell, head of responsible investment at USS Investment Management, explains why

Q It's been almost a year since your joint statement with GPIF and CalSTRS calling for a greater focus on long-term sustainability-related risks. What kind of response has this had?

Since March 2020, an additional 12 global funds have joined as co-signatories to 'our partnership for sustainable capital markets' statement. It is for each signatory to decide how to respond to address the challenges and opportunities highlighted in the statement. For our part, we hope that the support for the statement will send a strong signal to the market that asset owners now see long-term sustainability risks as a core component of investment and stewardship processes.

Q How does USS engage with external managers to drive climate action?

USS has a detailed ESG monitoring process which includes questions around how a manager is managing climate change related issues. These will of course vary in relevance depending on the sectors and type of companies in which the GP is investing, but we expect all managers to consider what the impacts of a changing climate, and climate related regulation, will have on their assets. As part of our monitoring programme, we review private equity portfolios to identify assets where climate change (either physical risks or transition risks) may be present and ask the GP how these are being managed.

Q What progress has been made over 2020 and what are your responsible investment aspirations moving forward?

Notwithstanding the issues associated with covid-19, we believe ESG issues in general, and climate change in particular, have continued to move up the agenda of private equity managers. Increasing numbers of GPs now routinely provide ESG data in standard fund documentation, including information around climate change related issues: we believe this will be the norm going forward.

During 2020, USS Investment Management itself made some major strides forward in its recognition of the growing importance of ESG and regulatory pressures on the portfolio and as a result, announced plans to exclude, and where necessary divest from, companies in those sectors that were deemed to be financially unsuitable over the long term. These were: tobacco manufacturing; thermal coal mining, specifically where this makes up more than 25 percent of revenues; and controversial weapons – companies that may have ties to cluster munitions, white phosphorus-based weapons and anti-personnel mines.

The burning of coal, in particular, has a significant impact on climate change. With a focus on reductions in emissions and a decrease in the cost of alternatives, it is likely that markets have failed to value adequately the potential risks coal mining companies face. This in turn will lead to pricing pressure. This cannot be mitigated by engagement, hence our decision to divest. Over the next two years, if not earlier, USS Investment Management will cease investing the scheme's assets in companies in these sectors and begin to fully divest of any such companies where we have investments we can control. These exclusions will be kept under review and may be changed or added to over time and will be made across the defined benefit and defined contribution sections. ■

KEYNOTE INTERVIEW

A customer-centric approach to ESG

Helping companies chart a path to sustainable growth built on strong ESG principles is a crucial value driver for private equity, say CVC's Jean-Rémy Roussel and Chloë Sanders

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Investors are increasingly focused on environmental, social and governance considerations. Climate change, racial injustice and the covid pandemic are injecting a real sense of urgency in both portfolio company boardrooms and with their sponsors. This isn't just a question of being a responsible business. It also makes financial sense: strong financial performance and sustainability have become inextricably linked, and there's no going back according to CVC Capital Partners' managing partner, Jean-Rémy Roussel, and ESG director, Chloë Sanders.

Q Why is ESG important for your firm?

Jean-Rémy Roussel: We want to create value in our portfolio companies, but not just in any way possible – our values need to be present in every important decision made. ESG is therefore extremely important to us for three main reasons. First, we find that where management teams have been fully engaged on ESG, the investments have delivered higher than expected returns. When management teams focus on ESG opportunities, they can make significant improvements to the business and more quickly deliver on plans. Over time we have also found strong evidence that an increased ESG focus throughout a company materially increases employee engagement.

The second element is the scale of our impact. At CVC we have more than 85 companies in our portfolio and they employ over 400,000 people, many with dependant families – our firm touches the lives of a lot of people in many countries. If we do this right, so that everyone benefits, employees can feel adequately remunerated, supported and proud of working for their companies. This grass roots philosophy can have a positive and far-reaching impact on society.

Third, if we, as a firm, want to be here in 30 years' time, we must actively drive the sustainability agenda both within our firm and across our portfolio. You need to maintain your social license to operate and reputation as a responsible investor. There is no trade-off between delivering superior returns for investors and creating value in a more sustainable and equitable way for all stakeholders involved. In fact, quite the contrary, one facilitates the other.

Q How is ESG integrated into your thinking and processes?

Chloë Sanders: ESG integration must come from the top – there needs to be a commitment from management to operate sustainably. At CVC we have engaged a corporate social responsibility mindset for many years, and we have continually refined our approach, for example by broadening environmental considerations from traditional topics such as pollution, to seek out opportunities – we are constantly pushing ourselves to do more. We measure our carbon footprint and are taking steps to neutralise it. We are also working with our portfolio companies to establish roadmaps to decarbonise and build offset programmes.

JRR: We consider ESG elements as integral ingredients within our portfolio companies' value creation plans (VCP). The engagement of the management team is key here – if you do not have buy-in from management, you will not achieve meaningful results. When working with a management team, we focus on six key priorities that help us track value creation: customer focus, simplification of processes, people and culture, community, environment and governance. They are all non-financial elements because our experience is that financials only provide a rear mirror view, and we want to look to the future. These elements are our lead indicators of proper value creation which will eventually result in superior financial results.

Of these six priorities, we see customer focus as the most important, yet it is not really addressed in traditional ESG metrics, so we decided to include it within more traditional ESG topics in our VCP.

Q Why do you see customer focus as the most important element?

JRR: Many people expect private equity to come into a business and just focus on improving financials by cutting expenses, reducing staff, and being very tough with suppliers – but this is rarely sustainable and not the way we work.

Instead, we start with the customer journey and customer awareness around products and services. This analysis shows a multitude of potential improvements from consumer decision making through to user experience. We can also accurately map the location and size of internal costs of consumer dissatisfaction. So, if you have a business where there are product breakdowns, addressing this problem will reduce inefficiencies. From the number of calls to call centres to the costs of repairing, this reduces costs and ultimately increases customer satisfaction. Getting the customer journey right is a much more engaging agenda for management than pure arbitrary cost reduction. Importantly, savings can also be re-invested in the business.

Q Can you give an example of this in action?

JRR: Zabka, a chain of 7,000 convenience stores, run by about 6,000 franchisees, in Poland, is a nice example. We could see the business had a lot of potential, but it faced many internal challenges, so we sought to address the engagement of two important customers: the franchisees operating the stores and the end consumer.

Two years before our investment, the franchisee churn rate was 37 percent which was very disruptive to the business. We measured the Net Promoter Score KPI, and for Zabka franchisees, it was minus 62, which meant we had a disengaged group of

customers. In response, management recruited a top team who worked closely with franchisees to implement a variety of initiatives including automatic store replenishment. After two years the NPS went up to +19, and franchisee churn reduced to around 10 percent.

To improve end consumer satisfaction, the marketing and category team revamped Zabka's offering with more than 12 different store concepts. The team also improved the product range with products that were better for the planet, such as introducing recycled packaging and using more natural ingredients. Three years on, the customer NPS score has increased from 15 to 47.

Another positive outcome has been the material improvement in employee engagement – over three years the Employee Engagement Gallup score increased significantly (by over 25 percent). If you build customer satisfaction, you create a resilient company that people want to work for. The financial impact has also been excellent – sales growth has climbed 20 percent over the last three years.

Q The sustainability of supply chains has come under increased scrutiny recently. How are you considering this area?

CS: Supply chains are a vital

Q Where do you see ESG opportunities developing in the future?

JRR: The 'E' and 'S' aspects will become as disruptive as the digital transformation we have seen in sectors such as retail or insurance. In four years, who will want to buy a company with an unmanageable carbon footprint? The environmental impact of a company could have a significant influence on its value. Similarly, if a company is unable to demonstrate an inclusive and diverse work force, will it be able to attract or retain talent?

There will be opportunities to buy companies that are currently underperforming on ESG and work with them to improve. If companies do not develop a long-term ESG roadmap, ultimately, they are putting themselves at risk – both financially and reputationally. There is a lot of work we, as hands-on investors, can do to set them on the right path and create value.

component of integrating sustainability into a business. Customers are increasingly demanding transparency, so there is a real reputational risk if you fail to manage your supply chain properly.

JRR: Watchmaker Breitling is a good example of how a management team has successfully collaborated with its suppliers to achieve long-term value. Breitling's watches are made using precious metals, diamonds and leather. The company has systems to rigorously track the origin of these materials and is also pursuing the use of more sustainable materials for its products and packaging. For example, Breitling has worked with NGOs to develop straps made from recycled materials such as fishing nets. Its new sustainable and smaller packaging, made from 100 percent recycled plastic bottles, has also been awarded the 'Efficient Solution Label' from the Solar Impulse Foundation. If the customer still wants the more traditional packaging they are able to offset the CO2 impact difference with a donation to Sugi (planting ultra-dense mini forests).

> *"If you build customer satisfaction, you create a resilient company that people want to work for"*
>
> **JEAN-RÉMY ROUSSEL**

Breitling has materially reduced its CO2 footprint across its production sites and offices and reduced water consumption in its production processes by 50 percent over the last five years. In addition, the business has plans to move to 100 percent renewable energy sources – a decarbonisation programme will be a strategic priority for management in 2021 and beyond.

CS: Syntegon (ex Bosch Packaging Technology), is a strong example of an equipment supplier pro-actively collaborating with its customers – several of them, like Nestlé and Mars, have already announced they want to move to 100 percent recyclable packaging by 2025. The company has established a consultancy team to collaborate across the value chain with clients and suppliers to reduce plastics and chemical products in packaging. Early results are already very encouraging and there is no doubt the company will not only continue to grow significantly and profitably, but it will also have a material impact on the environment through reduced energy consumption, CO2 emissions and plastic consumption.

Q One of the challenges of ESG is measurement. How can this be done effectively?

JRR: It is going to take a long time for there to be a global standardisation of company measurement, so our six priorities provide a macro level framework, underpinned by a few core KPIs, such as NPS, quality market standards, carbon emissions, along with industry-specific measures. Each of our investments are unique, so we have to adapt and balance for an individual company's maturity and local practices. We do consider emerging standards, but different investors need different information. By measuring our own KPIs using the six priorities of our VCP we can quantify and measure progress over the course of an investment.

CS: Investors want concrete evidence of what we are doing; not just which standards we are using. To obtain an official external validation of the ESG engagement of our companies, we asked EcoVadis, a trusted independent ESG rating agency, to perform an annual rating of CVC at the corporate level and for our portfolio companies by 2021. Its rating covers around 80 percent of our ESG focus areas. We will therefore soon have a consolidated view of all our companies' ESG efforts and progress over time. The aim is to stake a point of departure and then work with companies to improve the scores. The ratings show us a clear indication of where there are improvement opportunities. When there is a silver rating, there is room to move to gold. We recently did an ESG Spotlight webinar where over 25 portfolio companies came to share their experience and offer examples of best practice. We have found amazing levels of engagement of our portfolio companies' executives in sharing and learning from each other. ■

Biden administration sets new tone on climate change

The new US president's environmental agenda and plans for a 'clean energy revolution' could provide added impetus for ESG strategies in private markets. Eamon Murphy reports

With Joe Biden in the White House and Democrats in control of Congress, albeit tenuously, a more liberal attitude to environmental, social and governance investing at the federal level seems inevitable in the US.

Climate in particular was a centrepiece of Biden's presidential campaign, which pledged comprehensive investment in clean energy. But what will be possible for the new administration at a time of social crisis and political disturbance remains unclear. Although observers agree the momentum for disclosure around ESG will continue at the regulatory level, hopes for a legislative boost centre on the familiar yet elusive goal of an infrastructure bill.

ESG momentum has also been building in the private equity industry. As it stands, there are no reliable fundraising data that separate ESG-focused private vehicles from their non-ESG counterparts. Yet directional data from the UN Principles for Responsible Investment, which promotes the inclusion of ESG factors into investment decision-making, suggest that institutional capital continues to flow to sustainability-minded managers. The PRI had 3,038 signatories with assets under management totalling more than $103 trillion at the end of March 2020, up from 1,384 signatories representing $59 trillion of AUM in 2015. As of August 2020, more than 650 PRI signatories were US-based.

Meanwhile, the Global Impact Investing Network estimates that, as of the end of 2019, more than 1,720 firms were managing $715 billion in impact investing AUM. Impact funds may remain a significantly smaller presence in the market, but the space saw a high-profile arrival last month with the addition of former US Treasury secretary Henry Paulson as executive chairman of TPG's Rise Climate fund. The firm said the fund was formed in

response to the "increasing number of climate-focused companies... in search of climate-focused capital".

As a candidate, Biden vowed to rejoin the Paris Agreement and promised a "clean energy revolution" to eliminate carbon pollution from US electricity production by 2035. Given its increasing economic clout, private capital will be critical to completing this transition on time. "The private equity market has grown so dramatically, there are so many more layers," says Steven Rothstein, managing director of the accelerator for sustainable capital markets at the non-profit Ceres. "People are waiting longer to go public than they were, so we're not going to achieve this goal to be net zero – hopefully by 2040, no later than 2050 – if the private equity players are not active partners."

This is starting to sink in, Rothstein says, especially in Europe, where ESG investing is further along in terms of political support and reporting standards: "We've seen more leadership in Europe from several private equity managers that have already established 2040 goals and are working with their portfolios." Ceres advocates for mandatory climate risk disclosure and pushes companies to reduce emissions through a network of more than 175 institutional investors managing $30 trillion in assets.

"Everyone understands that you can't just rely on [the administration], whether it's a president who is more supportive or less supportive of these issues," Rothstein says. "If you're the CEO of a company or the mayor of a city, or a private equity manager, you can't assume someone else is going to solve that problem."

Under Donald Trump, regulatory action in favour of ESG was stymied, to the chagrin of many investors. "We were concerned and opposed to the administration's efforts at the Department of Labor to roll back the ability to consider ESG factors as a fiduciary," says Chris Hayes, senior policy counsel at the Institutional Limited Partners Association. "We don't think it detracts

> *"We're not going to achieve this goal to be net zero – hopefully by 2040, no later than 2050 – if the private equity players are not active partners"*
>
> **STEVEN ROTHSTEIN**
> **Ceres**

from acting as a fiduciary to do that."

Hayes expects that rule to be reversed and suggests "there is the potential to see some changes that would actually require [ESG] factors to be taken into account". Such considerations could be incorporated into the fiduciary requirements of the Investment Advisers Act, which applies to private fund managers with more than $150 million in AUM. A possible model is the proposed Climate Risk Disclosure Act of 2019, which would require public companies to report information including emissions, fossil fuel assets and risks related to worsening weather events and the energy transition.

"Generally, ILPA would be supportive of proposals that encourage investors and managers to consider [ESG] factors in their investment process," Hayes says, either through legislation or regulatory action. "This would be a big step forward." He notes that the Securities and Exchange Commission has so far limited itself to addressing how ESG funds are advertised.

Investing in infrastructure

On the legislative side, investment on the scale Biden has spoken of – $2 trillion over four years in R&D and tax credits to build out renewable power capacity and accelerate the rollout of electric vehicles – would require Congressional action in addition to executive orders. Infrastructure legislation was a much-ballyhooed subject during Trump's presidency, albeit one that never materialised. It remains an area of tantalising potential consensus.

"If there's a shot at a broad bill that has bipartisan support, it would be around infrastructure," says Fran Seegull, executive director of the US Impact Investing Alliance. "What we're calling for specifically is a federal domestic vehicle to invest in and promote inclusive economic growth."

Such a domestic development bank would "leverage the tools and lessons of international development finance to reinvest in American infrastructure and industry to create a more level playing field", she says, funding projects around issues such as climate resiliency and the digital divide.

Brent Burnett, co-head of real assets at Hamilton Lane, says "a stimulus package that is infrastructure-related or more comprehensive in its approach", including clean energy provisions that extend and expand on current incentives, would be more likely to pass than any specifically green bill. Executive orders could incentivise some behaviours and punish others, but Burnett adds that many states have adopted their own renewable energy standards. "Trump's disengagement from this actually led to more engagement from states and institutions," he says.

He adds that politicians favour the carrot-and-stick approach, but that the timelines are different: "The carrots they like to implement immediately, but the stick they like to push off to somebody else."

Subsidies and tax credits get put in place right away, "but the really hard restrictions – we're going to get to net zero by this date, we're going to phase out internal combustion engines by that date – tend to get pushed out 10, 15, 20 years, and at some point those policies are going to have to be validated by the electorate." ■

KEYNOTE INTERVIEW

Investing in sustainability along the food chain

Developing sustainable solutions to food production is an environmental and social imperative. It also makes good business sense, says Paine Schwartz Partners CEO Kevin Schwartz

According to the World Bank, by 2050, feeding a planet expected to have over nine billion people will require an estimated 50 percent increase in agricultural production. Kevin Schwartz, chief executive and founding partner at food and agribusiness-focused private equity firm Paine Schwartz Partners, explains why responsible investment is key to addressing challenges in the food and agricultural sector.

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Q Why is responsible investment so important in the context of food and agribusiness?

Food and agriculture are critical sectors for the obvious reason that everyone on the planet needs to eat and have access to the calories and nutrition they require to live. However, the situation is that demand is continually rising, as the global population grows. Diets are also changing. As people move up the wealth ladder, they consume more protein and fresh fruit and vegetables.

Protein, in particular, requires the production of large volumes of grain to be converted into animal protein, which has huge implications on the resources that we have available to produce food. We are also facing significant constraint factors, such as the availability of fresh water and a changing climate, which are creating more variability in yield outcomes. In other words, the industry landscape is characterised by inexorable increases in demand and constraints on supply, which make it critical to focus on sustainable solutions to producing the food we want and need to consume globally.

Q What sorts of ESG challenges, and opportunities, does that create for you as an investor?

For us, there are two key investment themes. First, increasing productivity in the food and agricultural value chain. The second theme is health and wellness. Within those core themes, we look across the value chain from 'before the farm', which means the products and services that are used on the farm to increase yield or productivity in a sustainable way, and also downstream, closer to the consumer, as they are making choices to purchase healthier food and nutritional products that improve their health and wellbeing.

An example of a portfolio company focused on the upstream part of the value chain is AgBiTech, a business we invested in around four years ago. That company has developed a technology to control caterpillar pests using their own naturally occurring viruses, which are completely harmless to any other living organism. So, rather than using synthetic chemicals, which have a negative effect on everything living in the field, including other animals, pollinators such as bees, and the plants themselves, we now have a naturally occurring pest control solution that is food grade. That product is being used in key agricultural production geographies including Brazil, the US and Africa. We have ended up with an organic and biological solution to what used to be controlled with a series of relatively harmful synthetic chemicals.

An example of a health and wellbeing investment, meanwhile, would be FoodChain ID. Consumers want transparency around the safety and security of what they are consuming. FoodChain ID, which we recently sold, provides more than 30,000 food, feed and agricultural customers with food safety and food quality testing and accreditation services.

Overall, we have an investment landscape that allows us to build a diversified portfolio across the value chain, anchored around those two core

A fresh approach

Paine Schwartz Partners backed publicly traded AgroFresh in June 2020, having tracked the company for a long time.

AgroFresh is all about food waste reduction, a key investment theme for the firm. To give some context, the UN Food and Agriculture Organisation has estimated that around a third of all food produced globally is wasted. That is about a billion tonnes of food per year. Covid-19 has only exacerbated these issues as demand chains have been upended, with restaurants closing and supermarkets scrambling to keep up.

Clearly, there is a financial value proposition in minimising this wastage. There is also a strong environmental gain. Approximately 8 percent of greenhouse gas emissions come from food waste, due to the high emissions associated with food production itself.

AgroFresh delivers solutions that extend the shelf life of fresh produce and therefore reduce waste. The company's flagship product specialises in revolutionising the post-harvest management of apples, allowing them to be stored fresh for longer periods of time, rather than being sent to landfill. According to AgroFresh, this product is estimated to have taken around 10 million metric tonnes of carbon dioxide out of the air in the US.

Paine Schwartz Partners backed the business to support its ongoing growth and the development of new products and technologies. Today, AgroFresh is operating in countries around the world and has created new products tackling other high value specialist crops ranging from bananas to cherries, citrus fruits, avocados, tomatoes, plums, and pears. "Our goal is to continue to support the business in its drive to have a material impact on the sustainability of fresh produce production," says Paine Schwartz Partners CEO Kevin Schwartz.

themes of productivity and health and wellness.

Q How do you incorporate responsible investment principles into your investment process, from origination through to exit?

We have tried to systemise everything that we do around ESG and responsible investment, to ensure it is deeply ingrained in all our activities. When developing our investment strategy, we have ensured we are investing in companies where the core value proposition is around driving sustainable solutions, whether that be boosting productivity, waste reduction or food safety and security. Our investment thesis is aligned with the goal of creating a more sustainable food chain.

As we build a funnel of investment opportunities, meanwhile, we screen for those positive characteristics. In due diligence, we use metrics to identify ESG risk factors from the use of scarce resources to other social and governance issues, which gives us a baseline. As we move into the ownership phase, each business has its ESG mission embedded at the board of directors level, and we continuously strive to improve on those metrics and to be unfailingly transparent about the progress we make. For example, all our portfolio companies disclose their Scope 1 and Scope 2 greenhouse gas emissions.

At exit we are also alive to whom we are selling an asset, looking for owners that are going to be good stewards of these companies from an ESG perspective going forward. Our approach to responsible investment spans everything from idea generation, all the way through to realisation and reporting.

Q How do you resource responsible investment within the firm?

It really starts at the top. As chief executive of the firm, I have ultimate oversight of our ESG mission. We have a cross-functional team where our head of investor relations is responsible for the calculating and reporting function at a firm level; our head of operational excellence is responsible for deployment of objectives and management of outcomes at a portfolio company level; and our investment teams are responsible for identifying issues, carrying out accurate due diligence and fulfilling objectives during the ownership phase. Responsible investment is embedded in everything we are doing across the firm.

> *"The industry landscape is characterised by inexorable increases in demand and constraints on supply, which make it critical to focus on sustainable solutions"*

Q How is responsible investment correlated with returns in this sector?

In an industry like food and agriculture, it is the end consumer who is ultimately the determining factor in what gets valued upstream. What we are seeing is an increasing focus, particularly in the developed world, on consumers making choices that reflect their desire for more sustainable, safe and healthy sources of food.

That is creating demand for sustainable production solutions, across not only environmental, but also social and governance issues. There is a real synergy, therefore, between ESG and responsible investment goals and those companies that are going to be long-term winners in this sector. We see no negative drag on returns whatsoever. In fact, there is a clear alignment between responsible investment objectives and investment performance.

Q Do you think that is something that institutional investors now universally buy into?

We are getting there. We have certainly seen strong demand from most of our investors for measurement against ESG performance metrics, which helps them with their reporting to their own stakeholders on these issues. We have also seen the emergence of pools of capital that are specifically orientated towards investment with impact, whether environmental or social. I would say the adoption of ESG and responsible investment principles are now very much table stakes, not just in the food and agricultural sector, but right across the private equity industry.

Q What does the future hold for responsible investment in the food and agricultural sector?

Responsible investment will become both increasingly well-defined and more and more measurable. Our strategy is closely aligned to the United Nations Sustainable Development Goal 2 – ending hunger on a global scale. The private sector's contribution to that goal is going to be critical.

There is also growing momentum behind the drive to combat climate change and weather volatility. The food and agricultural sectors are, of course, directly impacted by those trends, but they are also one of the greatest users of resources on the planet and one of the greatest contributors to greenhouse gas emissions. These issues are front and centre for the food and agricultural industry and so, as investors, they are front and centre for us as well. ■

INNOVATORS IN ESG AND IMPACT INVESTING 2021

Amid growing concerns about the state of the planet, PEI set out to gauge where private equity is bringing fresh thinking to the environmental, social and governance challenges facing the world

The big ideas shaping ESG

Whether it is fresh approaches to tackling climate change or new ways of measuring impact, private equity is proving it can innovate in responsible investing, write Graeme Kerr and Victoria Robson

For the last six months, the editorial team at *Private Equity International* have been on something of a voyage of discovery in responsible investing. Last July, we set out on a search to find inspirational examples of innovation in ESG and impact investing. The idea was simple enough: with the world gripped by covid-19 and the Black Lives Matter protests, we wanted to uncover examples that showed that the private equity world really could innovate in areas such as diversity, social responsibility and the environment.

We asked for submissions for *PEI*'s new listing of private equity's top innovators in ESG and impact investing and were blown away by the response. There were nearly 130 submissions: not just from the mega firms and multi-billion-dollar asset managers, but also from niche managers and impact investors that prove that you don't need to be a big name to make a difference.

We make no apology for the diversity of the initiatives highlighted here – that was exactly what we hoped to discover – nor the large number: the original aim was to feature just one entry per category but such was the standard that we have ended up detailing 36 separate projects, ranging from women's empowerment funds in Africa to ESG-backed subscription lines from some of the world's top private equity firms.

This listing of the *30 Big Ideas Shaping ESG* covers the cutting-edge innovations in fields ranging from finance to social responsibility, while our *Impact in Action* (p. 64-65) feature details six case studies that demonstrate the potential of impact investing.

The common factor is that all the initiatives show originality and a scale of ambition that suggest that private equity has the vision – and the tools at its disposal – to tackle some of the world's most intractable problems. ■

30 innovations in ESG

DUE DILIGENCE

- Diligencing target company ethics
- Vetting the way portfolio companies act

DIVERSITY

- Mentoring diverse leaders in Africa
- Investing with a gender lens
- The Women's Economic Empowerment Fund
- A 50/50 deal team gender balance

MEASUREMENT

- The Actis Impact Score
- Linking ESG to financial value
- Standardising impact
- Tracking farm emissions
- Calculating the financial impact of ESG

FINANCE

- The debt fund that pays for ESG projects
- ESG-linked leveraged debt deals
- ESG-backed finance facilities
- A fund to tackle covid-19 stress

ENVIRONMENT

- A tool to calculate GHG emissions
- Climate modelling for secondaries
- Integrating future considerations
- An ESG filter for private debt
- Parcel delivery offsets
- A TCFD framework

GOVERNANCE

- A corporate governance toolkit
- Aligning sustainability objectives with the portfolio
- An LP ESG Advisory Board
- EQT's statement of purpose

Finance

ESG-backed finance facilities have been one of the fastest growing areas of innovation over the last 12 months

The debt fund that pays for ESG projects

Bregal Investments

The challenge: Making ESG-related improvements requires early investment of additional capital, but realisation of the benefits takes years.

The approach: Bregal launched the €40 million Bregal Sustainable Development Fund, which lends to the firm's portfolio companies to support investments in ESG projects aligned with the UN Sustainable Development Goals. Loans are tailored to the capital structure and equity arrangements of the business and with its existing financing and governance structures in mind. Intended to catalyse ESG improvements, the initiative offers a new level of financial support to businesses undergoing an ESG transformation without jeopardising returns.

Bregal says: "The SD Fund is a unique initiative to provide tangible support to our portfolio companies in a way that helps accelerate ESG initiatives without jeopardising the fund's returns."

We say: An innovative attempt to provide the financing required to support ESG initiatives.

ESG-linked leveraged debt deals

The Carlyle Group

The challenge: How to build incentives into loans to encourage better ESG.

The approach: Carlyle linked sponsor-backed financing and institutional loans directly to ESG improvements with two European deals in 2020. At Jeanologia, which creates clean tech to manufacture denim, the GP linked a margin ratchet feature in the commercial bank financing to the amount of water the business was able to save. At Logoplaste, a rigid plastics packaging producer, Carlyle negotiated an amendment to its existing €570 million financing to link the interest rate to the business's ability to meet its carbon dioxide savings target.

Lenders say: "This is a situation where finance and sustainability come intrinsically together. It's a win-win for everybody."

We say: These early ESG-linked deals are a glimpse of the future.

The ESG-backed finance facility

EQT advised by Debevoise & Plimpton

The challenge: How to integrate ESG-related terms into fund finance.

The approach: EQT's €2.3 billion subscription line facility advised on by Debevoise & Plimpton and launched in June 2020 has an inbuilt ESG performance-linked pricing mechanism, which adjusts its margin in line with sustainability outcomes. The facility services the GP's current flagship vehicle and has an upper limit of €5 billion. Backed by a syndicate of 17 lenders, it is intended to encourage portfolio companies to implement specific ESG improvements and meet measurable targets.

EQT says: The facility incentivises portfolio company improvements in "systemically important ESG areas, thereby further aligning interests and encouraging the development of more sustainable and future-proof businesses and returns".

We say: The financing structure is powering a nascent transformation underway in fund financing.

Measurement

The race is on to develop standardised ways of quantifying impact

A fund to tackle covid-19 stress

Vital Capital Investments

- **The challenge:** How to help covid-hit companies in emerging markets where state support is lacking.

- **The approach:** In March 2020, the impact investor launched the Vital Impact Relief Facility to provide affordable debt financing in sub-Saharan Africa to businesses facing working capital constraints triggered by the coronavirus pandemic. To be eligible, businesses needed to show that impact objectives met with the firm's own priorities aligned with the UN Sustainable Development Goals. At least a quarter of staff needed to be women, preferably half.

- **Vital Capital says:** "Rather than invest in large equity deals, which take years to build and scale (which is Vital's typical strategy), we quickly realised the immediate need to help existing companies and jobs, so they could continue to provide goods and services in key development sectors, undisrupted."

- **We say:** A trailblazing fund that seeks to bridge the gap between local need and multilateral/government focus in a time of crisis.

The Actis Impact Score

Actis

- **The challenge:** Creating a common framework that helps managers track impact.

- **The approach:** The Actis Impact Score is an open-source framework, which applies the impact measurement and management principles established by the World Bank's International Finance Corporation and the Impact Management Project. The score is available to other asset managers, promoting peer-to-peer collaboration and the evolution of a would-be game-changing universal industry standard.

- **Actis says:** "Rooted in the UN SDGs, AIS provides a framework to target and measure environmental and social impact through verifiable metrics."

- **We say:** Being able to demonstrate tangible impact is the holy grail of responsible investing.

Linking ESG to financial value

Eurazeo

- **The challenge:** Tracking the financial value of ESG improvements.

- **The approach:** The Paris-based firm has applied a methodology that defines core KPIs and associated costs, as well as specific operational indicators relevant to a business (eg, kilowatts used per kilogramme of laundry washed), which, when combined, map performance. The result? A clear demonstration of the relationship between improved ESG, cost reductions and savings, and increased management support for new initiatives.

- **Eurazeo says:** "The main reason for launching this project was to demonstrate the financial value created by CSR policies and their contribution to a responsible and long-term value creation."

- **We say:** A useful demonstration of how ESG contributes to value creation.

Measurement

Standardising impact measurement

The IMP+ACT Alliance

The challenge: How to assess impact without being swayed by subjective judgments.

The approach: The IMP+ACT Classification system is a digital tool that enables asset managers globally, including private equity firms, to report their ESG and impact management practices in a standardised format and to classify investment impacts. Developed by over 150 asset managers and organisations, including Deutsche Bank, Bridges Fund Management and Nuveen (which applied the methodology to its global impact strategy), the scheme is truly industry wide.

Nuveen says: "The initiative helped by advancing the goal of fostering transparency among asset managers regarding the variety of impact measurement approaches and rating techniques that they use."

We say: The wide range of participants suggests this has scope to change the impact landscape.

Tracking Australian farm emissions

Macquarie Infrastructure and Real Assets

The challenge: Reducing emissions in agriculture, which accounts for 13 percent of Australia's emissions.

The approach: FarmPrint, developed by Australia's Energy, Emissions and Efficiency Advisory Committee and backed by institutions including MIRA, allows Australian farmers undertaking large-scale cropping to measure their emissions footprint both on-farm and in the supply chain (for the farm as a whole or per tonne of output). Tailored to a specific segment, the method allows those farmers to benchmark their performance against their peers and to assess the impact of alternative farming methods on emissions.

MIRA says: "Without a robust measurement tool, it is difficult for farmers to determine what they can do to improve."

We say: A vital initiative in a critical area.

Calculating the financial impact of ESG

Triton Partners

The challenge: How to estimate the financial value of ESG initiatives.

The approach: Using proprietary methodology, the GP has expanded its ESG KPI annual portfolio company reporting to include estimates on the financial value of ESG initiatives. The exercise provides a clear indication of where the GP can offer further support and resources. It also makes clear the business case for taking action. By showing the financial implications of ESG initiatives, Triton says the revised ESG KPI reporting process has changed the way the firm interacts with its portfolio companies and renewed the ESG conversation within the firm.

Triton says: "We believe we are one of the first PE firms to estimate financial value in this way across a portfolio."

We say: The exercise provides supporting evidence for the belief that better ESG practices create financial value.

KEYNOTE INTERVIEW

Why human capital is central to ESG

The pandemic has propelled human capital to the forefront of the conversation on ESG priorities moving forward, says Partners Group's Carmela Mondino

Last year was quite the year. While the coronavirus pandemic had serious implications for everyone's health, for private equity investors, covid-19 brought the wellbeing of their portfolio companies to the fore and, in particular, their performance on key environmental, social and governance topics. While the future course of the virus and the shape of the economic recovery remain unclear, we asked Carmela Mondino, head of ESG and sustainability at Partners Group, to tell us what she sees on the horizon for the fast-evolving responsible investment landscape.

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PARTNERS GROUP

Q In conversations with GPs, climate change and diversity and inclusion consistently come up as priority topics. Looking forward, are there other ESG areas where GPs are directing their attention?

There are three big ones: covid-19 and its impact on society; regulatory developments; and people. Coronavirus has made GPs more aware of their ownership obligations and their impact on portfolio company employees. As an industry, there is scope to improve how we engage with employees and take a more active role. This is ultimately part of our licence to operate.

At Partners Group, in response to the pandemic, we launched an employee support fund set up with donations from employees across the firm and management. We already had a plan to launch a stakeholder benefits initiative, and then when the virus hit, we directed those efforts towards helping portfolio company employees facing specific hardships caused by the pandemic. These included individuals who had lost a spouse, lost income or who needed to stay home because they could not afford childcare. It was an emergency response, but how to support employees under our stewardship is a conversation we need to have more frequently going forward. As a firm, we are always thinking about how we can be a good employer of those people that have embarked on this journey with us.

Q What does better employee engagement mean at the operational level?

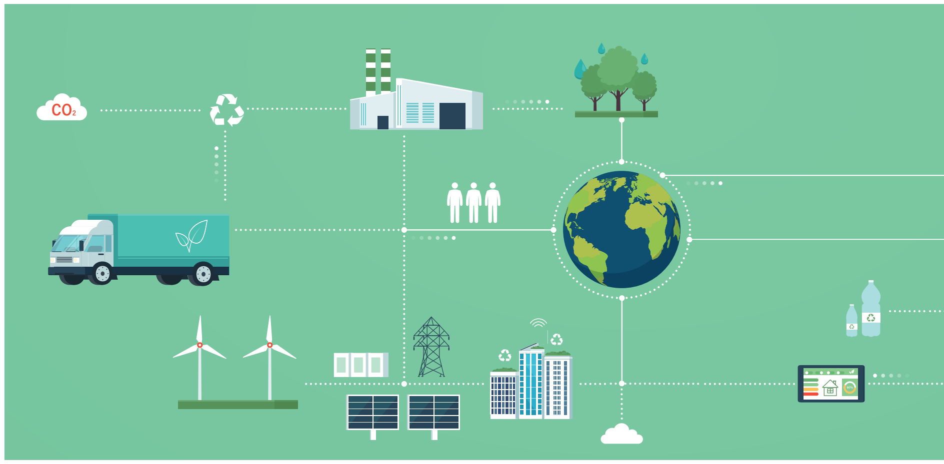
It depends on the circumstances of the company, the industry and the business model. For example, it could be about providing day care at a particular business to enable better staff work-life balance. In another example, it could take the shape of a bonus scheme or distributing shares or specific benefits. It is a broad concept but can be highly impactful.

Q What ESG-related regulatory developments are in the pipeline?

The European Union's new reporting and transparency regulations around sustainable finance come into force this year. From a thematic perspective, there is also a greater focus on human rights, particularly in due diligence. Investors will have to stay close to the topic, especially in countries where there is not a law like the UK's Modern Slavery Act. For instance, the US administration is taking a stand against imports of Chinese cotton over forced labour concerns. The move is related to the US-China trade dispute, but it is also a huge human rights issue and supply chain risk.

Q Where are the gaps in ESG implementation and how can these be filled?

ESG is not simply about mitigating risks and cost savings, it is about having a tangible impact. Customers are now asking for increased sustainability across the supply chain. That is a gap we are starting to fill. Partners Group's transformational investing approach actually embeds ESG into the strategy of our companies – we no longer view ESG as a separate workstream. For instance, if you own a company that has any sort of exposure to plastics, you cannot outsource this risk to the ESG team and announce a project on reducing packaging. It must be part of your investment approach and strategy.



Another gap is around reporting and benchmarking performance. Each firm has their own agenda and priorities. From a measurement perspective, it is difficult to get high-quality data from portfolio companies. We work very closely with portfolio companies, hold quarterly ESG meetings, and an annual validation meeting to discuss the information they have provided based on our 12 key metrics, which is useful to dig into any assumptions they have made. The whole process is time consuming, but it is time well spent.

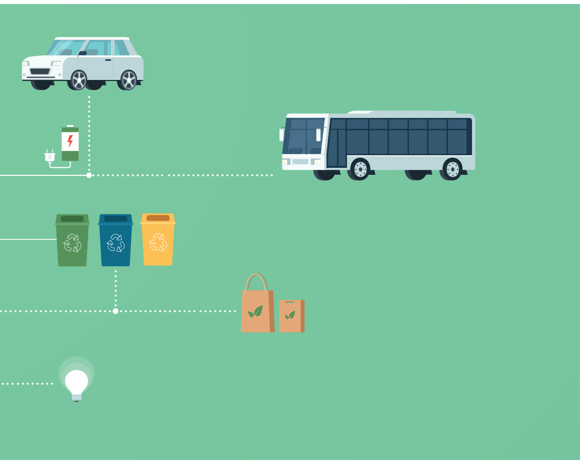
Q How do you keep up with ESG developments and decide the direction you take as a firm?

There are a lot of ESG topics and there is always going to be one that is really hot. It is important to be practical and focus on what is going to create value for a business and its stakeholders. We ask companies for their carbon footprint because it is important for them to understand their contribution to climate change and to have initiatives to reduce it, to mitigate risk and lower costs. We then need to think about how often we ask for this information, and to understand what will move the needle and what is simply nice-to-have. We need to keep in mind materiality and how important a specific topic is for a particular company.

At the industry level, there are platforms and forums through which ESG professionals engage with each other and exchange information. People are open to networking and sharing, and that helps steer the ESG conversation. I talk a lot with my peers. It is important to stay in touch with people, but it is also important to exercise some discernment to filter out the noise and establish priorities. We do that by connecting with the firm's values. Partners Group is a responsible investor and focuses on investing in assets that have broad positive stakeholder impact. Starting with our charter, we try to think about who our ultimate beneficiaries are, what they want and why they choose Partners Group to get it. This approach helps me understand where I should target my energy.

Q There seems to be a merging of the ESG and impact worlds. How do you see this overlap developing?

They are definitely converging or going in that direction. At Partners



Q What are the key innovations in ESG and responsible investing?

Good data is the basis for any decision-making process and technology is key to gathering it. For example, using new software, you can gather data and improve fleet routing in a logistics company. In retail, you can develop an app to engage with staff, or use it to track health and safety metrics, analyse trends and predict future incidents in order to improve your programme. A restaurant chain that is developing a dashboard to see sales could use the same technology to better monitor its stock and reduce food waste.

Overall, we are seeing the digitisation of ESG. These initiatives go hand in hand with the digitisation of businesses. To have a meaningful impact you need to think at scale, and technology and digitisation enables you to have more scale. It is very powerful.

Group, when we think about impact, we think about a business's products and services and whether they support the United Nations Sustainable Development Goals. For us, ESG is related to practices, which any company in any industry can adopt, and implementing a programme to improve them.

As an investor, if you looked at impact through the perspective of business practices, that would limit your investable universe to businesses that were already demonstrating positive impact. The beauty of private markets, compared to public markets, is that as owners, we can directly influence the way companies operate. If you identify ESG issues during due diligence and your period of ownership, you can instigate change and make a great contribution to the way a business is run.

The SDGs are useful for understanding where the gaps are; but there is a risk that as more people talk about impact, firms overuse the SDG logo or force things on companies where there is not a pressing need for them. There are businesses that are neutral in terms of impact.

For example, a restaurant chain may not be feeding the poor, but it is not causing harm either. You can see ESG and impact overlap if you quantify the link between ESG initiatives and SDG outcomes. For instance, you match energy efficiency to SDG 7 – affordable and clean energy.

> *"ESG is not simply about mitigating risks and cost savings, it is about having a tangible impact"*

Q What is next for ESG and responsible investing?

ESG will become more strategic. As professionals, we are leveraging what we have learned from other value creation topics, such as digitisation, and applying that to ESG.

Still, it remains quite a mixed field, ranging from firms with a high level of expertise and ambition that realise ESG creates value and should be implemented, to firms at the other end of the scale that are still getting their heads around it. It will take longer for them to get onboard. Managers that do not proactively put in place a programme will have to pursue an ESG agenda in the end because the regulator asks for it or their clients insist.

Previously, the private equity industry had to make the case for sustainability, and to explain why it is good, for instance, to treat employees well to reduce the risks and costs associated with high staff turnover – in addition to being the right thing to do. With the coronavirus pandemic, private equity has had to take ownership of ESG. As an industry we are becoming more mature and continue to evolve our sustainability agenda in step with society more broadly. ■

Diversity

Funds that champion women-led businesses and gender-balanced deal teams are among the innovations

Mentoring diverse leaders in Africa

Actis

The challenge: Providing effective mentorship to high-performing women and minority groups in emerging markets.

The approach: The growth investor's scheme, launched to encourage more diverse talent, matches high-performing, high-potential, female portfolio company employees, as well as individuals from minority groups in Africa with senior members of the firm's own team. These include board members, senior advisors and other portfolio company management. To date, all mentees in the 18 mentoring pairs are African, more than half are female and they represent a range of nationalities.

Actis says: "Academic research and professional studies indicate that mentoring can be a powerful tool for professional development."

We say: Feedback demonstrates both mentee and mentors are learning a huge amount from the relationship.

Investing with a gender lens

Development Partners International

The challenge: How to enhance women's empowerment and economic participation in emerging markets.

The approach: With a gender-balanced team, the African investor already has a track record in tackling the diversity deficit that plagues the industry. With its third flagship vehicle it is extending this commitment into new territory. African Development Partners III has been designated the first 2X Flagship Fund in an initiative backed by development finance institutions such as CDC, the European Investment Bank and FinDev Canada. In line with the goals of the 2X Challenge to promote investment in projects that enhance women's empowerment, DPI will integrate gender considerations into all stages of the investment process to pursue gender smart interventions, increasing the number of women represented at all levels of the portfolio companies.

DPI says: "ADP III is the first 2X Flagship Fund committed to investing with a gender lens."

We say: As the first fund to align with this new initiative, DPI demonstrates a pioneering combination of ambition and leadership.

The Women's Economic Empowerment Fund

SEAF

The challenge: How to champion women-led businesses in South-East Asia.

The approach: The emerging market growth investor launched the SEAF $100 million Women's Economic Empowerment Fund with the goal of improving the living standards of women and their families in South-East Asia. The fund champions gender equality through economic empowerment and the investment of capital, not just in female-owned and led businesses but also women dominated sectors and products. A central pillar is the investor's Gender Equality Scorecard, which it uses to screen investments and assess portfolio company performance around gender parity.

SEAF says: "The key innovation lies in executing on the premise that women-focused investing is vital to economic and societal development, particularly in emerging markets."

We say: Following on the heels of the 2017 SEAF Women's Opportunity Fund, its latest vehicle shows continued ambition to affect real change.

Due diligence

Good governance requires leading by example and setting out a clear set of principles

A 50/50 deal team gender balance

WestRiver Group

- **The challenge:** Creating a gender-balanced leadership team.

- **The approach:** At the Seattle-based VC firm, a gender-balanced leadership team is knitted into the fabric of the firm and regarded as a clear a route to generate superior returns. The investment team's 50-50 structure ensures individuals bear equal responsibility across similar roles; carry and upside is distributed equally across genders; and that everyone shares equal voting rights serving on one investment committee. If one partner leaves, the firm is obliged to find a partner of the same gender.

- **WestRiver says:** "Multiple studies have shown over the past decade that gender-balanced teams perform better."

- **We say:** By explicitly linking gender parity at the leadership level to financial performance, the firm sits at the vanguard of industry change in attitude and behaviour. That half of its female partners are women of colour cements this lead.

Diligencing target company ethics

Investindustrial

- **The challenge:** How to put ethical considerations at the heart of ESG.

- **The approach:** While conducting ESG due diligence on a target investment has become commonplace, the UK-based GP has gone a step further to create a proprietary methodology to spotlight potential ethical, integrity and reputational issues. Using metrics and other tools to collect ethics and culture data, this information is presented to the investment committee as part of initial and final investment recommendations. The evaluation considers seven separate metrics: transparency, integrity track record, respect, inclusion and fairness, ethical role modelling, policies and incentives.

- **Investindustrial says:** "Not only is a strong focus on business integrity likely to reduce the costs of misconduct, but it can afford companies a solid corporate reputation, genuine employee engagement, robust governance and even increased profitability."

- **We say:** The firm is one step ahead in recognising the impact culture and internal business ethics can have on financial performance.

Vetting how portfolio companies act

Wafra

- **The challenge:** A diligence process that aligns LPs and GPs on ESG.

- **The approach:** There is power in collaboration. The Constellation Platform is an initiative to invest in alternative investment firms backed by advisor Wafra, the Alaska Permanent Fund Corporation, RPMI Railpen and the Public Institution for Social Security of Kuwait. At its core is a mission to educate, train and support portfolio companies on the integration of sector-specific ESG frameworks by applying proprietary ESG due diligence methodology. Drawing on the platform LPs' ESG priorities, values and vision, Wafra works closely with investee asset management businesses to accelerate the adoption of ESG best practice.

- **Wafra says:** "Robust ESG diligence must also include thorough vetting of the way portfolio companies select, manage and direct their own underlying investments."

- **We say:** A good example of how collaboration can improve the diligence process.

Social responsibility

The pandemic has underscored the need for a more caring approach

The hiring platform for military veterans

Apollo Global Management

- **The challenge:** Providing jobs to the huge numbers of unemployed veterans.

- **The approach:** Built in partnership with Apollo portfolio company CareerBuilder, the GP launched the Apollo Veterans Talent Network in 2019. The AVTN website matches job seekers' military skills to the particular staffing needs of employers across Apollo companies. Displaying more than 8,000 job openings and enabling veterans looking for employment to search for them using military classifications and codes, the site seeks to combat high levels of joblessness among this group, where more than 60 percent of the unemployed are between the ages of 18 and 54.

- **Apollo says:** "Apollo is the first private equity firm to utilise technology to build a veteran talent pipeline."

- **We say:** The initiative shows the power of targeted technological innovation to meet a defined social need.

The SHE policy cutting accident rates

Blue Wolf Capital

- **The challenge:** Reducing accident rates for employees.

- **The approach:** Revolutionising entrenched working environments and behaviours is not easy. The US manager has done just that with its Safety, Health and Environmental policy, which stipulates clearly its expectations and responsibilities for the 51,000 individuals employed by its portfolio companies. Why is this innovative? The firm's metrics-based approach that reports to board level has laid the foundation for a new shared working culture that prioritises high-performing, results-focused teams and has slashed OSHA Recordable Incident Rates and Lost Time Accidents.

- **Blue Wolf says:** "In the past four years, Occupational Safety and Health Administration recordables and lost time accidents have been reduced 40 percent and 47 percent respectively."

- **We say:** The policy makes explicit that investing in human capital is as important as financial growth.

Partners Group employee fund

Partners Group

- **The challenge:** Providing benefit plans for employees.

- **The approach:** Employee profit-share plans were already germinating at the Swiss asset manager. Covid-19 has accelerated them. Through the launch of its SFr10 million ($11 million; €9 million) Portfolio Employee Support Fund (into which the firm's employees, senior executives, co-CEOs, executive chairman and founders all contributed), the GP is providing financial aid to employees whose health, income, expenses or families have been negatively affected by the virus. By Q3 2020, it had distributed close to $6 million, more than half directly to 10,000 portfolio company employees suffering the most hardship.

- **Partners Group says:** "Partners Group is leveraging learnings from the Portfolio Employee Support Fund and using them as a foundation for our broader Stakeholder Benefits Fund."

- **What we say:** Offering a stopgap in a moment of unprecedented crisis, the initiative represents creativity and commitment.

KEYNOTE INTERVIEW

Finding value through an ESG lens

Being systematic on the 'S' in ESG will help firms identify opportunities and build resilience, says Blue Wolf Capital's Adam Blumenthal

New York-based Blue Wolf Capital, which has a portfolio made up largely of healthcare services and industrial companies, found itself on the frontline of the covid-19 pandemic in the early months of 2020.

Adam Blumenthal, founder and managing partner, tells *Private Equity International* that the firm's long-term focus on environmental, social and governance factors was fundamental to its ability to cope with the pressures brought by covid-19.

Meanwhile, Blue Wolf's attention to the 'S' in ESG is at the heart of its strategy to unlock value as it prepares for life after the pandemic.

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BLUE WOLF CAPITAL

Q How has Blue Wolf been affected by covid-19 and how has it responded to the pandemic?

Due to the healthcare services aspect of our investment portfolio, we were aware of the likely impact of covid-19 very early. That insight meant we were able to educate our employees and put in place support across the portfolio to maintain safe workplaces and behaviours at our companies.

Through our longstanding Safety, Health and Environmental programme, we already had infrastructure in place that allowed us to not only roll out best practices but also to encourage broad cross-portfolio engagement of resources – which was necessary, because all our portfolio companies continued operating throughout the pandemic. All of them were deemed essential. We had to keep going and remain safely operational, despite the disruption.

Whether it was on the healthcare or the industrials side of the portfolio, we witnessed the heroism of frontline workers as they met the needs of society in the pandemic. We have a group of outpatient healthcare facilities that operate in areas of New York that were at the centre of the pandemic. Everyone around the world saw what was happening in Brooklyn. We had urgent care centres there, and people kept coming into work every day in the midst of covid-19, and had their workload increase.

The only good news is that now we have a year of experience on how you manage in a pandemic at a high-performance level, while keeping people safe and meeting society's needs. We are far better prepared to do that today than we were a year ago.

Q Blue Wolf has been focusing on ESG for many years; how did that contribute to the resiliency of its portfolio when covid-19 arrived?

We have always had a focus, portfolio-wide, on managing human capital and on employee health and safety. We think that engagement with our employees is an important driver of business success, and we have formal governance systems to ensure our portfolio companies are doing that – that is getting onto the 'G' in ESG. You need a governance process. Without the 'G', it just does not happen. You need to know what you are doing and measure it through board committees.

We have used the 'G' features of ESG to put in place supports for the 'S'. Having emphasised employee health and safety at the board and C-suite level for many years, when the crisis hit we did not have any questions about what our priorities would be or need to invent any new tools. If there are no questions about priorities and if you have the tools, it is easy for people to do the right thing.

We were able to track covid-19 infection rates across the portfolio and we found that less than 5 percent of our employees who contracted covid-19 were infected at work. We were able to demonstrate that if you are focused on providing people with a safe place to work and with the tools and the education to work safely, then it can be done. We are extremely proud of our work to make that happen.

Q The pandemic has highlighted inequalities in the US healthcare system. What is Blue Wolf doing to address these?

The American healthcare system is well known for its inefficiency. Although the US has some of the best healthcare in the world at the highest level, on average it provides lower-quality outcomes at a higher cost than in many other developed nations. Closing that gap is a driver of value.

Blue Wolf's approach to healthcare can be summarised by something called the Triple Aim – having better health, at a lower cost, with a higher level of patient satisfaction. We believe that the way to tell if you are creating value in American healthcare is whether your strategy is delivering on the Triple Aim. That has led us to embrace distributed home and community-based services that improve population health.

An example of this is portfolio company FOX Rehabilitation, which provides home-based physical therapies to a geriatric population. We have been putting physical therapists – with adequate PPE and testing – into the homes of 80 or 90-year-olds during lockdown. We help keep these people healthy, even though their mobility is restrained. We have great partnerships with assisted living facilities and senior citizen advocacy groups, because we can deliver the care where it is not happening otherwise.

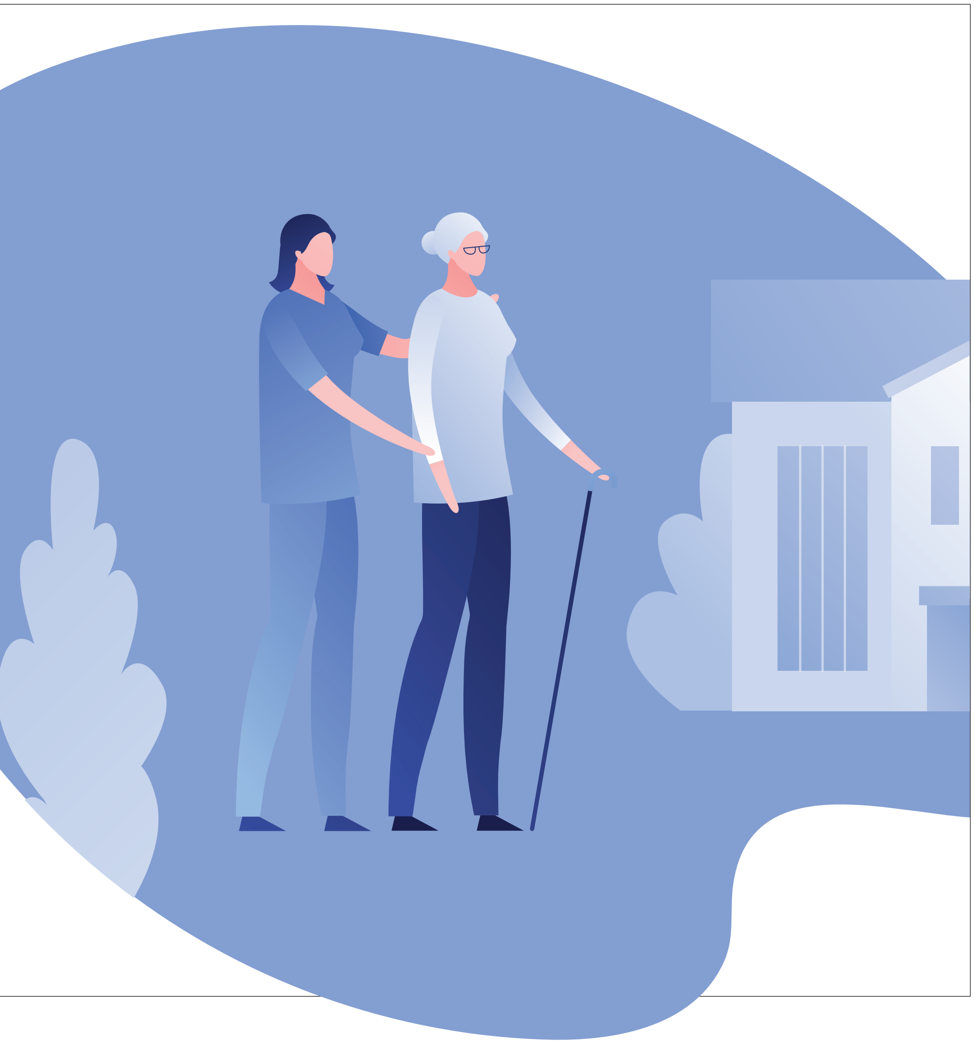
We think that the way to lose money in healthcare over the next decade is to provide high-cost luxury services. The way to generate value for society and for investors is to use the Triple Aim to provide quality outcomes at a lower cost, in the way that the rest of the world has proved it is possible to do. Since the pandemic, valuation multiples on home-based and community-based care have increased dramatically. Covid-19 has made it clear that they are a critical piece of creating value in the system.

Q 2020 exposed various social problems in the US. Can private equity investment help neglected communities while delivering returns?

With some of our industrial investments, we are the largest employer in small towns in America. We have operated sawmills in Dixie County, Florida, and Glenwood, Arkansas; paper mills in Madawaska, Maine. When we make an investment in a place like that, the advantage we have is that we are the only private equity company around. Because we are off the beaten path, typically, we can invest at valuations that are quite compelling.

We use ESG as a lens to find value creation opportunities. The fact that there is a lack of investment capital in these areas creates the opportunity to acquire attractive assets at low values. You get talented people, low-cost inputs and do not have a lot of competition.

However, it is not an anonymous world in Glenwood, Arkansas – your plant manager is going to have breakfast at the same café as the janitor. When you are operating in that environment, you need to be a community partner if you are going to be an employer of choice for the most talented people in the community. We view that as a business strategy as well as the way businesses need to behave.



> *"We have used the 'G' features of ESG to put in place supports for the 'S'"*

Q Does this approach extend to partnering with your workforces?

We have successfully invested in unionised companies since our inception as a firm. In a regulated environment, like healthcare, working collaboratively with unions is important. We approach our relationship with unions the same way we do with sources of financing or customers, and over 15 years, we have conducted ourselves so that we have a relationship of trust with unions. We negotiate hard for business success, but we tell people the truth and we recognise that unions and their workforces have a vested interest in the success of the company.

The result has been that we see investment opportunities that other people do not, because unions will call us and say: "Hey, we've got a problem at this company, is there a way you can buy this and fix it?" Usually we can't – but when we can, that is a really remarkable piece of off-market dealflow.

Q Will disruption to supply chains during covid-19 encourage investment in US manufacturing?

In our mind, it is about balance. American business followed a model of outsourcing to low-wage economies for many years that created structural risk within their supply chains. What is happening now is not a 180 degree turn from there, but companies are acknowledging the risks and investing to mitigate them. It is tragic that it took a pandemic for people to recognise that risk. We have been trying to mitigate it for many years. For example, we bought a building products company in 2016 and invested in domestic manufacturing to make sure we can always meet short-term demand. We want to have that kind of balanced, robust, resilient supply chain.

Q What are the main lessons from the past year? Can interest in ESG be sustained?

ESG is a lens for value creation – it forces you to see things that others don't, in ways that others don't. I believe the private equity community is serious about embracing this approach.

As an investor, you have to see problems that become evident today as opportunities to invest for the future. Certainly, the pandemic has highlighted problems in our society and economy, ranging from the vulnerability of our supply chains, to the quality of our public health infrastructure. At the same time, operating in the pandemic has made clear there is room for innovation to address those problems. The pandemic has taught many people how to operate in a safe and systematic way – that is an innovation that has been broadly accepted throughout our economy. ■

Environment

Climate change is taking centre stage as funds move to measure emissions

A tool to calculate GHG emissions

Apollo Global Management

The challenge: Measuring greenhouse gas emissions is a complicated and often subjective task, made even more difficult at the portfolio level.

The approach: To get around the variety of competing models, factors and possible inputs to calculate its businesses' Scope 1 and 2 GHG emissions, the US investor devised its own tool that uses the most recent factors for stationary and mobile fuel combustion, and heat and electricity consumption. The result is standardised portfolio company reporting that has boosted disclosure (which assists comparability), while encouraging businesses to devise their own emissions reduction schemes.

Apollo says: "This tool has increased portfolio company disclosure of GHG emissions and brought new levels of accuracy, consistency and comprehensiveness to reporting."

We say: Provides welcome transparency in an area often muddied by competing approaches.

Climate modelling for secondaries

Coller Capital

The challenge: How to climate model in secondaries where funds are a step removed from the underlying company.

The approach: Coller has accelerated its efforts to address climate change by undertaking a rigorous, forward-looking climate scenario analysis (both physical and transition risk) on all active funds. The analysis was undertaken by climate scientists and environmental economists in close collaboration with Coller's ESG team. Coller shared these analyses with the GPs, helping them to draw up action plans on ESG best practice, especially climate-related risks and opportunities.

Coller says: "We have sought to take the lead on climate action in our field by raising standards on what can be achieved in addressing climate risk."

We say: Coller attempts to show that secondaries firms can wield impact on GP attitudes toward ESG.

Integrating future climate considerations

FSN Capital Partners

The challenge: How to ensure ESG gains are maintained post exit.

The approach: The Norwegian investor's Climate Action project, inspired by the Task Force on Climate-related Financial Disclosures, provides a standardised way to consider climate risk and opportunities across the investment lifecycle. But the approach differs in that it intends for companies to remain sustainable after the GP has exited. Critically, in addition to raising awareness of climate matters to the deal and management teams responsible for integrating climate-related risk mitigation into the strategy, the forward-looking methodology aims to install a business model resilient to different climate scenarios.

FSN says: "With help from external experts, portfolio companies now assess the robustness of their business models and full value chains under three different climate scenarios."

We say: Exit strategy is a crucial part of the ESG equation.

An ESG filter for private debt

Kartesia

The challenge: How to bridge the ESG information gap between lenders and their portfolio.

The approach: Providing liquidity and credit to European SMEs, the Luxembourg-based financing specialist recognised a need to boost ESG reporting from its portfolio companies. In partnership with Sustainalytics, the firm has launched a project to annually map its companies' carbon footprint – the results for high-emitting borrowers are discussed with them – and estimate the overall weighted carbon-intensity of each of the firm's funds. The firm foresees extending its application to factoring in carbon emission data in pre-investment decisions.

Kartesia says: "Lenders are often not involved in discussions surrounding the carbon profile of a business being targeted by private equity sponsors, so relevant ESG data is not passed on."

We say: This is an early-mover in a fast-growing market.

Parcel delivery carbon offsets

L Catterton

The challenge: The environmental impact from the growing number of parcel deliveries.

The approach: The Small Parcels Contract launched by L Catterton will offset carbon emissions for itself and its portfolio companies linked to the delivery of small parcels. Launched in summer 2020, it is expected to offset 9,000 tonnes of carbon emissions in its first year. As the firm owns more than 45 businesses in North America alone, the scheme has the potential for broad environmental impact across its portfolio. The contract has also prompted ESG conversations between the GP and its brands around topics such as packaging and supply chain management.

L Catterton says: "L Catterton sees this offset programme as a small step towards a larger sustainability journey for both ourselves and our participating portfolio companies."

We say: An important area for innovation.

A TCFD framework

Pantheon Ventures

The challenge: Encompassing the Task Force on Climate-related Financial Disclosure recommendations.

The approach: The Task Force on Climate-related Financial Disclosures has been instrumental in making financial services more aware of climate change risks. The European investor has taken the TCFD's recommendations a step further toward implementation by producing a TCFD reporting framework that measures climate-related risks and opportunities in its infrastructure portfolios and shares information on its approach, including greenhouse gas emissions, with its clients. The next move is to use this framework to address the more complex task of measuring climate change risk in PE portfolios (in addition to existing GP due diligence reporting on the topic).

Pantheon says: "We have been an early mover in incorporating climate change decisions into our due diligence processes."

We say: Has the potential to revolutionise climate reporting.

Governance

Good governance requires leading by example and setting out a clear set of principles

A corporate governance toolkit

Development Partners International

The challenge: Building good governance is a complicated task for managers operating across borders in markets where practices and regulations can differ vastly.

The approach: The African investor has tackled this challenge head on by devising a proprietary corporate governance toolkit that can be applied across its portfolio to improve board culture and behaviour, controls and processes, disclosure and transparency, and share/stakeholder practices. Including terms, templates and diagnostic questions, the toolkit offers a standardised and repeatable means to boost good governance, and is a basis for ongoing appraisal.

DPI says: "The toolkit allows LPs to follow a standardised format to corporate governance for existing and new portfolios, regardless of their territory or corporate governance system."

We say: A practical approach to a difficult issue.

Aligning sustainability objectives with the portfolio

Ambienta

The challenge: How to ensure ESG is embedded in portfolio companies.

The approach: Ambienta's award-winning ESG in Action programme guides ESG integration at the GP and portfolio level. The proprietary programme is based on five macro steps, which are applied consistently across all operations including investment analysis, decision-making processes and portfolio management. The Italian private equity investor measures the effects of the impact it creates on an annual basis and discloses the figures publicly.

Ambienta says: "The ESG milestones we achieve through our investments are purposefully designed to remain embedded in the organisations and represent an enduring legacy for our companies."

We say: Demonstrates the value of a holistic approach.

An LP ESG Advisory Board

Energy Impact Partners

The challenge: Giving LPs a stake in ESG policies.

The approach: The US GP has formalised LP input into its ESG and impact priorities by establishing an ESG Advisory Board comprised of its inhouse ESG/impact specialists and leading impact institutions within its LP base. Recognising that traditional LPAC engagement on the topic was insufficient to meet shared climate and energy transition goals, the ESG board was launched to improve the quality, transparency, diversity and accuracy of methods and metrics the firm applies to its ESG programmes and impact reporting.

Energy Impact says: "The ESG Advisory Board serves to continuously improve the quality, transparency, comprehensiveness, and accuracy of methods and metrics EIP applies."

We say: A deepening of GP/LP engagement around responsible and impact investing.

Technology

Tech offers rich possibilities for ESG innovation

EQT's statement of purpose

EQT

The challenge: Setting out a clear set of principles and responsibilities.

The approach: In March 2020, as part of its annual report, EQT published a Statement of Purpose that formally integrates its positive impact priorities into its articles of association. Targets include ensuring 65 percent of professionals recruited in 2020 are female, and that a quarter of independent board members at the portfolio company level and the same percentage of advisors should also be women. In addition all portfolio companies are to start a transition to using 100 percent renewable energy.

EQT says: "EQT's overall approach is to lead by example and inspire both portfolio companies and others in the industry to follow suit."

We say: The statement is a textbook example of how GPs should be clarifying their responsibilities.

The technology charter

Gaia Capital Partners

The challenge: How to provide a framework for sustainable investment in tech.

The approach: The French growth equity GP's framework for sustainable investing in tech makes explicit the need to consider ethical, social, environmental, human rights and governance questions. The result is the Responsible Investment in Technology Charter, which includes metrics and guidelines governing tech impacts and potential improvements to business models and practices. The open-source tool, which can be used by both investors and companies, provides fresh momentum to changing behaviour within this sector.

Gaia Capital says: "We find that tech executives are particularly keen to address issues of responsible innovation."

We say: A reminder that technology is a worthy area for ESG analysis.

Digital monitoring of employee wellbeing

Partners Group

The challenge: Increasing the wellbeing of staff working in remote locations.

The approach: The Swiss-based firm's portfolio company USIC deploys 9,000 field technicians across the US, working largely alone in sometimes high-risk environments, to locate and maintain critical infrastructure. To better protect employees and boost job satisfaction, the business developed and integrated a software upgrade into its core field technology that allows supervisors to better track employees' wellbeing through a simple check-in process. The software also optimises routing. The initiative eliminated over one-third of all motor vehicle accidents and the rate of injuries in the field fell by nearly 50 percent.

Partners Group says: "Partners Group is harnessing innovation to increase employee retention, protect employee health and safety, and reduce the company's carbon emissions."

We say: Absenteeism, working while ill and burnout are issues that any responsible employer needs to take seriously.

KEYNOTE INTERVIEW

Private equity's opportunity to lead global change

As the drivers of an industry-wide focus on impact investing and ESG pick up pace, KPMG's Tania Carnegie argues the opportunity for private equity is significant, particularly when players collaborate

Q Given the events of 2020, how do you see the private equity industry's focus on ESG changing in 2021, and what do you think the new drivers will be?

The past year demonstrated the increasing relevance of ESG, and how, when managed effectively, it contributes to value creation and risk mitigation. As a result, we are seeing private equity firms incorporate ESG throughout the investment lifecycle in a more rigorous way.

Recent events have exacerbated existing societal and environmental concerns.

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The global pandemic, the Black Lives Matter movement, wildfires and other natural disasters have all impacted the economy, and the ability of companies to carry on business as usual. Companies with an effective ESG strategy are better equipped to deal with such crises and may not suffer the effects as deeply.

There are a number of factors influencing the view of ESG as a strategic imperative, including LP expectations and the increased interest of regulators. Changing expectations of public companies around stakeholder capitalism also provide opportunities to create value at portfolio companies, especially ones on track for an IPO.

Talent attraction and management is also a key driver. Increasingly, people expect to work for organisations that align with their values, and a firm's commitment to ESG is one of the ways it conveys what it stands for. If this energy is harnessed correctly it can have a tremendous impact on culture, which has positive implications for private equity firms as employers, and for the companies they invest in.

> *"The opportunities for private equity firms associated with supporting the transition to a low carbon economy extend beyond environmental implications"*

Q Do you see a new impetus towards impact investing? How different are the drivers for ESG?

The pandemic amplified the severity of key societal and economic issues such as inequality, and added to the urgency for commercial solutions at scale – which is the domain of impact investors. Additionally, the pandemic dramatically increased the pace of change as we saw with the rapid transition to digital as many scrambled to work, learn or access healthcare from home. This also makes clear the need for a fundamentally different way of doing things, as well as a new sense of what is possible.

As a result, there was a flurry of activity in 2020 from a transaction perspective as well as new fund development and expansion of existing platforms. This further demonstrated the range of opportunities impact investing represents across different industries, geographies, areas of impact-focus and stages of maturity of investee companies. The disruption combined with the momentum in the market is attracting more investors.

Fundamentally, the drivers for ESG and impact investing are similar. ESG

Q What challenges remain for GPs looking to invest more responsibly? And what hurdles face the industry around ESG and impact investing?

One of the things that is evolving is the concept of what it means to be a responsible investor. For example, people are realising it is not a black and white issue whether a company is responsible or not. It is about how a GP assesses the opportunities and risks associated with an investment decision along the dimensions of E, S and G, and how they can move the needle to help achieve sustainable growth.

Similarly, a lot of progress has been made to shift the mindset about impact investing, especially for traditional investors with focused investment mandates. There is still work to be done, particularly around demonstrating authenticity and accountability, and proof of concept to investors who remain on the fence. These areas will continue to be a big focus.

There has been a lot of focus on what to measure in the absence of standards and ease of access to relevant data. Frameworks including the Sustainability Accounting Standards Board and Taskforce on Climate-Related Financial Disclosures are being widely adopted, which is helping to establish common practices.

Towards the end of last year, we saw a number of initiatives and collaborations to help streamline different frameworks and approaches. There is tremendous desire for greater alignment, which will attract more private equity firms and investors.

relates to factors relevant to the governance and operations of the company, while impact investors focus on how the products or services offered create positive impact. The two approaches complement one another and create value in different ways by looking at social and environmental issues through different perspectives.

Q What opportunities does private equity have to position itself at the heart of a green recovery as nations look to build back better?

The pandemic provided a serious wake-up call that the social and economic shocks associated with climate change will far eclipse those of covid-19.

Many large corporations and governments have made net zero commitments reflecting the increased priority of climate. Many private equity firms are already working with their portfolio companies to improve energy efficiency, with an increasing number now focusing on ways to enhance climate resilience. Significant progress is needed in short order to meet pledges made (beyond the use of offsets and initial reduction efforts) to realise the benefits of those strategies.

Private equity provides the capital to bring these solutions to scale, plus the focus and dedication needed to be successful. A number of firms are already investing in renewable energy and pursuing strategic opportunities in areas including sustainable infrastructure, packaging and agriculture. To be transformational, we need innovation to drive permanent changes in the energy efficiency of day-to-day life. This creates a breadth of new investment opportunities across different industries and sectors around the world.

The opportunities for private equity firms associated with supporting the transition to a low carbon economy extend beyond environmental implications. It is more holistic as it also includes supporting economic equality through job creation and more stability in marginalised communities. As the effects of climate change are far-reaching, so too is the positive impact of investment in the green recovery.

"Although the leadership demonstrated by individual firms is critical to continue raising the bar, it is through collaboration that the entire industry advances"

Q What about the rest of the private equity community, beyond GPs? What is KPMG doing to drive industry collaboration on ESG and impact matters?

Last year we launched KPMG IMPACT, an initiative to bring together our global professionals and subject matter experts to help our clients deliver growth with purpose, and I lead the effort to support our private equity and asset management clients. We are working on creative ways we can contribute, in particular as convenor, to help move the industry forward in a collaborative way.

The ESG and impact investing ecosystems are dynamic and growing. Although the leadership demonstrated by individual firms is critical to continue raising the bar, it is through collaboration that the entire industry advances. This is where things get exciting… over the past year we have hosted a series of roundtables with our private equity and asset management clients to explore what can be accomplished to advance ESG and impact by working together.

As a firm we have been working with the other big-four firms on a project to define common metrics for sustainable value creation championed by the World Economic Forum's International Business Council. We have also been working with the International Finance Corporation and other assurance providers to refine the independent verification guidelines associated with the Operating Principles for Impact Management.

KPMG contributes to many initiatives of the industry organisations we are members of, including FCLTGlobal, a not-for-profit that encourages long-term investment and business decision-making. We recently participated in a meeting convened by FCLTGlobal of private equity CEOs to develop an action plan to increase diversity in the boardrooms of portfolio companies.

Q How do you see the risk-return discussion evolving around ESG and impact?

The perception that ESG or impact investing requires investors to accept a lower financial return is diminishing with proven examples of how these approaches contribute to value creation. An effective approach to ESG helps private equity investors better anticipate risks, be more resilient and maximise operational efficiency.

Some still question whether impact is consistent with an investment mandate to maximise risk-adjusted returns. Investments made over the past few years have demonstrated that tremendous value can be created by companies with market-based solutions to the biggest problems facing society. Rather than being incompatible, it is a key driver of financial performance. ■

Tania Carnegie, MVO, MBA, CPA is the global lead – private equity and asset management for KPMG IMPACT

The ESG influencers

Investing in businesses at one remove means secondaries firms require a different dynamic if they are to innovate on environmental, social and governance issues, writes Victoria Robson

Last year was not notable for its optimism. However, as coronavirus swept the globe, in one corner of the private markets, investor sentiment remained in good health. Overall secondaries fundraising, including in real estate, infrastructure and credit, hit a record $95.6 billion in 2020, according to preliminary *PEI* data.

At the same time, in light of the pandemic, investors and other stakeholders across private funds have intensified their focus on environmental, social and governance topics. With hefty piles of capital stacked up ready to put to work in the year ahead and deals in the pipeline as the market wakes up from a pause, the question is: how do secondaries managers integrate ESG into their investment process?

A common assumption is that it is, if not impossible, then very restricted given that in a traditional LP sale of fund stakes buyers are distanced from the underlying assets. Market participants disagree.

"The industry holds a limiting belief that in secondaries you can't have an influence on ESG," says Adam Black, head of ESG and sustainability at Coller Capital, which is marketing its eighth flagship secondaries vehicle targeting $9 billion. "We aren't managing the assets, but we have influence. It is just a different dynamic."

Sitting within the investment team at Coller, pre-deal, Black's ESG team "immediately starts thinking about sector risk, the questions we should ask and what we might be able to do post-investment", he adds.

In GP-led transactions, close scrutiny of the underlying assets is easier as GPs are keen to engage with potential buyers. In transactions involving multiple fund stakes, investor investigations zero in on the manager. "You are always looking at the GP, and to the extent to which it makes sense, you examine the underlying assets as well," says Black, adding that his team uses in-house and third-party databases to screen every deal "to alert us to any issues that are potentially problematic to our investors and ourselves".

If they find one, the firm will take its concerns to the GP. "We will push on more challenging issues," he notes.

Researching hundreds of underlying companies within a tight transaction window is a daunting prospect. However, Keimpe Keuning, executive director at LGT Capital Partners – which was in market last year with a flagship secondaries vehicle – argues that pre-investment, secondaries investors enjoy a key ESG advantage that primary investments do not: being able to scrutinise existing assets already in the portfolio. "That's a significant difference," says Keuning, who oversees the firm's ESG programme for private markets. "You can filter for red flags,

Secondaries

get a greater degree of insight and form an opinion."

And if, at the portfolio company level, concerns around the industry, products or services cannot be addressed satisfactorily, there are options. "As a secondaries investor, you need to be careful and consider your commitment to the deal," says Carmela Mondino, head of ESG and sustainability at Partners Group. "An asset could be subject to an exclusion. If we see something of concern relating to ESG practices [at an underlying business], we try to reach out to the manager to understand how they see the issue. Not so long ago, we made an exclusion after a call with a manager in which we realised that they didn't see the problem we saw, so we couldn't gain comfort. Once we have committed to a manager, we monitor."

Given that managers are at different stages of ESG maturity, it is not surprising that risk perceptions and ESG standards vary. But, Mondino says, in her experience, "those that are trying to get on the journey are receptive" to the firm's input. In general, the bigger the firm, the more influence you can wield, she adds.

> *"The industry holds a limiting belief that in secondaries you can't have an influence on ESG"*
>
> **ADAM BLACK**
> **Coller Capital**

Experience and exposure also determine manager reach. "If you are a sizable capital allocator, you already have an idea about which GPs take ESG seriously and can anticipate their performance and openness to dialogue," Keuning notes.

In deals comprised of multiple fund interests, there is the possibility of carving out a manager a secondaries investor does not wish to be exposed to, he adds. That said, "we are a strong believer in engagement and would not necessarily say no. With spin-outs or new managers, ESG may not be a priority, but we can talk to the team and get a view."

Post-investment, the potential for engagement continues. Having stepped into the seller LP's shoes, the secondaries investor has an opportunity to become an active LP and perhaps participate in the LP advisory committee, Keuning says.

"The majority of GPs we work with have been known to us for years and we understand how they do business," says Black, noting that the firm keeps a database and ranks its managers on their ESG approach. While acknowledging it cannot tell GPs what to do at the portfolio company level, Black says his team seeks to share best practice and prompt conversations and thinking around specific themes by, for example, sending out topic notes.

"There have been occasions where a firm has a less formalised ESG approach and we'll work with them to enhance their programme and policy and assist them with thematic issues and operationalising ESG within their portfolios," Black notes. "We are looking for a GP that has the desire to engage on ESG, with the right culture and is open to a conversation about doing more."

With the US Securities and Exchange Commission paying more attention to ESG, "you need to do what you say and say what you do", Kline Hill Partners chief operating officer Louis Sciarretta told *PEI* last year. On the eve of the pandemic, the firm was closing a deal a week on average with an average size of $2.5 million across a range of fund vintages. "We have to be thoughtful about what we can influence and what we can't. But ESG certainly plays into how we run our business."

He added: "Once the fund comes on board and if an ESG matter comes to light, we're on the phone to that manager." ■

The need for a responsible approach

Across the private equity industry commitment to ESG excellence is rising.

"The number of managers that have yet to get their act together has decreased over the years," LGT Capital Partners' Keimpe Keuning says. And that includes in secondaries as more firms embark on their own ESG journey. The opportunity is huge.

Secondaries investors, with their exposure to multiple GPs, have a role to play in percolating ESG best practice throughout the market. After all, beyond the reputational and branding benefits to the firm of demonstrating its ESG credentials, promoting ESG as a value driver has a positive impact on returns. "The more we can get people to embrace ESG, the better secondaries opportunities we are likely to see because they'll be better run businesses," says Adam Black of Coller Capital.

KEYNOTE INTERVIEW

Readying for a step change in ESG data

As regulatory regimes tighten, managers need to think carefully about their ESG strategies and how technology and data can help, say IHS Markit's Kevin Bourne and Rishi Kotecha

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Q What ESG-related trends and regulatory developments are on the agenda for 2021?

Kevin Bourne: Regulations are only going in one direction with regards to ESG and climate change. The regulatory regime is going to become much tighter globally as we see a coming together of regulatory standards. We already have China and Europe looking at a joint assessment of the European disclosure regime because China is seeking to align its new regulations with what Europe is doing as the pacesetter. The new Sustainable Finance Disclosure Regulation that comes into force in Europe in March will bring some challenges and is certainly front of mind.

Rishi Kotecha: SFDR will be a gamechanger for the private markets, with its requirements to go into the data and report across the whole investment management process. The regulation will mean there is no hiding place and will act as a true catalyst as the industry continues to drive forward its ESG practices. As we witness increasing investor pressures as sustainability gains greater prominence in the allocation of investor capital, GPs will have to know their data.

Q How do these themes affect demands for data?

KB: The demand for data is a reflection of where ESG has come from, which is a need for increased reporting by public companies, many of whom still have limited or no information in the public domain.

More and more GPs are evaluating ESG considerations as part of due diligence, and the close reporting relationship with investors means the private equity community is keen to make progress on this. Really, effective ESG is about data discipline, and historically the private equity industry is good at that. We may get to a point where there is more ESG data available about large private companies than there is for smaller and mid-sized public companies, just because private equity firms will support their portfolios with this.

RK: The demand for data is increasing and the impact intensifies as there tends to be a lack of in-house expertise. Historically, having an ESG element to the portfolio would fall under the risk team, but now firms need subject matter experts.

The value of ESG spans across all areas and is not just driven by regulation; some of the demand is coming from a shift in consumer habits, employee expectations, and the way in which companies are operating and futureproofing. In private markets, there is also the value creation angle, where non-financial indicators are becoming more important when thinking about long-term sustainability.

There is no data harmonisation in this area, and no standard set of key performance indicators. There needs to be progress on that to enable benchmarking and so different reporting standard setters can agree on equivalence. However, there is a larger focus on data-driven decision making across private markets, as investors seek a 360-degree view on their portfolios, and with that transparency will come more sophistication on ESG insights.

Q How do the ESG-related pressures facing managers impact risks and returns?

RK: ESG is having an impact across the investment lifecycle, including key fundamental areas of capital allocation, due diligence, data management and risk. It also can impact reputational risk. Surveys conducted across the LP community show how focused they are on future-proofing their portfolios and looking for sustainability.

From a risk perspective, one thing we continually hear is GPs opining that they have always had good practice around ESG, since a fundamental part of success is to have the core operating practices in place, but it just was not called out as such. That is up for debate – what we do need to ensure now is strong alignment and measurement between investment processes and ESG practices to support long-term value creation.

Demonstrating good ESG is also important for exit strategies, especially if a private equity firm is looking at an IPO there is real value in being able to demonstrate strong ESG practices during those processes.

> *"If you cannot have a dialogue about how your portfolio takes these issues into account, investors will increasingly question your processes"*
>
> **KEVIN BOURNE**

KB: I cannot imagine why any company would go public today without an ESG report that covers all the basic facets, making it a transparent element of the company's message. Any CEO should understand the operational footprint of ESG credentials, as ESG data is becoming an absolute must-have.

The tenor for this was set back in 2015 with the Montreal Pledge, when asset owners said they wanted to understand the emissions footprints of the companies they were invested in and asked GPs to calculate them. Many fund managers said no, but those that said no did not get the same level of engagement from investors and so were forced to change their approach.

The market has moved on since then and there is much more understanding that investors want this information, and it does have risk and return implications. Any private equity or venture firm that does not understand ESG in its portfolio is at risk and any public fund manager that does not understand ESG is at risk, because they are out of step with investors, with regulators, and with the reality of the capital markets. If you cannot have a dialogue about how your portfolio takes these issues into account, investors will increasingly question your processes. Understanding ESG as a commercial risk for all managers is now critical.

Q How can managers get ahead of the market when it comes to responsible investment?

RK: First, if managers are not following guidelines today, they need to do so. They need to take stock and focus on and understand the KPIs that need to be collected, and the regulation is going to be a good driver for that.

There has been an accelerated focus on preparedness and disaster recovery in light of covid-19, with managers making sure they know how their

Q Is there a role for technology in addressing ESG challenges?

RK: There is an increasing demand for data and an increasing need for digitisation to drive a step change in this area. ESG is driving a focus on data and insights because what gets measured gets managed, and technology is a critical component to quantifying that ESG data and optimising its value.

We are seeing increasing maturity and professionalism in ESG practices, but there is still a disparity in the data being collected.

This is no longer a box-ticking exercise for GPs, with LPs demanding the ability to look at ESG metrics across their portfolios and dashboards to understand companies better, particularly with the advent of SFDR. Technology will be the enabler to take all that forward and it will play a pivotal role as it helps avoid duplication and inconsistencies and allows private equity firms to look across their portfolios and focus on the right levers. We have seen the significant role that technology already plays for private equity firms, GPs and LPs when it comes to monitoring the financials of their portfolio and benchmarking; all in turn leading to data management efficiencies and better decision support efforts. The ESG paradigm is another extension of that and making sure that the technology is relevant, robust and scalable is critical.

KB: One of the big challenges is not just having the technology to analyse the data but knowing what funds are seeking to do with the data. We are regularly asked to help private equity funds build and develop their ESG frameworks, with some starting from ground zero and others with frameworks in place that need third-party review. Managers have got to create frameworks, get them down to companies and develop workflows that will make the right information available.

It is easy to build a system that collects the data, but not so easy to build a system that uses the data to solve the business problem and enables measurement and reporting. Managers need to think about how they are going to share scores with investors, which requires first-class ESG data as well as first-class systems. A lot of private equity managers, including some of the biggest players, are finding they still have a long way to go and need to get there faster.

portfolios will be impacted. Managers need to start with a series of high-level KPIs, because the direction of travel is only going one way and that is towards greater transparency on non-financials and how those impact portfolio performance.

Best practice will evolve, and we will hopefully see more data harmonisation as the regulation pushes a drive for standard taxonomies. GPs are facing a growing number of requests and firms like ourselves continue to focus on our asset manager clients and how we can bring more simplification around a common data set.

KB: If a private equity firm asked me how best to approach this, I would suggest tackling it in layers. If the firm tries to do everything at once, it may not succeed. Managers need to focus first on getting the foundations right, which is about technology and process, and getting the data right, which is about how they engage with their portfolio and assemble that data. Then it is about communicating that information to investors.

The next step is using ESG not as a reaction to the market but as something firms can lead with, demonstrating it is not just something they do but a reason to invest with them. It is a business attribute rather than just a regulatory response.

My advice is: do not try and collect too much information from your portfolio and instead be realistic about what data points you are trying to collect. Make sure you are consistent across these data points so that you can drive comparison. In this way, and by tackling it in layers, you will be able to get to the point where ESG is an attribute much sooner. ■

Kevin Bourne is managing director and head of sustainable finance, and Rishi Kotecha is head of commercial strategy – private equity, at analytics and solutions provider IHS Markit

Impact in action

Six case studies that show the potential of impact investing

Partnering with African women

Alitheia Capital/ Goodwell Investments

The issue: How to encourage women's economic participation in emerging markets.

The approach: While providing women with better opportunities is a common theme in impact investing in emerging markets, and local knowledge is a prerequisite, Nigeria-based impact investor Alitheia Capital is going a step further. Women-founded and led, its core mission is to invest (and provide non-financial support) to SMEs headed by gender-diverse teams in sectors that engage and serve a significant percentage of women. By partnering with Goodwell Investments to manage and advise the Dutch firm on its West African investments (through its €100 million uMunthu Fund), the vanguard local investor is further extending its reach.

The impact: uMunthu invests in 19 portfolio companies: eight head-quartered in West Africa, seven in Southern Africa and four in East Africa, serving over 25 million households.

Environmental impact in China

Asia Green Fund

The issue: The need to foster sustainability in China.

The approach: It is rare to see an Asia-based manager so explicitly aligned with ESG goals as Asia Green Fund. The $500 million fund's portfolio includes Hosjoy, a platform for green and smart home renovation, and Horen Group, a recycler of industrial packaging. The Beijing-based GP applies a "green impact assessment" throughout the firm and portfolio company investment cycle, and a quantification system (the Green Impact and SG Performance Analytics) to measure the impact of every dollar invested. Chairman and CEO Bo Bai is a former partner and managing director at Warburg Pincus, where he led its investments in the energy, industrials and business services sectors in Asia.

The impact: AGF estimates that it has saved 1,200 GWh energy per 100 million yuan ($16 million; €13 million) investment.

India: Supporting smallholder farms

Nuveen

The issue: Nearly 60 percent of Indians depend on agriculture for a living, but volatile commodity prices, weather changes and disease result in inconsistent farmer income levels.

The approach: Despite government support, banks have been reluctant to lend to the Indian agricultural sector so the US asset manager stepped in with its $20 million investment in Samunnati, a non-bank lender to local smallholder collectives. Not only does the company provide finance, it is spearheading change by supporting farmers with advice, training – for instance on leadership development, technology and financial literacy – and connections to the broader agricultural market.

The impact: Samunnati is working with more than 500 farmer producer organisations in 16 Indian states.

Increasing African farmer incomes

SilverStreet Capital

The issue: Farmers in Africa, many of them women, face substantial barriers to optimise production and escape the poverty trap.

The approach: By tackling issues in the Tanzanian poultry supply chain, Silverlands Tanzania, a poultry business and out-grower project owned by the European investor's agriculture vehicle, has helped boost the incomes of local smallholders, the vast majority of which are women. The project, which includes a poultry business that sells feed and day-old chicks, soya processing facilities that encourage farmers to diversify away from maize, a feed mill and silo storage, also encourages more sustainable farming practices within this group.

The impact: Since it was established in 2014, Silverlands Tanzania has benefited more than 65,000 farmers, increasing annual income by more than $400 per year.

Pharmacy finance in Kenya

Total Impact Capital

The issue: For SMEs in Africa, obtaining working capital to grow is challenging. If they can meet a bank's qualifying criteria, they find that loans are typically expensive, fixed term and include additional hidden charges.

The approach: The US impact investor's Nairobi-based portfolio company ImFact has devised a solution that allows pharmacies to securitise their invoices as collateral to obtain the capital necessary to stock their shelves and serve their communities. By evolving a new way for pharmacies to access revolving short-term financing, the initiative demonstrates originality and impact on a fast-growing and fundamental segment, with potential application to SMEs in other sectors and countries.

The impact: An analysis of a leading pharmaceutical distributor showed the financing increased revenues by between 18 percent and 22 percent and the return on equity by 7 percent.

Revolutionising South African education

Old Mutual Alternative Investments

The issue: How to improve educational attainment in underserved communities in South Africa.

The approach: OMAI's investment in schools business Royals had a simple but radical remit: provide upgraded local educational facilities to previously racially excluded and underserved communities at a price they can afford. Today, the business's learner base stands at 4,300 up from 750 in 2014 when OMAI made its investment. In addition to meeting strong demand for access to quality education, Royals sees itself as a core part of those communities, contributing use of its facilities and preferring to use local labour and procurement during the construction.

The impact: In 2019 Royals achieved a matric pass rate of 97 percent (against a national average of 81 percent) and a 55 percent exemption rate for university entrance exams (compared with 37 percent nationally).

KEYNOTE INTERVIEW

More than a glossy brochure

Responsible investment must be defined and quantifiable, say 3i private equity director Rupert Howard and infrastructure partner Tim Short

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Q What does responsible investment mean to 3i?

Rupert Howard: On the private equity side, we see responsible investment as a core part of investment due diligence. I cannot envisage a world where a business that is not responsible has a significant role to play in the future. Given our potential for longer hold periods, it is therefore essential that we support companies acting in a socially responsible and sustainable way. This is what consumers are increasingly demanding and any business that is not moving positively in that direction will be left behind.

Tim Short: It is much the same for 3i's infrastructure business. By the very nature of the asset class, we are investing in long-life assets and, as Rupert says, you cannot do that successfully without taking the sustainability of the business model into account, in the broadest sense. That clearly involves taking a responsible attitude towards all stakeholders.

Q What global mega trends has the covid-19 crisis highlighted and how does that inform responsible investment?

TS: The energy transition – from fossil fuel sources to greener, less carbon-intensive alternatives – is a key theme for a number of our infrastructure portfolio companies. Covid-19 has affected demand for all types of energy through the various lockdowns, which has highlighted one of the implications of this trend: the impact of intermittent sources of renewable power such as solar and wind on electricity grid stability. For our portfolio company, Infinis, which generates electricity from landfill gas, this has meant an opportunity to offer new flexibility services that play a key role in alleviating the issue.

Q What has covid-19 taught us about resilience?

TS: The disruption that covid-19 has caused has shone a light on the operational resilience of different business models. Some of that has been about the ability to adapt to remote working, of course, but in other cases it has exposed the benefits of having a diverse customer mix versus single points of failure. We own a business called Ionisos which owns and operates cold sterilisation facilities. The pandemic resulted in reduced demand for sterilising surgical, cosmetic and veterinary products but this was largely compensated by an increase in demand for sterile medical PPE and packaging.

Q What other sectors are affected by responsible investment themes?

RH: Responsible investment and sustainability are themes that play across all sub-sectors, and particularly so in the consumer sphere. Whether they are buying food for themselves, their families and pets or even a garden shed, consumers increasingly want to know that the products they are buying have been responsibly sourced. It forms an increasingly key part of their purchase decision.

This plays out across our two most recent private equity investments. GartenHaus, a specialist online retailer of garden buildings which we backed in September 2020, sources its timber from sustainably managed forest areas, which is something consumers are actively looking for when they buy these products. MPM, a leader in premium natural pet food and an investment we completed in December 2020, knows its customers want to understand exactly what they are feeding their pets, in the same way you or I would want to know the ingredients going into our food. MPM uses limited ingredients, which are immediately recognisable – for example, chicken breast, rice and water.

Q How do you approach diligencing the responsible credentials of a potential investment?

> *"It is vital your management teams are onboard"*
>
> **TIM SHORT**

RH: This is a key part of our evaluation of any business from the start. During an investment process recently, I was asked whether responsible business practices were integrated into the culture of the organisation or simply something the company was doing because it knew that it should. That level of detail is important because, ultimately, we are custodians of these businesses. If the management team is not looking at its operations and driving responsible practice throughout the organisation and its culture, then positive change is simply not going to happen.

TS: Responsible investment cannot be thought of as a separate diligence item. It spans all the diligence workstreams. It is a mindset with which you approach a business plan and assess a management team. It is also a lens through which you can look at value creation opportunities. All these things contribute to a final investment decision.

Q How do you work with management teams to ensure a business continues to improve its credentials?

RH: We own majority or significant minority stakes in our businesses, sit on the board and drive the board agenda, and therefore have ample opportunity to ensure management teams remain focused on this. We do a granular ESG assessment of all our portfolio companies, including detailed input from a specialist advisor. We track progress regularly through our detailed portfolio monitoring discussions to ensure we are seeing improvement, and we share learnings across the portfolio. We have previously done this around plastics and the circular economy for example, by bringing together companies that operate at different stages of the plastics lifecycle, together with experts from two fast-moving consumer goods companies. In 2021 we will focus on carbon, to support our portfolio in measuring and addressing its footprint.

Q What advice would you give a firm just embarking on a more formal responsible investment journey?

RH: First, define what you mean by responsible investment and ensure everyone in the organisation buys into that. Second, make sure you quantify, track and benchmark your progress. It is easy to say you are making improvements in the companies you back, but unless you have a way of measuring that and holding yourself to account, your responsible investment practice will lack substance.

TS: Responsible investment does not begin and end with a glossy brochure. It is the ongoing quantification, that allows you to set and measure yourself against targets, that makes a difference. It is vital your management teams are onboard, and in fact incentivised, around responsible business practices. That is when you will see real change.

Q Will we ever reach a stage where responsible investment is simply the expected standard?

RH: I really hope so. Certainly, where you have limited partners, or shareholders like we do, demand for responsible investment from your ultimate principal is so high, that it seems reasonable that will be the case. Of course, there will always be those who put responsible investment practices further up the agenda, but I am pleased with the direction in which things are heading. More and more people are being serious and taking actions about responsibility, rather than just saying they are serious. ■

Getting ready for SFDR

The new EU rules will bring ESG disclosure requirements for fund managers. Claire Coe Smith reports

From March, new EU regulations will require fund managers to disclose their environmental, social and governance policies and practices or risk facing difficult questions. Although the rules have been beset by controversy and delays, they represent a new compliance challenge and the beginning of enhanced scrutiny of funds' ESG efforts.

The EU's sustainable finance and climate change agenda comprises three pillars: the Taxonomy Regulation, which sets out a framework of definitions to help investors assess whether activities really are sustainable; the Sustainable Finance Disclosure Regulation; and the Low Carbon Benchmarks Regulation. The Taxonomy Regulation will now not apply until 2022 at the earliest, making the SFDR, which comes into force on 10 March 2021, the most pressing.

The SFDR requires all investment fund managers to disclose, for all the funds they manage, how sustainability risks are integrated into their investment decisions and the likely impact of sustainability risks on returns. There are additional requirements for funds that promote environmental or social characteristics, and for those that have a sustainable investment objective.

There have been delays to some of the SFDR's mandated disclosures – the so-called Level 2 requirements – meaning not everything will come into force in March as originally intended.

Necessary disclosures

"Firms are going to have to think about making sure they are making the necessary disclosures at firm level, product level, and for ESG-specific products," says John Verwey, a partner in the private funds group at Proskauer. "On the basis that Level 2 will likely be delayed, that shouldn't be as onerous a project as it could have been if it had all been coming into force in March. That being said, it is still something that needs to be done and be focused on."

Two requirements that are going ahead as planned require disclosure of the integration of sustainability risks into investment decisions, and of how a firm's remuneration policy is consistent with that process.

William Yonge, a partner at Morgan Lewis, says: "In terms of formulating an internal checklist, you would first start with creating an internal policy describing how sustainability risks are considered in your investment decision processes. Then you would amend your remuneration policy to ensure consistency with the integration of sustainability risks.

"Next, in relation to both of those initial tasks, you would need to be aware that you would be obliged to publish on your website the main features of your sustainability risks policy, or the whole policy if you wanted to be completely transparent voluntarily, and information showing consistency with your remuneration policy. You are not required to publish the revised remuneration policy."

The next step would be a requirement to look at the product range to see if any funds fall within the definition of promoting ESG goals.

Kirsten Lapham, partner at Proskauer, says: "Firms are concerned that a lot of funds could fall in the scope of the disclosure requirements by promoting an environmental or social characteristic or as having a sustainable investment objective, even if they are not being promoted as green funds. They may make some broad references to ESG or make negative statements about avoiding investments in tobacco or palm oil forestry, for example, and there are questions being raised as to whether these kind of references would mean that they are captured by the more wide-ranging disclosure rules."

Contentious areas

Probably the most contentious aspect of the new proposals is a requirement for funds to disclose the principal adverse impacts of their business on the world at large, which will be mandatory for certain large investment firms and optional for others. It was initially planned that this disclosure would need to be against more than 30 mandatory indicators, on a whole-firm basis across strategies, but while the headline requirement to disclose remains live, implementation on the underlying detail and the indicators has been pushed back while regulators digest feedback.

Yonge says: "The consultation on some of this has been very difficult, and there is a feeling that it is unrealistic to expect managers to make quantitative assessments of the impact of their investments on sustainability measures, because there is insufficient information available to them. The top regulation does allow for the making of qualitative assessments, which are regarded as much more realistic."

It is unlikely we will see heavy-handed enforcement. "I don't think the regulators are really going to go after fund and asset managers and enforce for lack of compliance from day one as the Level 1 Regulation is high-level and open to varying interpretations," says Verwey. "The real penalty is that if firms don't comply then investors are going to push back on why there is not a policy or ESG decision-making framework in place, so there will be a commercial impact. A lot of the rules are based on the principle of either 'explain how you comply' or, if not, 'explain why you don't comply', rather than any prescriptive instructions. That makes it incumbent on a firm to either comply with all the ESG requirements or otherwise explain its reasons for not doing so."

Impact of Brexit

Brexit presents an added complication. It has now been confirmed that the UK will not implement SFDR and will instead put forward a different set of recommendations. In November, UK chancellor Rishi Sunak announced plans to mandate climate disclosures by large companies and financial institutions by 2025.

The country's Financial Conduct Authority intends to consult on its plans for 'UK SFDR' in early 2021, with director of strategy Richard Monks setting out the direction of travel in a recent speech. Nicola Higgs, regulatory partner at Latham & Watkins, says: "Monks' speech makes clear that the FCA is considering whether it would be helpful to articulate a set of guiding principles to help firms with ESG product design and disclosure. These would overlap fairly significantly with the Level 1 rules of SFDR, covering topics such as sustainability policies, product disclosures and periodic reporting. This would suggest a comply or explain approach rather than mandatory disclosure standards, as in EU SFDR.

> *"Firms are concerned that a lot of funds could fall in the scope of the disclosure requirements"*
>
> **KIRSTEN LAPHAM**
> **Proskauer**

"However, pan-EU firms can take comfort that EU SFDR implementation plans are likely to comply with UK proposals for the most part, limiting the prospect of a double implementation burden."

Michael Raymond, a partner at Travers Smith, says the ambiguity in the UK should not impact managers' implementation of SFDR: "For most managers, this doesn't mean they can ignore the EU rules as they will catch UK and international managers who, for example, offer private funds to EU investors. UK managers will therefore need to comply with a number of the new requirements on a lowest common denominator basis if they wish to access European capital."

Paul Davies, partner and co-chair of the ESG taskforce at Latham, says: "International private equity houses may find themselves subject to EU regulatory requirements and/or other regulatory developments concerning ESG disclosure, including those that emerge in the UK. As such, the ability to obtain the necessary information and data from portfolio companies will be an important consideration.

"We can expect significant developments and innovation in technology, as the ESG data lake grows and resources are needed to enable a quick, simple and cost-effective means to analyse ESG performance and benchmark performance against peer companies." ■

KEYNOTE INTERVIEW

Collaborate and listen


Sharing best practice between investee businesses is the optimal way to embed ESG across a large and diverse portfolio, say Cinven's Vanessa Maydon and Matthew Sabben-Clare

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Q How do you assess environmental, social and governance risks and opportunities in the due diligence phase?

Vanessa Maydon: In the pre-investment phase, the responsibility sits with the investment team, who assess where risks and opportunities lie on a company-by-company basis. That team will mandate external advisors or carry out additional due diligence as required before putting together the investment committee papers, all of which have a mandatory section to describe ESG risks, how these are mitigated and areas of opportunity. One of the senior partners that sits on the investment committee, meanwhile, also sits on the ESG steering committee, to ensure that there is continuity between these two forums. ESG is a critical consideration in the investment process.

Q Once the acquisition is completed, what guidance do you offer new portfolio companies and how do you engage on this issue throughout your ownership?

VM: Even before we acquire a business, we start to socialise ESG with the portfolio company. We are clear on our values and approach, and on the standards we expect them to uphold. We have a tried and tested methodology when it comes to ESG onboarding. We continue our engagement with management teams during our ownership where we conduct a thorough ESG assessment, taking all the reports gathered in due diligence, together with an ESG questionnaire that companies are required to complete. More recently this has been supplemented by a cyber-risk assessment.

We then work with external specialists, where necessary, to assess any vulnerabilities and set out practical actions and initiatives which are appropriate to the business. We also conduct a benchmarking exercise, looking at the peer group of a portfolio company to be sure we know what best practice looks like. It is a very collaborative process, and we make that clear from the outset. The businesses we invest in are often already doing really good work on ESG. What we do not want to do is come in as a sponsor and make ESG an onerous reporting requirement simply for our own purposes.

Q What are your reporting requirements?

VM: We have five mandatory key performance indicators. The first three have been in place for a number of years: greenhouse gas emissions; incidents of anti-bribery and corruption; and work-related health and safety incidents. More recently, we added the incidence of workplace grievances and gender diversity. We then also require companies to establish KPIs specific to their business, based upon those ESG topics most material to the business and each of their individual circumstances. In addition, each portfolio company must have an ESG policy and a non-Cinven board member with overall responsibility for ESG, so that we can get the reassurance we need that this has been mandated, and performance is monitored, from the top.

Matthew Sabben-Clare: Vanessa's point about collaboration is really important. Ultimately, the portfolio company has to own its ESG development because that will enable it to take this forward in the long term. If we are going to support sustainable change, responsibility must lie at the portfolio company level. At the same time, it is a two-way process. We see examples of very strong practices that we can learn from ourselves and help other portfolio companies to apply. When it works well, both teams are learning.

Q How is ESG responsibility structured within Cinven itself?

MSC: We are clear that ESG strategy is a topic that sits with the executive committee. This is not something that is delegated down the firm. We also have a portfolio review committee, that has oversight of ESG. Yet ESG is, by its very nature, cross-disciplinary. We therefore have a cross-functional steering group that meets regularly to review progress in detail.

Q How has covid-19 impacted the way in which you engage with portfolio companies on ESG?

VM: When covid-19 first started to emerge, our portfolio team introduced weekly, and later monthly, covid impact assessments for all portfolio companies. Clearly, those assessments targeted impact on financial performance and resilience. But, very early on, a specific ESG assessment also took place which covered everything from health and safety to return to work strategies, PPE provision, adaptation of workplace policies and the extent to which businesses were equipped to deal with those things.

A little further into the pandemic we also sought to understand the implications for employment, including redundancies and reduction of working hours. In particular, we focused on how these issues were being communicated to staff. Other areas of attention included IT resilience and cyber vulnerability, supply-chain risk and crisis

Q How have the ESG challenges and opportunities that you face as a firm changed over the years? Are there new areas of focus on the horizon?

VM: ESG has changed unbelievably over the years from the perspective of the level of attention that it receives. That is a real positive. Meanwhile, the events of 2020 – the covid pandemic, of course, but also the rise of movements such as Black Lives Matter and growing awareness of diversity issues – have forced ESG even higher up the agenda.

One area where we are seeing focus grow is on the 'S' in ESG. Historically, it has been far easier to understand environmental risk factors and opportunities, as well as the governance aspects within a business. By contrast, it has been far harder to understand social factors and to set out practical ways to make improvements. However, we recently started working on a research project with the Institute for Sustainable Leadership at Cambridge University. We are working with them to develop a framework for measuring social initiatives and outcomes in our portfolio companies. There has also been significant input from our peer group of GPs who are helping inform what good looks like, and we would certainly hope to share the results of this work with those GPs as well.

> *"We see examples of very strong practices that we can learn from ourselves and help other portfolio companies to apply"*
>
> MATTHEW SABBEN-CLARE

response plans. We were constantly capturing that information to see if there were areas where we could provide assistance and share information on good practice. Where we saw positive examples of staff redeployment, employee engagement or community support, for example, we disseminated that through the portfolio.

Q What challenges are associated with embedding ESG in such a large and diverse portfolio?

VM: The first is resource. Trying to get your arms around the sheer number of portfolio companies which we invest in across multiple industries and geographies can certainly be challenging. However, as Matthew says, we have a strong cross-functional team and work with external advisors on areas where technical expertise is required. The scale of some of our transactions also brings challenges, in that we may invest alongside other sponsors or co-investors, each of which could have a slightly different approach to ESG and ESG reporting.

Something that has been incredibly important to us is to ensure those sponsors are fully aligned so that we are not going back to the portfolio company with duplicate requests for ESG information. We have recently spent more time working with co-investors to be clear about who is leading that workstream, what information is required and how that is going to be progressed as efficiently as possible.

Q In what other ways has your approach to ESG evolved over time?

VM: The inclusion of the cyber-risk assessment at the outset is one of the newer developments. We are also looking more closely at climate change. We conducted a one-off climate risk assessment of portfolio companies in 2019, looking at how a shift to a lower carbon economy could affect financial performance. We are also discussing whether to introduce that as part of our ESG onboarding. Diversity and inclusion is another area where we are spending more time.

MSC: We have done a lot of work over the past few years on our own diversity and inclusion approach as a firm. We are now turning our attention to what we can do at a portfolio company level to help promote diversity and inclusion. Many of the companies we work with are pretty sophisticated in this area, but it is uneven. As with other aspects of the ESG programme, we share best practices between businesses where we can.

Q What role does regulation play in helping define your ESG strategy?

VM: We have to acknowledge that for a lot of our portfolio companies, as well as for Cinven itself, the requirement to report on ESG topics is growing. The regulation coming out of Europe is full of acronyms including TCFD, SFDR and NFRD. In the UK, you then have the Modern Slavery Act and gender pay gap reporting. We continue to work with portfolio companies to support them where needed in meeting these regulatory requirements but, back to Matthew's point, the company itself needs to own this.

Q Why is it so important to get ESG right as a financial sponsor?

MSC: I think there are three main reasons. First, we are investing money on behalf of large institutional fund managers and they have clear expectations that we invest that money responsibly. Second, investing in businesses brings its own responsibilities. In many cases, those companies are large employers with major local – and sometimes international – footprints. It is important we contribute as a shareholder in a positive way, working with companies to help them act responsibly within their own communities. Lastly, with respect to the investment process itself, we see ESG as not only part of our overall risk management programme, but also as part of our value creation programme as well. ■

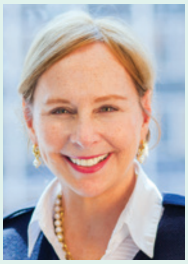
Vanessa Maydon is corporate affairs director and Matthew Sabben-Clare is partner and chair of the ESG Steering Group at Cinven

The ESG talent pool

Responsible investment-related roles are proliferating in the private equity industry, with firms searching for individuals with skillsets ranging from investor relations to a track record of ESG integration

As the private equity industry's focus on environmental, social and governance issues continues to gather steam, and LPs dial up the pressure on managers, the question of how firms resource ESG functions becomes increasingly critical. *Private Equity International* asked two recruitment experts – US-based Mary Gay Townsend and UK-based Simon Nixon – to outline the hiring landscape.

Panel



Mary Gay Townsend
Managing partner at Norgay Partners

Simon Nixon
Managing director and head of alternatives at Carpenter Farraday

Q What demand are you seeing for senior ESG and responsible investment-related roles in private equity?

Mary Gay Townsend: The demand for investing using ESG guidelines has been increasing and has accelerated over the past year in the US. This includes a strong interest in investing in funds that back diverse management teams. As firms acquire more data that reflects diversity managers' track record and ability to outperform their peers, there is an expectation that increased demand for diversity-led funds will follow. We expect more firms will get into the game because of this trend, and when they do, they are going to want the best talent to run these strategies.

There has also been increased demand for impact investing. As performance metrics and returns point to success, impact investing is increasingly viewed as not only the right thing to do from a social standpoint, but also the economically practical decision. In many cases, we have seen firms look internally for talent to run these efforts or lead ESG. They will often move a top performer out of traditional investing into a leadership role within impact investing. This is a good retention strategy that rewards strong talent with a leadership role in a growing sector.

Simon Nixon: We have seen an increase in demand, albeit at a relatively subdued rate. Many private equity firms are small organisations, so it is currently only the larger players recruiting dedicated professionals to lead ESG. In smaller funds, aspects of ESG are usually split across a range of functions. For example, leading on diversity in both the funds and portfolio companies can be taken on by an internal HR professional within the fund. It is also more common for operating partners or those involved in 'asset management' to spearhead ESG initiatives in portfolio companies. For embedded ESG, we also see a lot of hiring from corporate ESG departments or from specialist consultants.

For firms recruiting positions covering the full spectrum of ESG initiatives, the role can often sit in investor relations. A lot of the requirements and initiatives are driven by LPs and will continue to increase as the EU Sustainable Finance Disclosure Regulation becomes active from March this year.

Q What kind of skills and experience are PE firms looking for?

MGT: Regardless of strategy or industry, the strongest private equity investors are smart, deeply curious, motivated to learn and inquisitive with excellent interpersonal ability. Especially when it comes to recruiting talent for ESG roles and investment opportunities, we see firms looking beyond traditional PE backgrounds and into other areas to build candidate slates. PE is in many ways an apprenticeship model and nurturing smart and motivated professionals is one way to grow successful investors. Sources they can tap into include LPs, such as endowments and foundations, as well as companies that focus on relevant industry verticals like energy, agriculture and infrastructure.

We are also seeing strong candidates coming from the public sector and central banks whose experience working with governments and municipalities is valuable to impact investing and ESG standards. Finally, given that many GPs are eager to effectively communicate to LPs the steps they are taking to incorporate ESG into their investment strategies, many firms are also looking for candidates with communications, PR or marketing backgrounds.

SN: The jobs can be very different between organisations, especially where there may be a split between those who see it as a regulatory/box-ticking exercise and those who really believe it should be part of the investment and post-acquisition process. The skills we look for are varied, including investor relations, marketing and PR, internal training on ESG, and external engagement through industry seminars and events.

We also look for individuals with a track record of leading ESG implementations in portfolios. This requires the seniority and influence to be able to get leadership teams on board with why such ESG initiatives should be introduced.

Q How much competition is there for talent?

MGT: Because ESG and new impact investment verticals are still nascent in the US without large numbers of legacy platforms to tap when looking for talent, there is a lot of competition. Firms are having to think outside the box about where to source their talent.

Historically, PE firms tend to fish in the same pools of candidates from the same platforms with similar professional backgrounds. While this can be perceived as a 'safe' route to take, a lack of diversity in perspectives and backgrounds can put investment teams at a disadvantage over time. Good talent is everywhere, and candidates can gain the relevant skills and experience in many different professional environments. PE funds need to catch up in this regard, but we are seeing a growing commitment to doing that and, in many ways, it is being driven by the need to recruit with ESG in mind as they add new strategies.

> *"Firms are having to think outside the box about where to source their talent"*
>
> **MARY GAY TOWNSEND**
> **Norgay Partners**

SN: At present, there is not what would be classed as a competitive market for talent as most organisations are looking for tailored or specific skills relevant to their needs rather than uniform experience so the supply of candidates with experience is still greater than demand. For those with a track record of successfully integrating ESG across PE funds, the talent pool is significantly smaller, which can make recruitment more challenging and, in some cases, more costly.

Q What hiring trends are you seeing for impact funds?

MGT: Demand has increased and many firms are actively looking to establish or grow impact investing capabilities. We expect this trend to gain momentum as larger firms build out their platforms and teams. Mid-sized and smaller firms will need to keep up and spin-offs will inevitably take place. Keeping up with the competition makes for a compelling argument to build and raise funds. This will in turn lead to a greater need to build strong management teams that can both attract capital and deploy it into impact investing opportunities. Success begets success and I think we will see that drive demand for more impact and diversity funds and, as a result, more recruiting activity around it.

SN: Impact investment funds are generally smaller and can be focused on growth investing, but we are seeing an increase in first-time funds. Many of them are involved in areas such as sustainable food supply, energy storage and financial infrastructure for underserved emerging markets, but the largest focus is primarily on energy transition, renewables and other more nascent energy technologies. In certain specialist areas there are very few experienced investors, so we find that we are recruiting industry experts, which is perhaps a little more akin to venture capital recruitment rather than private equity. ■

EXPERT COMMENTARY

A proactive approach to environmental, social and governance factors can identify risks that static datasets may miss, says Alexandra Mihailescu Cichon, executive vice-president at RepRisk

Beyond the checklist

Interest in private markets has grown at the same pace as the funds they launch – fast. Private equity firms have a total of $3.4 trillion under management globally, according to a report published by *Institutional Investor* in June 2020, and the asset class has more than doubled in size over the past 10 years.

This unprecedented growth means private markets are uniquely poised to further the work of sustainable investment through ESG implementation, and they have the opportunity to integrate ESG in a way that circumnavigates the growing pains experienced by public markets. True sustainability cannot be achieved by public markets alone, so why have private markets been slow to adapt?

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According to a study published by *Sustainability* in July 2020, 'ESG Factor Integration into Private Equity', which surveyed the top 23 private equity players in 2019, private equity firms primarily rely on checklists to assess ESG factors, and only a few firms have sought out external advice from industry experts. At RepRisk, we argue that a tailored method based on industry, geography and company-specific attributes is preferable to the checklist.

ESG due diligence should illuminate any past risks and serve as a reality check for how companies conduct their business. A checklist fails to do this – it may tell you if a company has a codified human rights policy in place, but it is not risk-focused and therefore will not reveal any alleged human rights violations. The static data provided by a one-time questionnaire does not give the full picture of a company's past and current ESG performance, or how it will likely handle future ESG matters.

Checklists also allow for selective transparency. In a world where companies are 100 percent transparent, company self-reporting could be used to create robust ESG due diligence data that accurately reflects business conduct. However, companies are only selectively transparent in their disclosures, potentially masking relevant and material ESG risks.

Similarly, the one-size-fits-all nature of checklists leads to obsolete and outdated self-reported data that is neither meaningful nor comparable over time or across industries or portfolios.

A tailored approach

Self-reporting checklists are a step in the right direction for investors just dipping their toes into the water of ESG integration, but ultimately fall short as a path to truly sustainable investing. Private equity and private debt investors that have discovered the value of ESG integration and employ granular, timely and multi-dimensional data have seen improvements in the following processes:

Due diligence and monitoring: It is crucial to identify hidden risks during pre-investment due diligence and while monitoring a portfolio, as ESG risks do not go away once the ink dries. This requires comprehensive, granular and timely data.

ESG research should aggregate outside-in information on a company from a variety of national and international sources, as well as local sources on the ground, and in multiple languages to get a broader view on current ESG issues affecting a particular sector or peer companies during due diligence – and be better informed on the scope of ESG as a whole. This allows for a more proactive and holistic monitoring approach, enabling managers to stay on top of the ongoing news flow regarding ESG issues linked to their investment universe, for easy flagging of incidents that could lead to major risks down the line.

Engagement: It is critical to have all the necessary research to support internal and external communications and create risk mitigation plans when issues arise. RepRisk provides specially curated risk incident details so no stone is left unturned.

Funds can implement monitoring processes using ESG data to identify incidents that could pose risks, proactively contact managers in relation to a specific ESG issue and explore the implications for that business – as well as how the company is managing the issues and engaging with their stakeholders.

> *"The static data provided by a one-time questionnaire does not give the full picture of a company's past and current ESG performance"*

> *"Crises move quickly – ESG data should too"*

Proactive monitoring via machine learning

The key to successfully crisis-proofing a portfolio is proactivity. Crises move quickly – ESG data should too. The most effective methodologies for generating meaningful ESG data for proactive protection are those that combine artificial and human intelligence. RepRisk is the only ESG data science provider to systematically cover ESG risk for private companies since day one – covering more than 100,000 private companies. Its AI and machine learning technology provides the capacity to screen more than 100,000 data sources in 20 languages on 95 ESG factors every day, while more than 90 highly trained analysts curate and analyse the incidents according to a rules-based methodology and relay those results back to the machine, constantly optimising the algorithm for more refined results.

This approach allows for the best of both worlds. Relying solely on artificial intelligence – say, a keyword search – produces large amounts of unrefined data very quickly. Relying solely on human intelligence and research produces small amounts of refined data very slowly. Leveraging the best parts of artificial and human intelligence, while eradicating their respective shortcomings, produces a large and refined dataset.

What is next for ESG in private markets?

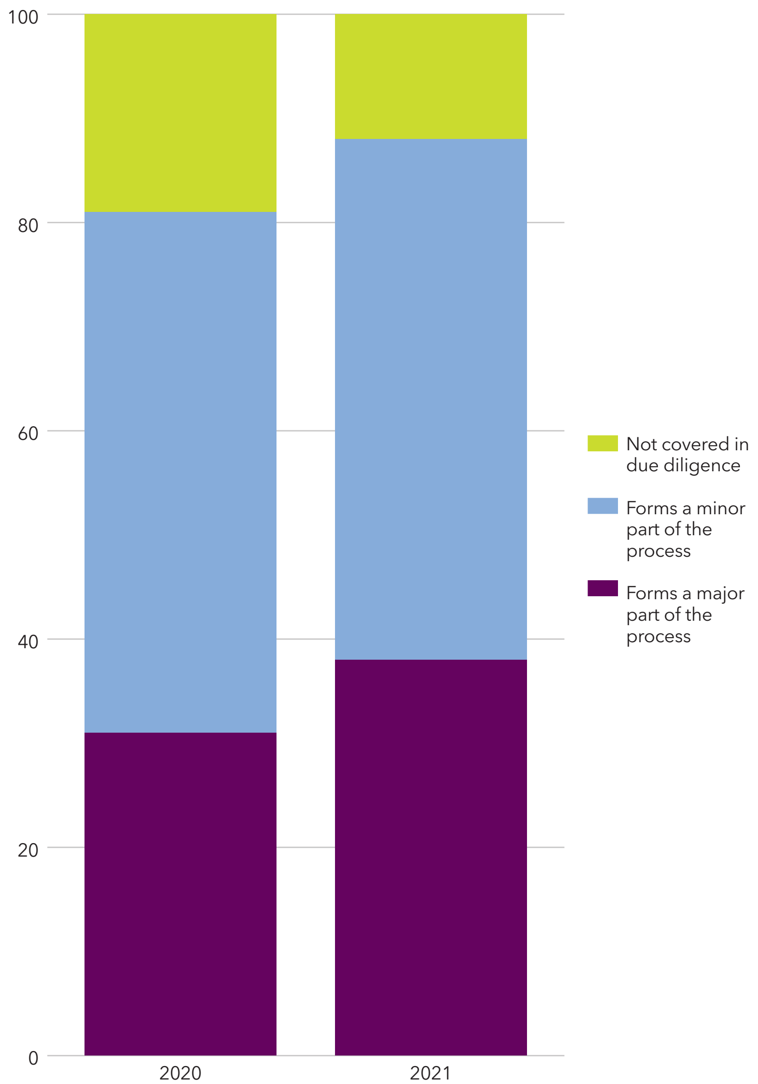
Private fund managers are presented with the unique opportunity to learn from the pitfalls faced by managers first integrating ESG into public markets, and to implement an approach based on meaningful data that provides a holistic view of their portfolios and enables them to be proactive, see around corners and mitigate risk early.

Fewer than 10 percent of the 8,810 global private equity firms are signatories of the Principles for Responsible Investment, according to the *Institutional Investor* study. There is a call for private investors to be pioneers of ESG integration in their field. We invite them to answer by partnering with us and unlocking the potential of the most comprehensive dataset available. ■

ESG pressure mounts

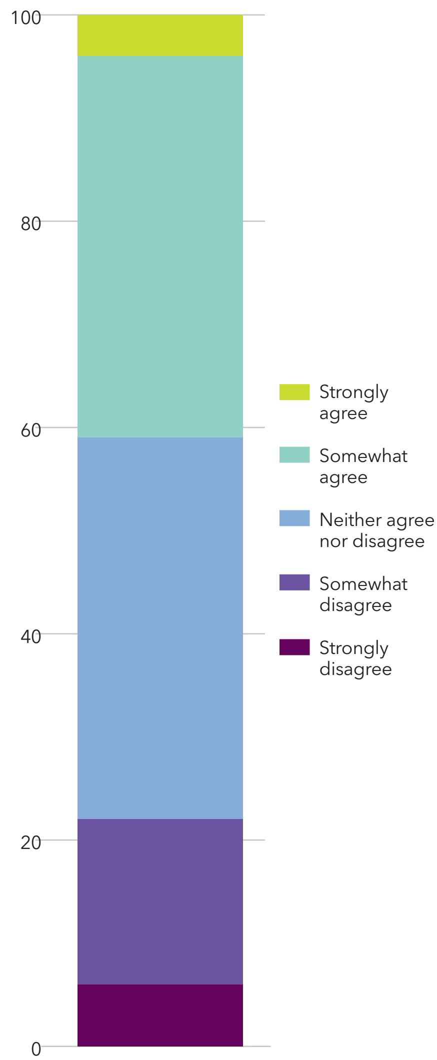
LPs remain uncompromising in their focus on ESG in the face of covid-19, with GPs' approaches to ESG taking on increasing weight in due diligence

How significant a role does evidence and consideration of ESG play in LPs' due diligence (%)



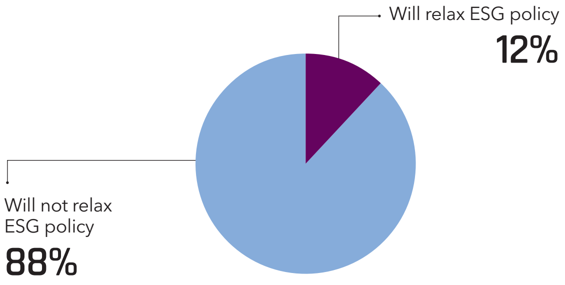
Source: Private Equity International's LP Perspectives 2021 Study

The extent to which LPs agree GPs are taking the risks of climate change seriously enough in their own investment policies and practices (%)



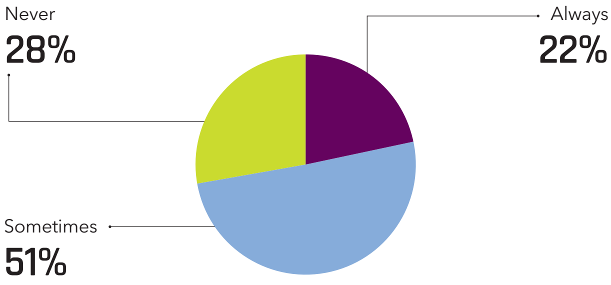
Source: Private Equity International's LP Perspectives 2021 Study

The percentage of LPs that will relax their ESG policy as it relates to private markets fund investments, in light of covid-19 (%)



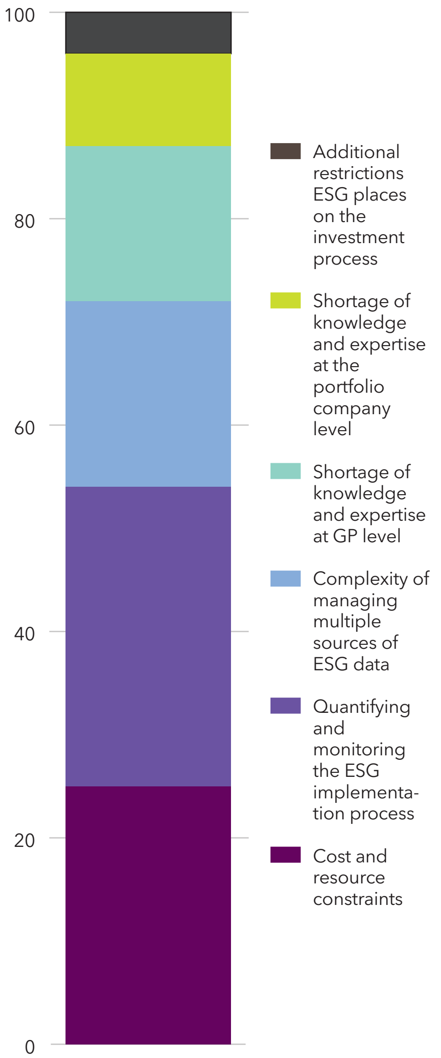
Source: Private Equity International's LP Perspectives 2021 Study

The extent to which LPs ask, during due diligence, whether funds have an ESG consultant in place to advise on responsible investing across their portfolio (%)*



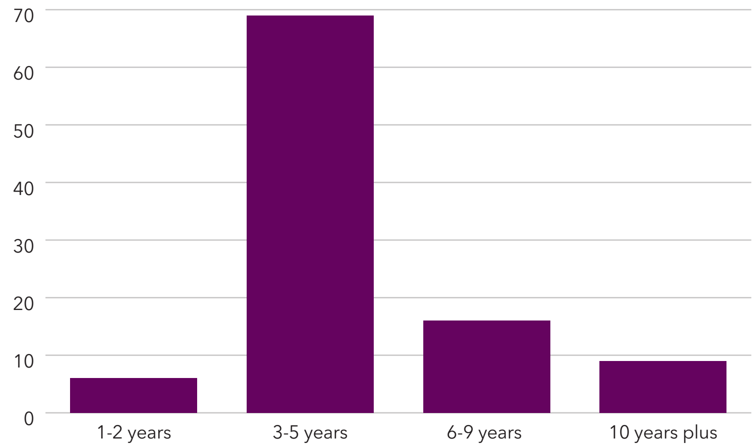
*Figures have been rounded
Source: Private Funds CFO Insights Survey 2021

What fund managers view as the biggest obstacles preventing the adoption of ESG programmes in private equity (%)



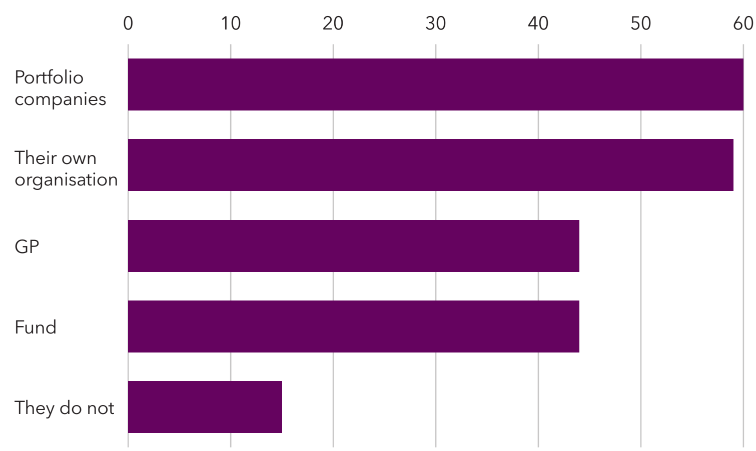
Source: Intertrust's Global Private Equity Outlook 2020

How long fund managers estimate it will be before ESG data across portfolio companies becomes fully standardised, allowing investors to make better informed investment decisions (%)



Source: Intertrust's Global Private Equity Outlook 2020

LPs consider ESG risk factors and/or impact at the following levels (multiple responses allowed, %)



Source: PitchBook's Sustainable Investment Survey 2020

KEYNOTE INTERVIEW

Setting the tone on ESG

A thoughtful and up to date environmental, social and governance policy is a critical part of the bedrock of responsible investment, says Northleaf Capital Partners' Jeff Pentland

The events of 2020 have amplified calls for action on environmental and social issues not only within the private equity industry, but across private markets. *Private Equity International* caught up with Jeff Pentland, managing director at private equity, private credit and infrastructure investment firm Northleaf Capital Partners, to discuss the nuances of developing an ESG policy that spans multiple asset classes.

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Q How much progress have you seen in the adoption of responsible investment principles in private markets?

Significant progress has been made, at least partly due to investor demands and increasing interest, but also because ESG considerations are a natural place for private markets managers to be focused, particularly given the long-term nature of these asset classes. As a long-term owner, it makes sense on every level to pay attention to the sustainability of the environment and the communities into which you are investing, and good governance has always been fundamental to the benefits that private markets ownership brings. There is a natural alignment between private markets investing and responsible investing principles.

Q Are there differences between the asset classes in terms of the progress achieved thus far?

Infrastructure feels the most advanced, which is probably natural given the nature of the investments in the asset class. These tend to often be larger, conspicuous investments with potentially greater impact on the environment (whether positive or negative). That is not to say the other asset classes are laggards. Good progress is being made there as well, but infrastructure is probably in the lead.

We also see differences across the various geographies in which we operate. The Europeans and Japanese tend to be at the forefront. ESG issues are prominent across these societies and that is reflected in the investor base as well. Australia is also very advanced. The US lags behind slightly, while Canada is probably somewhere in between.

Q Has covid-19 impacted attitudes towards ESG issues within private markets?

It has certainly reinforced interest in these issues. For example, there is increasing recognition that human economic endeavours that encroach on the environment and destroy biodiversity create the potential for more health issues and, in particular, new viruses to emerge. Meanwhile, on the social side, covid-19 has highlighted everyday challenges, such as the ability to take sick days. People are being forced to make a choice between their livelihood and doing the responsible thing and staying at home. Cybersecurity is yet another ESG consideration, the importance of which has been reinforced during the pandemic. These are real-world impacts that covid-19 has brought directly into the limelight.

Q What role does an ESG policy play in determining the scope, governance structure and management of a responsible investment programme?

An ESG policy is critical to those endeavours. Having a clear articulation of intent is important for investors interested in understanding how managers are approaching these considerations, but also, internally, for our investment teams as well. The investment teams need to be fully cognisant of the risks and opportunities associated with environmental, social and governance factors and the ESG policy really sets that tone.

Such a policy needs to be a living document that can evolve with the times, as different ESG considerations develop. We crafted our first Responsible Investment policy in 2011 and there have been several iterations since then. Most recently, we looked at some of the core documents published by the Principles for Responsible Investment to ensure we are tracking against the considerations that have been identified. That has been helpful in making sure our approach is current. Among the recent changes we made was reinforcing our commitment to First Nations rights, for example.

Q What are the challenges associated with integrating ESG considerations in a multi-asset class firm?

Actually, I wouldn't say that there are challenges. I would say that there are a great many benefits of being a multi-asset class private markets platform because there are synergies that can be achieved by facilitating information flows across investment teams. We can leverage developments in one asset class, in terms of ways of diligencing, managing and monitoring ESG considerations, across the other asset classes.

We use our ESG governance structure to try and capture those synergies. We have an ESG committee, made up of senior members from across each of the investment teams. Each of those members then heads up asset class specific sub-committees. We make sure those groups come together regularly, not least when completing the annual PRI survey responses. That can prove a useful time for making sure learnings are shared across the different business units.

Q For ESG policies, is it a case of the more detail the better?

I think there has to be a balance. It's a policy, not a manual. Yet it is important that the document is thorough and considered. Our policy starts with general statements outlining why we believe ESG factors are important, from both a risk and opportunity perspective. We then detail the types of factors that we consider across each of the asset classes in which we invest – infrastructure, private credit and private equity. We specify how those factors will be considered at each stage of the investment cycle, from sourcing and due diligence, through to ongoing management and monitoring and, ultimately, exit. We also detail how those processes will differ for each asset class.

Q Why might those processes differ across business areas?

The transaction types we focus on differ in each of the asset classes. In our infrastructure programme, for example, we make direct equity investments in mid-market opportunities across OECD countries. We have control, or joint control, over the entities in which we invest, so we can take a more direct approach in terms of ESG considerations. We also make some direct investments on the private equity side, and there our approach is similar. However, we also make secondaries and fund investments, where we are a step removed from the underlying portfolio companies. There, the articulation of ESG considerations is a bit different. It is important to recognise those differences within a policy.

Q Do you view climate change as part of your environmental considerations, or does it warrant attention of its own?

There are different ways of looking at climate change. Some managers see climate as a double click into the 'E' in ESG while others treat it as more of a standalone set of considerations. At Northleaf, we are doing the latter. We view it as imperative that climate risks and opportunities – both physical and transitional – are being adequately considered both in origination and in ongoing management and monitoring.

Q There was an immediate need to support portfolio companies during the pandemic, but how have you addressed covid-19 demands at the firm level?

At Northleaf, we always make a point of turning the ESG lens on ourselves

"Having a clear articulation of intent is important for investors interested in understanding how managers are approaching these considerations"

as managers. That covers everything from making sure we are complying with environmental regulations in our various office locations, to having robust diversity and inclusion policies, or procedures to support new parents. In terms of governance, external audits are conducted to ensure we are complying with our own policies and our limited partnership agreements. When covid-19 struck, we made sure we employed that same degree of introspection, as well as working to support our portfolio companies.

We set up a covid-19 working group – our "nerve centre" – and activated our business continuity plan which has now been in place since March 2020, when we moved to remote working. We made it clear there would be no staff reductions as a result of covid-19. In fact, we continued to hire and onboard remotely throughout the pandemic. We provided work-from-home support ranging from equipment allowances to an online health, wellbeing, and productivity resource centre. We also brought forward a percentage of year-end bonuses to alleviate financial concerns, and we provided additional paid time off.

Finally, to ensure that as a firm we all felt we were contributing to the broader pandemic containment and relief efforts, we donated to the World Health Organisation, and made a series of donations to charitable organisations in each of the communities where we have an office. In lieu of the gifts that we traditionally give to our investors during the holiday season, we made additional donations to these grassroots charities. We did that because it is the right thing to do. It also sends a clear message to our client base and our employees while demonstrating our commitment to connecting with a wider purpose.

Q What does the future hold for responsible investing in private markets? Will we reach a point where being a responsible investor is the norm rather than a differentiator?

I believe we are on the path to achieving that. As I said earlier, it makes complete sense for private markets managers to take ESG considerations into account, both in terms of risks and opportunities, as they are long-term investors in the environments and communities where their assets reside.

As investors continue to lean into these issues, I do think it will become an accepted norm. At the same time, however, I believe it will remain possible to differentiate based on the rigour of a manager's policies and processes, and the way in which ESG factors are considered at each step of the investment journey. ESG is rapidly becoming table stakes, but there will still be a spectrum based on how committed and thorough firms are in their approach and execution. ■

A new string in fund finance's bow


Guest comment by **Thomas Smith** and **Felix Paterson** of Debevoise & Plimpton

Private equity sponsors are driving ESG developments in fund finance and other asset classes are following suit

Environmental, social and governance considerations have only recently become a notable trend in fund finance, driven by developments such as the closing of EQT's ESG-focused subscription facility last year. The €2 billion-plus subscription line facility incorporated ESG mechanics and was signed up to by a large club of lenders. The theory of the mechanics is quite straightforward (though underpinned by complex ESG metrics) – if the sponsor successfully improves certain ESG metrics of its portfolio companies, the margin on the facility will go down and, if certain metrics are not met, the margin will go up.

The EQT facility was among the first of its type and remains the largest of its kind. There have been a handful of similar deals done since (including another very large transaction led by EQT), and the market is growing as sponsors, LPs and lenders alike see the benefits of a fund-level focus on ESG.

The real advantage of putting in place a capital call facility with ESG mechanics is that it institutionalises the focus on ESG for a sponsor. The benefit from the margin adjustment encourages management and deal teams to improve ESG metrics in portfolio companies, so all levels of a PE firm become focused around that objective.

For sponsors that are serious about ESG, adding ESG mechanics to a subscription line facility is a tool that allows them to demonstrate that commitment. The purpose is not to limit the type of investment the fund can make and ESG provisions in a subscription line facility are not intended to require a sponsor to pass up investment opportunities (although there are other types of ESG-focused facilities that can work this way).

Rather, the ESG mechanics in a subscription facility are designed with a focus on ensuring the sponsor improves ESG metrics post-investment. The metrics are therefore necessarily bespoke, as they must take into account the types of investments that may be made by a sponsor going forward, and the ESG-focused levers available to a sponsor in respect of those investments.

> *"We see the market expanding to all types of strategy"*

Changing lender views

For their part, fund investors are focused on encouraging sponsors to do more in the ESG sphere and the establishment of an ESG-linked fund facility is the sponsor's assurance of alignment with its investors' needs. It is also interesting to see lender views on ESG-focused facilities changing. Although the benefit to lenders is less tangible and lenders may end up accepting lower pricing on their facilities if the sponsor performs against the ESG metrics, more lenders are seeing the benefits of using ESG-linked fund facilities, as offering the product allows them to potentially expand their market share.

ESG-focused developments in fund finance to date have been driven by private equity sponsors, but we see the market expanding to all types of strategy, including real estate, infrastructure and even secondaries and credit funds (where the sponsor does not have control over the underlying investment).

This is a novel and exciting strand of fund finance, reflecting both macro geopolitical trends and asset managers' interest in responsible investing. We envisage it continuing to grow. ■

Thomas Smith is a partner at Debevoise & Plimpton. Felix Paterson is an associate

INVESTOR

Q&A

Opportunities beckon for private debt investors looking for impact in Africa, John Simon, founding partner at Total Impact Capital, tells Ben Jackson

Working with NGOs on the ground, Total Impact Capital has established vehicles to channel investment into small businesses providing basic services – including healthcare providers in Africa – that are otherwise unable to access capital. John Simon, founding partner, explains its approach.

Q What's the strategy behind your business model?

We're impact-first investors. We look for things that have high impact and then we want to have a financing mechanism that is sustainable, that can attract capital, but isn't necessarily promising extraordinary returns. Our investors are interested in the impact, and the range in which the returns can fluctuate are not so great as to make them feel they're giving something up. When euro interest rates are negative and dollar rates are below one percent, we're offering 3-5 percent. That's in a risky environment, but it's still a pretty good spread above the riskless rate.

Q How would you describe the market for private debt in Africa?

For investors looking for impact through private debt, I think the market is strong and largely untapped. There's a large opportunity to scale up. But the opportunity to issue private debt in local capital markets is very thin. The idea of putting your money into a company-issued bond is a very new thing for most African markets.

"An impact vehicle has a very strong market to play in"

You have a private debt market that's the opposite of robust, but then you have players around the edges trying to provide services that the commercial institutions don't really provide. That's why there's a great opportunity for impact private debt. An impact vehicle has a very strong market to play in.

Q What criteria do you use in deciding whether to provide loans?

Our model is somewhat unique. We work largely in partnership with NGOs on the ground that work with small-scale enterprises that need access to credit. Working in partnership with those folks on the ground gives us a lot of confidence in the underlying credit we're providing.

For instance, in Africa we helped create the Medical Credit Fund, which provides financing to health SME enterprises. The Medical Credit Fund, until covid, had NPLs of about 3 percent. The reason they had such low NPLs is because they worked in partnership with an NGO that could help make sure they were going to utilise the funds in a sound way.

Q How has covid-19 affected your portfolio in Africa?

People don't want to go to a health facility where they might run into somebody who's sick and catch covid. We've begun to recover as lockdowns have eased and the disastrous predictions haven't occurred, but covid has been brutal for the portfolio we have in Africa. We've had to do a lot of restructurings.

The other impact of covid, in our case, has been a flood of covid-relief resources that we've been able to use to help address these issues. We've been well-supported by our development finance institution partners with our facility. They're interested in making sure that if we need help, we have it. One consequence of covid is a lot more of the type of blended capital resource that's needed to make the type of model that we do work. That's been a counterweight to the challenges that covid creates for borrowers. ■

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