PEI Alternative Insight

February 2016 privateequityinternational.com

FOR THE WORLD'S PRIVATE EQUITY MARKETS

PRIVATE EQUITY INTERNATIONAL

THE RESPONSIBLE INVESTMENT SPECIAL 2016

A PEI supplement

Monitoring and reporting methods
ESG in fund due diligence
Responsible co-investment
LP perspectives
Data on impact returns
...and more

Sponsors
Actis
Cinven
ERM
Goldman Sachs Asset Management

Supporter
Meridiam


the positive power of capital
65+
year heritage
$7bn*
funds under management
13
offices
170
investments made
100+
exits
c.70
portfolio companies
Africa
China
Latin America
South Asia
South East Asia
*as of September 2015
Actis
www.act.is

PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

ISSN 1474-8800
FEBRUARY 2016

Senior Editor, Private Equity
Toby Mitchenall
Tel: +44 207 566 5447
toby.m@peimedia.com

Senior Reporter
Isobel Markham
Tel: +44 207 167 2032
isobel.m@peimedia.com

Asia Reporter
Carmela Mendoza
Tel: +852 2153 3148
carmela.m@peimedia.com

Staff Writer
Annabelle Ju
Tel: +1 646 380 6194
annabelle.j@peimedia.com

Web Editor
Victoria Robson
Tel: +44 207 566 5463
victoria.r@peimedia.com

Contributor
Nicole Miskelly

Production Editor
Mike Simlett
Tel: +44 20 7566 5457
mike.s@peimedia.com

Production and Design Manager
Miriam Vysna
Tel: +44 20 7566 5433
miriam.v@peimedia.com

Head of Advertising
Alistair Robinson
Tel: +44 20 7566 5454
alistair.r@peimedia.com

Subscriptions and Reprints
Andre Anderson, +1 646 545 6296
andre.a@peimedia.com

Jack Griffiths, +44 207 566 5468
jack.g@peimedia.com

Brix Sumagaysay, +852 2153 3140
brix.s@peimedia.com

For subscription information visit
www.privateequityinternational.com.

Group Managing Editor
Amanda Janis
Tel: +44 207 566 4270
amanda.j@peimedia.com

Editorial Director
Philip Borel
Tel: +44 207 566 5434
philip.b@peimedia.com

Director of Research & Analytics
Dan Gunner, dan.g@peimedia.com

Publishing Director
Paul McLean, paul.m@peimedia.com

Chief Executive
Tim McLoughlin, tim.m@peimedia.com

Managing Director – Americas
Colm Gilmore, colm.g@peimedia.com

Managing Director – Asia
Chris Petersen, chris.p@peimedia.com

From 'Why?' to 'How?'

TOBY MITCHENALL
EDITOR'S LETTER

It's easy, when immersed in the industry, to start thinking that responsible investment and ESG (environmental, social and governance) issues are a distinctly 'private equity' concept.

One mustn't forget, however, that of the 958 asset manager signatories of the Principles for Responsible Investment (PRI), most are primarily concerned with publicly traded securities. And yet it's hard to see how any other manager of assets is as well positioned as a private equity fund to influence the behaviour – responsible or otherwise – of its portfolio companies. A private equity firm with a control position can study as much KPI data as they care to gather and exert ultimate influence over the direction of the company; a minority shareholder has a trading update and vote.

With this in mind, it is interesting to see how 'responsible investment', which in the last decade has morphed from an abstract concept into a phenomenon that can (and indeed *must*) be measured and reported, has been adopted by private equity.

When ESG first became an industry talking point, much of the discussion started with 'Why?' Specifically: 'Why should we introduce a policy or framework for something that we do intrinsically as part of our process of building better businesses?'

Another, perhaps more candid question went like this: 'Why should we worry about non-financial matters, when our LPs are interested first and foremost in returns?'

Perusing the pages of this, our sixth *Responsible Investment Special*, it seems clear to me that the industry has well and truly moved on from 'Why?' and is now deeply entrenched in the question of 'How?'

We explore how, for example, certain GPs are building their own frameworks and metrics to meet the new challenges of applying consistent ESG principles across their portfolios, measuring these through KPIs and reporting back to LPs. Read about this on p. 11.

As limited partners ramp up their demands on managers for ESG-related information, many smaller shops with limited back offices have started to ask themselves how they can possibly keep up. With different LPs wanting different data sets, the task becomes even more burdensome. On p. 22 we examine the PRI's efforts to produce a standardised due diligence questionnaire to ensure that LPs are not forcing GPs to duplicate their efforts.

Meanwhile, on p. 33, David Russell, co-head of the responsible investment team at USS Investment Management, explains how the £48 billion pension scheme assesses prospective GPs on non-financial matters before it writes any cheques: a useful 'how-to' for any LPs wondering how to integrate ESG into their due diligence process. We also hear from Ontario Teachers' Pension Plan's chief investment risk officer on how it applies its five responsible investing principles across both its fund commitment programme and its extensive direct investment programme (p. 16).

Private equity is getting to grips with responsible investment at an institutional level. Please read on to find out how.

Enjoy the supplement,

Toby Mitchenall

e: toby.m@peimedia.com

THE RESPONSIBLE INVESTMENT SPECIAL 2016


11

16

NEW YORK
16 West 46th Street, 4th Floor
New York NY 10036-4503
+1 212 633 1919
Fax: +1 212 633 2904

LONDON
140 London Wall
London EC2Y 5DN
+44 20 7566 5444
Fax: +44 20 7566 5455

HONG KONG
14/F, Onfem Tower
29 Wyndham Street
Central, Hong Kong
+852 2153 3240
Fax: +852 2110 0372

Private Equity International is published 10 times a year by PEI.

To find out more about PEI please visit: **www.thisisPEI.com**

PRINTED BY
Hobbs the Printers Ltd
www.hobbs.uk.com

ISSN 1474-8800

Cover image:
Sergei Bachlakov / Shutterstock.com

FSC
www.fsc.org
MIX
Paper from responsible sources
FSC® C020438

meridiam

INVESTING FOR THE COMMUNITY

44	150	$3.5bn
PROJECTS	EMPLOYEES	OF ASSETS UNDER MANAGEMENT
AROUND THE WORLD INCLUDING 11 IN NORTH AMERICA	INCLUDING 70 WORKING IN PROJECT COMPANIES 20 DIFFERENT NATIONALITIES	FOR PROJECTS WORTH **$40bn INVESTMENT**

Founded in 2005, Meridiam is a global investor and asset manager specializing in the design, financing, building, operation and management of long term public and community infrastructure in Europe and North America.

Meridiam promotes a hands-on approach with a strong focus on technical, environmental and social aspects as well as an active engagement with project stakeholders. Currently managing $3.5 bn of assets, the firm has to date invested in 44 projects in Europe, North America and Africa. 2015 saw the creation of the Meridiam Infrastructure Africa Fund (MIAF), which will invest in projects that fit the rigorous criteria demanded by Meridiam for long term, stable returns on investment.

Meridiam is a responsible investor and seeks to align public sector aspirations with private investment aimed at sustainable development. Meridiam maintains a strong focus on Environment, Social and Government (ESG) considerations and their potential impacts throughout the life of the assets as well as principles of responsible investment. In Africa, this will include further development of Meridiam's ESG approach to factor in country differentials throughout the life of the project. Specific attention will be paid to local populations' access to affordable, essential services (energy, water, waste, and transport), environmental concerns (carbon footprint, biodiversity and pollution), local job creation, worker health and safety regulations, as well as local governance and transparency.

TEN YEARS meridiam 2005-2015 10 ANS

road railway environmental infrastructure social infrastructure

PARIS **NEW YORK** **LUXEMBOURG** **ISTANBUL** **TORONTO**

www.meridiam.com

RESPONSIBLE INVESTING

Raising the bar

Thanks to pressure from LPs the majority of fund managers have made huge strides on responsible investment in the last decade, but it shouldn't end there, writes Isobel Markham

Every few years – or indeed months, in some economic climates – the balance of power between fund managers and their investors shifts back and forth. In tougher times, LPs can call the shots; in buoyant markets, GPs can gain ground.

But when it comes down to it, the power to really move the needle within the industry as a whole lies with the person with the chequebook. Such was the case with responsible investment.

"Originally it was the LPs, in particular some of the larger northern European asset managers, who really focused on the topic and requested that GPs embrace ESG in order for their funds to qualify for commitments," says Ellen de Kreij, ESG implementation lead for Apax Partners.

This year marks the 10th anniversary of the launch of the United Nations-supported Principles for Responsible Investment (PRI), and thanks to both this initiative and the push from investors, the private equity industry has made huge strides within the responsible investment arena in the last decade.

"Once the industry gets going, it really gets going and many managers have since stepped up and developed their responsible investment approach," de Kreij says.

However, it shouldn't stop there. "Pretty soon the LPs will need to raise the bar again. Now that they've seen that the industry is responding, [they need] to say, 'This is where we would like you to go next with your ESG approach," de Kreij says.

Mark Goldsmith, a former director in the responsible investment team at emerging markets specialist Actis, has recently set up Fiveoak Consulting to provide sustainability services to the financial services sector. He agrees that, unlike in recent years, the push now is to engage more LPs.

"The LPs were instrumental in taking the lead – and you can see that with the sign-up to the PRI – and now I think some of the GPs are keen to take the initiative and are really committed to this," he says. "One of the focuses [the PRI has] for this year is to encourage more LPs to sign up."

Events in the wider market in 2015 are galvanising factors for LPs, says Goldsmith, from the COP21 climate conference in Paris and the agreement of the UN Sustainable Development Goals to scandals including Volkswagen's emissions tests and corruption at Brazil's state oil company Petrobras.

Marleen Groen, senior advisor to StepStone and director at impact manager African Wildlife Capital, also sees the progress made at the Paris climate conference as an additional driver for LPs beyond responsible investment and toward social and conservation impact investing.

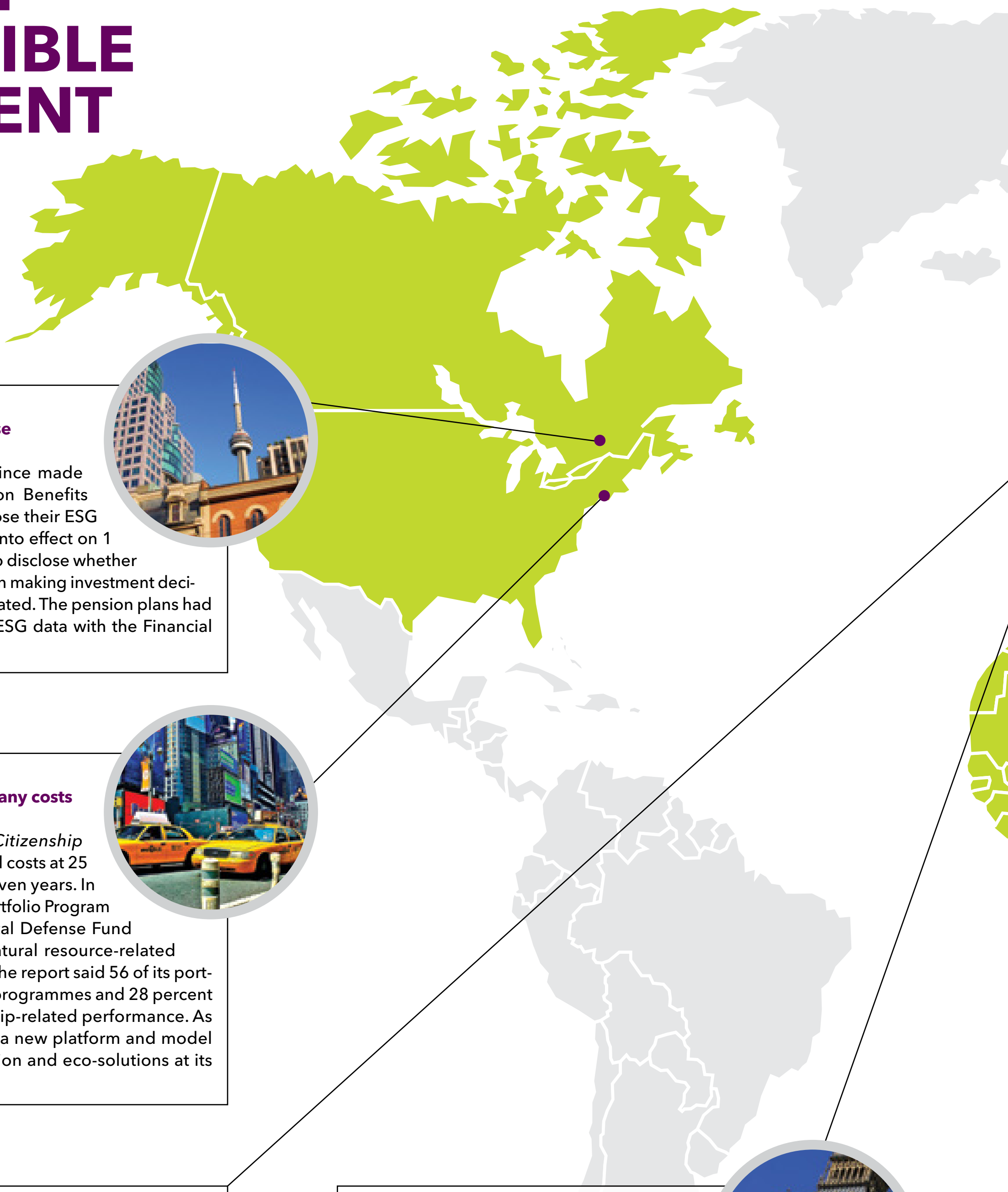
"Institutions such as public pension funds and family offices have been sticking their heads together to try to figure out how they can invest in appropriate social and conservation impact funds and what the right fund parameters need to be," she says.

"As soon as we can actually work out how to measure social returns or conservation returns in addition to the financial returns, many institutions will seriously look at investing in impact fund vehicles that aim to give them effectively both an internal rate of return and an external rate of return."

Back when the PRI was launched, the LP community asked and the fund managers delivered. To make such dramatic progress in the next decade, it's time for investors to ask again. ■

> ***"Institutions such as public pension funds and family offices have been sticking their heads together to try to figure out how they can invest in appropriate social and conservation impact funds***
>
> **Marleen Groen**

A YEAR IN RESPONSIBLE INVESTMENT



ONTARIO

Ontario requires pensions to disclose ESG data

In January 2015 the Canadian province made amendments to the Ontario Pension Benefits Act to require pension plans to disclose their ESG practices. The changes, which came into effect on 1 January 2016, call for pension plans to disclose whether or not ESG factors are considered when making investment decisions and, if so, how they are incorporated. The pension plans had 60 days after 1 January to file their ESG data with the Financial Services Commission of Ontario.

NEW YORK

KKR trims $1.2bn in portfolio company costs via ESG

KKR published its fifth *ESG and Citizenship Report* in July, showing it had reduced costs at 25 portfolio companies over the past seven years. In 2008 the firm introduced its Green Portfolio Program in partnership with the Environmental Defense Fund in order to review the waste and natural resource-related activities of its portfolio companies. The report said 56 of its portfolio companies participated in ESG programmes and 28 percent disclosed ESG or corporate citizenship-related performance. As of July, KKR was planning to launch a new platform and model to tackle eco-efficiency, eco-innovation and eco-solutions at its portfolio companies.

LONDON

CDC Group launches ESG toolkit for fund managers

British development finance institution CDC Group launched an ESG toolkit for GPs at *Private Equity International*'s Responsible Investment Forum in June. The toolkit, which is designed to be a practical guide on assessing environmental, social and corporate governance risks, includes individual sector profiles, such as manufacturing, healthcare, retail, agriculture and aquaculture. It also provides guidance on issues such as how to address ESG matters throughout the investment cycle, how to assess and manage governance and business integrity matters and what to expect when working with CDC.

LONDON

Permira appoints first ESG head

Permira appointed Adinah Shackleton to its newly-created role of head of ESG in London in August. Shackleton came to Permira from sustainability consultancy Environmental Resources Management, where she worked since 2006. As the firm's first head of ESG, she works with Permira's existing environmental, social and corporate governance steering group, led by Jörg Rockenhäuser, to further develop its strategy.

STOCKHOLM

Nordic bolsters ESG and communication team

In January 2015 Scandinavian firm Nordic Capital expanded its team with two newly-created roles focusing on communication and ESG issues. Karin Lepasoon, formerly the executive vice-president at construction company Skanska, joined Nordic as a director of communications, ESG and human resources, while Emma Brandt arrived as ESG manager. The appointments came as Swedish GPs were preparing to launch industry guidelines on greater transparency. The Swedish Venture Capital & Private Equity Association subsequently published a code of conduct evaluating the role of private equity in society.

LONDON

PRI kicks off consultation on ESG reporting

Advocacy group Principles for Responsible Investment launched a public consultation in June on a template designed for LPs to question GPs on ESG issues. It began gathering feedback on whether it contained the core information LPs need to know about a GP's practices, whether the proposed questions would allow LPs to ask diverse GPs, and whether requests for information from GPs are reasonable. The consultation closed in September and was part of an industry-wide discussion on the standardisation of ESG reporting.

BRUSSELS

Invest Europe publishes professional standards book

Invest Europe published its 2015 *Professional Standards Handbook*, which took into account new regulations for the European private equity industry. Among other issues surrounding transparency, the guidelines included recommendations for the reporting of non-financial disclosure, including ESG. Marta Jankovic, vice-chairman of Invest Europe's professional standards committee, said the handbook would provide specific guidelines for those looking to make ESG an integral part of their business. Updates in the latest edition include clarifications of the definitions of responsible investment and ESG, while the latter had also been added as a specific item within the reporting guidelines.

ZURICH

Research points to investor pressure

A growing body of research documented the rise of ESG issues up LPs' agenda. London Business School's Coller Institute of Private Equity and Adveq published a study in February 2015 that found that environmental, social and corporate governance had become a core value creation strategy. The study surveyed 42 private equity firms representing a broad geographic and sector focus with a collective AUM of more than $640 billion. Most large firms (85 percent) said they felt pressure from LPs to integrate ESG policies into everyday business processes. In another study the following month, Switzerland-based alternatives firm LGT Capital Partners and consultant Mercer found unmet demand for GPs embracing ESG. Three-quarters of 97 institutional investors surveyed said they incorporate ESG when investing in alternative assets, but 65 percent of them said most GPs they reviewed did not include such factors in their decision-making process.

AFRICA & ASIA

OPIC commits $200m to LeapFrog

The Overseas Private Investment Corporation (OPIC) announced in December that it will commit up to $200 million to LeapFrog Investments, marking the largest commitment in history to an impact fund. The commitment will go towards LeapFrog's Fund III, which is expected to target $800 million and fundraise this year. It also marked OPIC's single biggest commitment to a private equity fund and will push LeapFrog's overall capital raised beyond $1 billion. The firm will invest the capital in financial services and healthcare companies in Africa and Asia.

ESG PLANNING

Taking responsibility

With a growth markets focus and a heritage spanning over 60 years, Actis has a unique approach to investing responsibly. Here, the firm's Head of Responsible Investment, Shami Nissan, explains why RI is very much a core element of investment decision-making and how Actis' RI approach continues to evolve

Nissan: *'We view any ESG shortfalls as opportunities to improve company performance'*

Actis, a leading growth markets investor, has had responsible investing at its heart since inception in 2004, building on a history as the UK government's private investment arm. From the outset, Actis has integrated environmental, social and governance (ESG) considerations into the investment decision-making process.

Shami Nissan is Head of Responsible Investment, and says: "Our exclusive focus on growth markets makes us distinct from many other investment houses. ESG issues are typically more acute in our markets and therefore can have material implications for business – we would not be fulfilling our fiduciary duty if we did not systematically consider ESG issues in our investment processes. We view any ESG shortfalls as opportunities to improve company performance, helping to build more successful, profitable and resilient businesses.

When investing in OECD countries, there are more ESG safeguards in place in terms of regulation, legislation, enforcement, voluntary codes and industry benchmarks which spell out what is permissible and what constitutes best practice. In our markets such safeguards are absent or weak, and for that reason Actis applies international ESG standards to all of its investments irrespective of the local regulatory environments".

AT THE TOP TABLE

At Actis, the Responsible Investing team is an integral part of the investment committee process and is well placed to advise the investment committee and individual deal teams on the nature and magnitude of relevant ESG issues and to recommend appropriate next steps.

"We are fully integrated into the investment decision-making process," says Nissan. "We look at ESG issues through a materia-lity lens, so our time, effort and resources are focused specifically on the set of ESG issues which are material to the business and have clear link to value. These vary by sector, geography and the company's track record and capacity."

It is not necessarily the case that portfolio company management of ESG issues is on a par with best practice international standards. Indeed if that were the case, says Nissan, "we may as well shut up shop – it is that opportunity to raise standards which is a core part of our value creation thesis."

Rather, the key question becomes whether management has the appetite to address the issues, within an acceptable timeframe. If so, we can work with management to develop and agree ESG workstreams post-investment, and ensure we monitor progress throughout so we can demonstrate the improvements made.

TOP DOWN, BOTTOM UP

Actis takes both a top down and bottom up approach to assessing ESG risks and opportunities. So, as highlighted, company track record, capacity and commitment (bottom up) are key.

"We also apply top-down assessments, to provide a more strategic and more systematic means of assessing ESG risks in particular. By considering the inherent ESG risks to a sector and geography, and mapping this to our c. 70 portfolio companies, we can determine where our risk 'spikes' are, what our priorities should be, and put our mind to developing a framework which enables us to better manage and mitigate the risks in a consistent way across Actis."

Actis invests across three asset classes and six sectors: Real Estate, Energy, and within Private Equity, consumer, financial services, healthcare and industrials.

In 2015, Nissan developed a Real Estate Impact Model that mirrors a similar model Actis developed for the Energy sector in 2010. It comprises ESG metrics which can be used to measure ESG performance of investments – this enables Actis to track performance of an asset over time and pinpoint where the greatest shortfalls are. Essentially, the model measures the progress Actis makes over the lifetime of each of its real estate investments against a defined universe of ESG metrics. These include areas such as resource efficiency, health and safety, security, clear land title and community relations. Real estate also presents significant opportunity to deliver social benefits, not least through job creation in both construction and operational phases.

Mitigating risks is a primary focus, as are cost savings through more efficient use of energy and water, for example. Actis is a pioneer in developing green buildings in sub-Saharan Africa, having developed the first green-rated building in West Africa, which opened in 2015; One Airport Square. The office building in Ghana achieved a 30 percent reduction in energy use and the first LEED-certified (Leadership in Energy and Environmental Design) mall in East Africa. That project, Garden City in Nairobi, Kenya, includes Africa's largest solar panel-covered car park, delivering much cheaper water and electricity, and 70% of construction material was sourced locally. Heritage Place, a world-class office development that Actis is soon to launch in Lagos is redefining the standards of green design and quality of office space in Nigeria.

In the healthcare sector, Nissan has led the development of a framework for assessing and managing business integrity risks.

We have a framework that provides a systematic and consistent approach to assessing business integrity risk pre-investment and post-investment

Shami Nissan

The importance of upholding the highest standards of business conduct was recently highlighted by the GlaxoSmithKline bribery case in 2013, where the UK pharmaceuticals company was hit with the largest bribery fine ever imposed on a foreign company in China.

Nissan says: "We invest in the healthcare sector across our markets, including China, and we resolved to develop a more robust way of assessing and managing business integrity risks, such as bribery and corruption, in the sector. We now have a framework that provides a systematic and consistent approach to assessing business integrity risk pre-investment, including how we structure due diligence, and post-investment, looking at the best route map for the company to get to a position of best practice.

INVESTING IN ENERGY

The Energy sector is another where Actis is at the forefront, with the current fund heavily invested in renewables businesses, including wind and solar. To date, Actis' energy investments have provided electricity to c. 65million people and built c. 14.5 GW of generating capacity.* In this sector, a perennial focus is community buy-in and ensuring that businesses have a social license to operate. There are a myriad of examples which highlight the business criticality of this and where failure to establish a positive dynamic with communities has led to business disruption through blockades, protests, sabotage and violence.

Many Actis energy investments are wholly owned platforms, established by Actis from the outset. "Because we handpick the team and dictate the organisational design of the platform, we ensure there is a Head of ESG at the platform, and very often I or one of my team is involved in selecting those individuals," says Nissan. "Similarly, our energy platforms have ESG sub-committees to the Board. We recently held our first conference at which all Heads of ESG from our portfolio companies were brought physically together for the first time, offering a combined pipeline of c. 4.5GW of generation under development, in construction or operating and networks providing 3.4 million electricity connections.* It was a great opportunity to share best practice and accelerate learning. Despite operating in different environments, cultures and market regimes, commonalities were evident and robustly discussed."

While it may be leading the charge, Actis sees ESG challenges moving up the agenda for all investors, particularly as more large buyout firms invest in emerging markets, LPs become more sophisticated in their appreciation of the issues, and the global sustainability challenges such as climate change, urbanisation, water scarcity and population growth become more acute.

Fortunately, as investor requests for ESG information get ever-more granular, Actis remains comfortably ahead of the game. ■

* as of June 2015

ACTIS

65+
year heritage

$7bn*
funds under management

200+
limited partners

c. 90
investment professionals

13
offices

c. 70
portfolio companies

27
countries

114, 444
employees in Actis portfolio companies

Actis is a leading investor in growth markets, delivering consistent competitive returns, responsibly. It has a growing portfolio of investments across Asia, Africa and Latin America and US$7bn* funds under management today.

The firm invests through insights gained from trusted relationships and local knowledge, deep sector expertise and an unparalleled heritage, set within a culture of active ownership.

Applying developed market disciplines to growth markets, an established team of c. 90 investment professionals in ten countries identify investment opportunities in response to two trends: rising domestic consumption and the need for sustained investment in infrastructure across private equity, energy and real estate asset classes.

Actis is a signatory to the United Nations Principles for Responsible Investment (UNPRI), an investor initiative developed by the UNEP FI and the UN Global Compact. Actis targets consistent superior returns across asset classes over the long-term, bringing financial and social benefits to investors, consumers and communities. It calls this *the positive power of capital*.

In 2015 Actis was voted 'Private Equity Firm of the Year in Africa' by *Private Equity International* (*PEI*), 'African Infrastructure Fund Manager of the year' by *Infrastructure Investor* and *Catalyst*'s 'Deal of the Year', awarded for the acquisition of Compuscan.

INVESTMENT HIGHLIGHTS INCLUDE:

Food Lovers Market: the largest independent food retail group in Africa ($54m, December 2015)

Sigma Pensions ("Sigma"): a leading Nigerian Pension Fund Administrator ($62m, November 2016)

Coricraft Group, one of South Africa's leading home furnishings retailers (September 2015)

Lekela Power: a pan-African renewable energy generation platform ($1.9bn, February 2015)

Ostro Energy: an Indian renewable energy platform ($230m, February 2015)

Genesis Group (Genesis): Brazil's largest grain testing and inspection business ($45m, December 2014)

Integrated Diagnostics Holdings ("IDH"): Egypt's largest private sector healthcare diagnostics service provider ($113m, December 2014)

Université Centrale Group: a leading provider of private tertiary education in Tunisia ($50m, December 2014)

Tekkie Town: South Africa's leading independent sports and lifestyle shoe retailer ($65m, November 2014)

IT'sSEG: Buy and build insurance broke-rage platform in Brazil ($100m, November 2014)

Zuma Energía: Mexican energy platform ($250 million, September 2014)

Société Nationale d'Electricité (SONEL): Cameroon's national integrated utility ($202m, June 2014)

Credit Services Holdings (CSH): A pan-African buy-and-build credit services business ($100m, April 2014)

Upstream: the leading emerging markets mobile monetisation company (April 2014)

Symbiotec PharmalabLimited: an Indian leading specialist producer of steroid- hormone active pharmaceutical ingredients (APIs) ($48m, October 2013)

Atlantic Energias Renovaveis S/A: a Brazilian renewable energy company ($169m, September 2013)

www.act.is

* as at Sept 30 2015

Finding the right approach

With no industry standard on how to due diligence, measure and report ESG issues at private equity portfolio companies, fund managers have had to come up with their own way of addressing the challenge. Isobel Markham looks at four GP initiatives making waves on the responsible investing circuit

THE BOARD-LED APPROACH

When pan-European buyout house Cinven was developing its approach to ESG, it had two definite 'don'ts' in mind: don't have a one-size-fits-all mind-set, and don't make the reporting piece overly burdensome to the portfolio company.

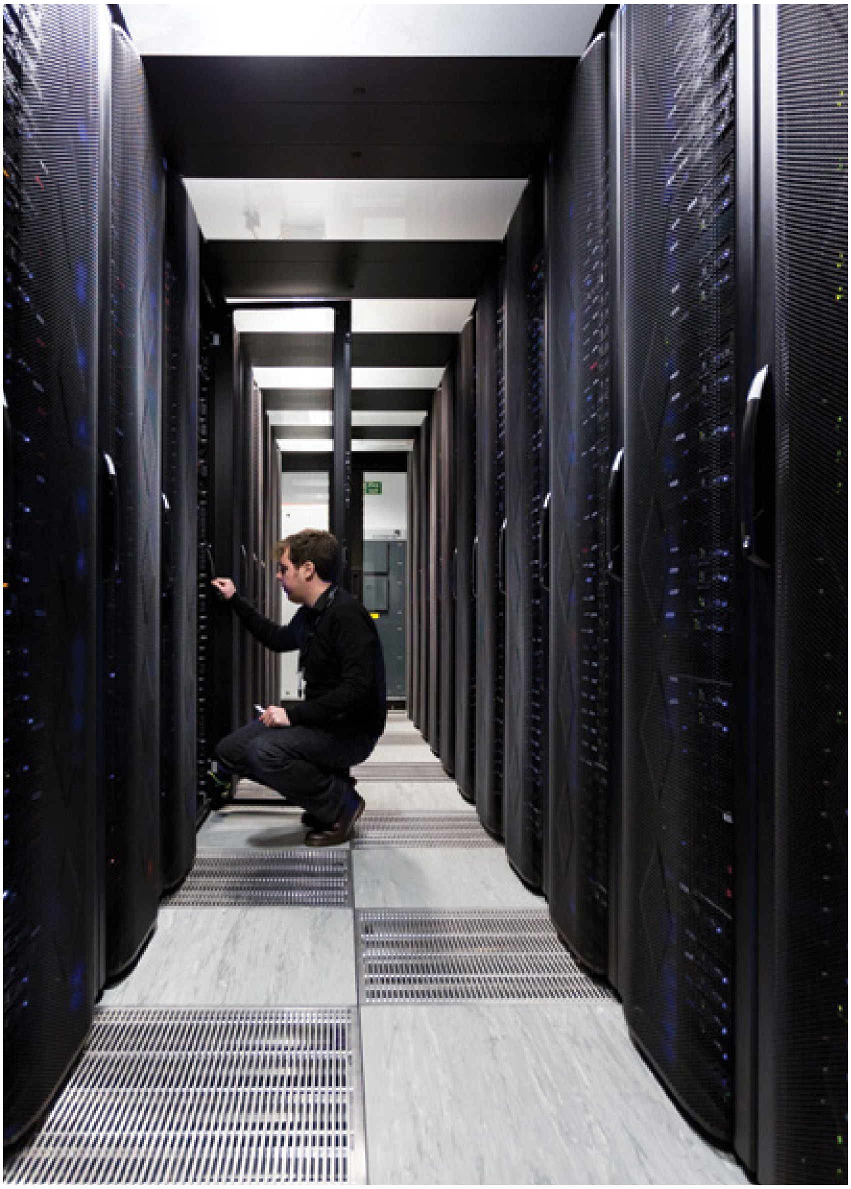
"We were very conscious that under private equity ownership there are a number of reporting requirements already, and we wanted to ensure that whatever we were asking portfolio companies to do on ESG was something that outlived our ownership and was properly embedded," says Vanessa Maydon, corporate affairs director at Cinven.

As a result, the firm decided to ask its portfolio companies individually to define their own ESG-related KPIs based on a materiality basis.

"Our approach to ESG has focused on our portfolio companies developing their own bespoke KPIs that are relevant to their business and aligned with the ESG metrics they are already recording as material to their business," Maydon says.

Cinven prepared guidelines to help its portfolio companies carry out a materiality assessment on ESG and to help them structure their reporting framework.

"Within that we recommend that if they don't have a dedicated head of ESG or sustainability, that one way of pulling all the data together and reporting on it is to put an ESG steering committee together, and on that to have board representation," »



***Cinven:** working with portfolio company HEG to reduce carbon emissions across its global data centre operations*

» Maydon says. A specific member of the company's board, therefore, takes responsibility for ESG within their own company, rather than an external member of the Cinven team.

"How they then structure their internal reporting framework in practice, and who that board individual is, is up to them. We haven't wanted to be too prescriptive about it because the way companies are structured is slightly different [in different geographies]."

Cinven currently uses iLevel reporting software internally for financial reporting and operational KPIs within each of its portfolio companies, and it is in the process of integrating ESG KPIs into the system to streamline the reporting process.

THE PUBLIC MARKETS APPROACH

Like its similarly-sized peers, funds managed by Apax Partners invest in many companies with an enterprise value of more than €1 billion, and therefore at least several of them are highly likely to end up being publicly quoted. As a result, Apax always has one eye on what the public companies are up to.

"We found that public companies were increasingly including non-financial metrics in their annual reporting in line with stakeholders' demands for transparency of their ESG footprint," says Ellen de Kreij, ESG implementation lead for Apax Partners.

Having worked predominantly with external advisors on ESG due diligence and value creation within its portfolio companies, in 2012 Apax brought in Credit360, a sustainability software system used predominantly by the public equity community to track ESG-related KPIs.

"It's typically used by large multinationals with different divisions in different regions that have to do a lot of data collection and quite a bit of reporting around it," de Kreij says. "If you think about it, that's the profile of a large-cap private equity firm. Funds advised by Apax control a variety of global groups across four sectors and have a requirement to do quite a bit of reporting."

Apax has come up with around 80 sustainability-related KPIs, covering everything from resources usage to workforce diversity to regulatory compliance. Individual portfolio companies input their data into their own section of the cloud-based system which, where necessary, has been tailored to them. This data can then be collated and analysed across portfolio companies, which allows for comparative analysis across similar businesses across the four sectors in which the Apax funds invest, and tracking of how individual portfolio companies are improving year-on-year.

As well as providing a rich source of information for Apax itself, the information collated through Credit360 is reported back to LPs through an annual sustainability report, which distils the data to give investors a picture of ESG progress within the portfolio. For those that need a more detailed breakdown, the data is readily available for Apax to provide.

THE BESPOKE GROWTH MARKETS APPROACH

For LPs investing in growth markets private equity funds, how fund managers approach ESG is a major consideration.

"Especially in some of these markets in their early stages, our investors were very keen that we were adhering to the right levels of governance," says Wahid Hamid, a partner and global head of The Abraaj Group's Performance Acceleration Group (APAG).

Abraaj considers responsible investment to be an integral part of its DNA. However, it was keen to move beyond compliance and risk mitigation towards measuring the impact of the private sector and propelling it "up the learning curve in areas of sustainability".

"We're firm believers that the private sector has a very strong role to play in

promoting these practices, and if we could play a part in that, if we can infect [these markets] with the virus and make sure that they're focused on these aspects in the broader sense of the word, then we'd have a positive impact in terms of the private sector's contribution to issues of sustainability in these markets," Hamid says.

As a purely growth markets-focused investment firm, Abraaj found that none of the measuring or reporting tools already in use were a good fit for the businesses in which it invested. In 2008 the firm developed the Abraaj Sustainability Index (ASI), a system which measures its portfolio companies' development impact from a private sector perspective.

"We had to develop something bespoke, something that reflected the nature of the

Abraaj: *since 2014 more than 6,500 vendors and agents have been trained by Fan Milk Ghana*

companies we were investing in," says Hamid. "The metrics and attributes that we felt were important measures of sustainability for our markets were slightly different than for the others."

The ASI has recently gone through an internal review; its six pillars of sustainability have been narrowed to four, and its 70-plus KPIs have been trimmed to around 50. Abraaj is also launching an online system through which its portfolio companies can directly input their ESG data and do their own analysis, including benchmarking themselves against peers within the Abraaj portfolio.

"The one thing that we constantly struggle with is keeping this simple, because if you make it too complicated or we focus on too many things, it's not going to see the light of day, because these are also companies that are rapidly growing. They've got many other priorities and a sense of urgency to scale the business, so we've got to pick our battles," Hamid says.

"Even though we have 50-plus metrics that we've identified, we tend to hone in on a few that we focus on with the partners to get them to improve."

THE COLLEGIATE APPROACH

Arguably the best authority on how to overcome ESG issues in portfolio companies are portfolio company management teams that have already overcome similar issues. French private equity firm PAI Partners recognises that many common ESG issues affect multiple portfolio companies, and therefore sharing best practice and experience across businesses is paramount.

In 2011 it created the PAI Sustainability Club. Its biannual meetings bring together ESG managers and teams from all of PAI's portfolio companies for seminars, presentations, workshops and lessons with ESG and consulting professionals. Discussion topics in recent years have included responsible procurement, reporting, and human resource management.

Bringing management teams together helped to bring on board those more reluctant to embrace ESG monitoring and reporting, says Blaise Duault, head of compliance and public affairs at PAI.

"When you are investing in the management and strategy, you want them to have specific views on ESG," he says.

Keen to continually develop its approach to ESG, in 2015 PAI launched an ESG reporting software system.

"We decided to work on a tool that would create a dialogue with our companies and be more interactive with them," says Caterina Romanelli, head of responsible investment and ESG at PAI.

Duault adds: "Having worked on ESG since 2010, we had developed some expertise on what the expectations of LPs were on the subject, which was very useful in tailoring the tool."

The reporting tool includes 145 ESG indicators, out of which PAI identifies those that are relevant to each portfolio company. The tool can then be used to track progress and to report back to investors.

Not content to stop there, in November PAI joined with fellow French private equity firms Apax, Ardian, Eurazeo and LBO France to launch the 'Initiative Carbone 2020' to address the carbon footprint of portfolio companies. The firms jointly committed to measure both the direct and indirect carbon footprint of 30 sample portfolio companies, raise climate issue as a strategy across all controlled companies and publish company data as of 2020. ■

Creating an ESG legacy

With the right backer, portfolio companies can build sustainable and meaningful frameworks that endure well beyond private equity ownership, say Cinven partner ***David Barker*** *and corporate affairs director* ***Vanessa Maydon***

Q Cinven was an early signatory to the PRI, joining in 2009. Why was this important to the firm?

Barker: Cinven has always taken a responsible view towards investing, but we recognised that we needed to be doing more, both to ensure we were adhering to best practice and to provide assurances to our investors and the wider world about how we do business. When the UNPRI first emerged, there was a lot of negative sentiment towards the banking industry – and private equity was grouped in with that. We felt it was important to stand up and be part of a movement that was seeking to ensure responsible investment practices prevailed.

Investors in our funds – many of whom are public pension funds that have a strong interest in making good returns in a responsible way – are increasingly looking for evidence of commitment to ethical practices both at a fund and portfolio level.

Q What tend to be the most common barriers to effective ESG management and reporting before you invest in a company?

Barker: In new portfolio companies, we often have to go from a standing start – there is usually no centralised management of ESG. This is because, while ESG is rising up the agenda in most companies, in some of the smaller, private businesses that private equity tends to target, people just haven't had the time or expertise to think about how they can manage these issues. And in divisions that are being bought out of larger parents, the teams usually haven't had the responsibility for their own thinking on ESG matters. Most of the time, management are willing to engage but they just don't know where to start.

Maydon: I agree. Time constraints are the most common reason most businesses we back don't have formalised ESG management and reporting in place before investment – most don't have anyone dedicated to ESG matters. Yet very often businesses are already capturing some of the key information required to manage ESG effectively, such as that on health and safety and legal compliance; it's just that they can't yet draw together the data from different departments. That is often the key challenge: getting the information centralised and then ensuring there is high-level responsibility for managing according to that information.

Barker: Sometimes there is also a misunderstanding about what ESG actually is and a big challenge then can be getting management to see how important an issue this is – it's not just a woolly fad, and it's about far more than company fun runs. Sound ESG practice is at the heart of good business, risk and reputation management.

Q How do you go about establishing an ESG framework in portfolio companies?

Maydon: We have developed a process over the last few years for this. Our starting point, once we have invested, is to send out an ESG questionnaire to establish which ESG data the company already captures. This is important as we don't want our portfolio companies to view ESG as just an onerous reporting requirement put in place by their private equity owners. From this, we prepare a set of guidelines for our portfolio companies that helps them structure a framework that works for them. Importantly, we also make it a requirement of our investment that ESG is a board agenda item. We recognise that sound ESG management can only get up and running if it is being driven at a senior level within the organisation and sometimes we have to demonstrate to management how this is critical to their business, in terms of risk, but also opportunity.

In addition, we run an annual conference to which we invite portfolio companies. There, companies can share best practice, some are invited to present case studies and we also invite expert speakers along.

However, we also realise that our portfolio companies sometimes need expert support, so we have teamed up with the sustainability team at KPMG, who can help review policies and KPIs and, if needed, work more closely with them to develop the right approach, bespoke to their business.

Q So how can companies develop a framework that is meaningful and works for them?

Barker: One challenge is defining ESG KPIs – what should individual companies be looking at? And while managing these issues shouldn't require additional in-house resources, sometimes companies benefit from external specialists as they can advise on what other businesses in the same sector are doing and benchmark performance in some of the key areas.

In many ways the right framework depends on the business, so the KPIs for

Maydon: *the company has to have ownership of the initiative*

Barker: *sound governance is the key item in ESG*

a manufacturing business will necessarily be very different from those of a software company. When we started devising our process we were very keen not to take a cookie-cutter approach as this can lead to a box-ticking mentality.

Maydon: The company has to have ownership of the initiative if the ESG framework is to be meaningful, so we ask portfolio companies to decide which KPIs are most critical to their business, as even within the same sector there can be different drivers from business to business.

There are three main KPIs that all of our portfolio companies report on – CO_2 emissions, frequency of accidents at work and anti-bribery and corruption measures – but beyond that, it is very much tailored to individual companies. So if we take fibre telecoms operator, Ufinet, as an example, the company installs networks alongside electricity cables and gas line ducts in geographic regions such as Latin America. Health and safety is one of the most important areas to measure, so the company reports on the percentage of staff that receive training. For CeramTec, a German high-performance ceramics manufacturer, energy reduction, which directly relates to CO_2 reduction, is an important measure in CeramTec's energy intensive production; and in financial services, the governance part of ESG is the most relevant to these businesses.

Q Many of the businesses you back operate across many different geographies. How can they ensure ESG is measured and managed on an international scale?

Barker: For any of the businesses we invest in, sound governance is the key item in ESG, although particularly so for international companies. It's relatively easy to maintain good ESG procedures if you're just operating in the UK. Yet if you are negotiating contracts in some developing markets, where corruption can be an issue, or if you have to manage waste disposal in a country that doesn't have developed networks for this, you have to ensure that the company's governance is strong enough to ensure ethical standards at all times. It's absolutely essential that ESG objectives permeate the whole organisation.

Maydon: One example is speciality pharmaceutical company AMCo. One of the challenges it had faced, but has overcome, was getting partners to sign up to appropriate guidelines. It could see there was an advantage in building a reputation for being an ethical provider of medicines. When we invested and brought two companies together to create the business, it undertook a complete review of how it approached ESG issues. It became the first pharmaceutical company to gain the BS10500 anti-bribery management standard, for example.

Q And how much emphasis do buyers put on ESG issues in today's market in your experience?

Barker: I'd put ESG into three main buckets: first, issues that improve economic performance, such as reducing energy use and wastage; second, matters that have serious consequences for the business – risks that may or may not arise that could have a material impact; and third, those that are nice to have.

Buyers would generally expect that most businesses are good at the first category. On the second, as sellers, we have to ensure that the company has addressed these issues as they can have an impact on exit. In some cases, this can be an opportunity – so, if a company has a poor record on pollution, we can invest to clean it up, thereby reducing the discount on exit. The third category is where we've seen less focus as these tend not to have an economic impact on the business in question.

Maydon: Nevertheless, the third category can feed into reputation. If we look at AMCo again, the company has done a lot of work in the community, which helps keep staff motivated. You can't put a value on that, but if the reverse were true and staff weren't motivated, there would be an impact on how the business performed. ■

ONTARIO TEACHERS' PENSION PLAN

Direct responsibility

OTPP's Barbara Zvan tells Isobel Markham about the differing challenges of backing private equity funds and investing directly into portfolio companies when it comes to responsible investment

As a pension fund seeking to both maximise and safeguard returns for its members, responsible investing comes high up the list of priorities for Ontario Teachers' Pension Plan (OTPP).

"Our framework at Teachers' is to look at financial and non-financial factors," says Barbara Zvan, senior vice-president, strategy and risk, and chief investment risk officer at the pension plan. "We started talking about governance many years ago."

The C$154.5 billion ($106.6 billion; €97.9 billion) pension plan, which has been investing in private equity since the early nineties, currently invests around C$21 billion in private equity globally, with a roughly even split between a funds programme and direct and co-investments.

Within its primary fund investing programme, OTPP has made commitments to funds such as local manager TorQuest's C$535 million Fund III, the $4.7 billion Ares Corporate Opportunities Fund IV, the $2.68 billion MBK Partners Fund III and the northern Europe-focused €4.82 billion EQT VI, according to PEI Research & Analytics.

Within its well-established direct investment programme, one of OTPP's highest-profile investments was Maple Leaf Sports and Entertainment (MLSE), the owner of the Toronto Maple Leafs ice hockey team and the NBA basketball team the Toronto Raptors, in which it first invested in 1994. In 2012 the pension plan sold what was then a 79.53 percent stake in the company to Bell and Rogers Communications for C$1.32 billion.

As well as investing in accordance with its board-approved Risk Appetite Statement, which sets out the OTPP board's tolerance for various investment-related risks, the plan has also established five responsible investing principles that help to guide its investment team as they evaluate investment opportunities and the associated material risks.

Zvan: *governance is the first priority*

If you don't have governance, then it's hard to deal with the environmental and social, and even any other type of issues

Barbara Zvan

The principles seek to balance risk, return and reputation, and include: integrating ESG factors into its investment processes; being engaged owners; evolving its responsible investment practices; seeking relevant information and disclosure; and collaborating with like-minded investors.

The motivations behind the focus on ESG are the same whether OTPP is investing in a fund or backing a portfolio company directly. However, in practice, the ESG due diligence takes very different forms.

"When you're dealing with a fund, you're trying to understand how the GP will look at different situations and understand how they manage their portfolio companies," Zvan says. "You really want to get a grasp of what they've done in the past, what kind of policies are in place, what kind of practices they have in place."

With a direct investment OTPP takes on the ESG assessment work that the GP would be doing on each individual portfolio company. It has the opportunity to do its own "deep-dive" and to ask detailed questions around any specific material risks.

"They're difficult in different ways," Zvan says of assessing investment funds and portfolio companies.

"In buying a direct company, there's always time limitations, you're confronted perhaps with a company you don't know that well, you have to rely on different consultants' views, you're trying to ask the right questions and you're trying to balance the things that you're finding. Whereas

Passing the puck: *Maple Leaf Sports and Entertainment, owner of the Toronto Maple Leafs ice hockey team, is one of OTPP's highest-profile investments*

with a fund you're really trying to make sure that they have the right practices and procedures in place, and if you're on the LP advisory committee you can ask questions. The approaches are quite different, but both are still very engaged."

Of the three aspects of environmental, social and corporate governance, the governance part is the first priority.

"If you don't have governance, then it's hard to deal with the environmental and social, and even any other type of issues," Zvan says. "We don't see it as the most important, but it's definitely an enabler. If you don't have it right, it's hard to deal with the other problems."

For OTPP, which has a long-term investment horizon and in some cases, such as MLSE, holds its investments for as long as several decades, understanding material issues around ESG upfront is crucial, Zvan says.

"Value creation is really important, and during that period of time we're looking to improve the business in many different ways. One of them is around ESG issues that we observed during due diligence or that we've learned while we've been holding the company."

Instead of having specific responsible investment team members that work alongside the private equity investment team at OTPP, Zvan's team prepares the investment professionals themselves to take on the responsibility for assessing material ESG issues.

"The way that accountability works here is that it lies with the investing team," Zvan says. "We've tried to make sure that the portfolio teams are equipped. We have some speciality skills in my own department that assist them in making sure that they ask the right questions and understand the information they're receiving back."

When it comes to co-investment partners, Zvan sees a broad range of attitudes to and capabilities around ESG among the GP community.

"There are some GPs we looked to when we were putting our own practices in place, and others we were trying to move along," she says.

However, Zvan is increasingly finding that fund managers are "aligning much more with us" on their approach to ESG.

For fund managers seeking a commitment from OTPP, when discussing ESG Zvan suggests listening closely to the pension fund's own point of view on responsible investing and then presenting a clear picture of how their own policies have evolved and how they interact with their portfolio companies on material ESG issues.

"This is an area where people are progressing and gaining experience, and so [we're interested in] how they've evolved [and] how they've learned to get a better understanding of how they're equipped going forward," Zvan says.

"We're looking at [whether] they understand it from a return point of view, a risk point of view [and] a reputation point of view. How do they understand ESG? How important is it to them?" ■

THE COMMERCIAL VALUE OF "DOING THE RIGHT THING"

ESG is a value driver

Responsible investment is a route to operational value creation, says sustainability consultancy ERM

Responsible Investment (RI) has become 'business as usual' for the financial sector. Driven by societal demands, fiduciary responsibilities, regulation and a better understanding of the potential materiality of issues, Environmental, Social and Governance (ESG) consideration is now approaching mainstream. It's not about risk management alone, good ESG performance can provide a significant opportunity to create business value. However, recent industry and client discussions have focussed on the ongoing challenges of unlocking the full value of ESG factors in investments.

The general consensus remains that ESG issues can materially impact the value and operations of invested companies, with wider implications for the portfolio and investment manager.

BUSINESS BENEFITS OF OPTIMISING ESG PERFORMANCE

Outcomes for Investment Manager

- Higher performing funds
- Protection of GPs reputation, alongside that of its investors
- Trust built with investors
- Enhanced fund raising potential

Outcomes for Portfolio

- Strategic advantage: products, revenue and brands
- Operational savings: cost efficiencies, staff engagement, increased productivity
- Risk management: operational enhancements, commercial benefit, enhanced reputation

Material value enhancement can be achieved when General Partners' (GP) focussed engagement with invested companies is informed, not only by in-depth understanding of strategic ESG drivers that may impact the companies' value and growth plan, but also the experience of being able to actually unlock these ESG performance improvements on the ground and communicating success stories transparently and credibly.

However, ESG does not always get the attention it warrants especially where it has to compete with other business initiatives, and where stakeholders within the GP and invested company are unfamiliar with the additional business value that can be created.

In ERM's experience, "ESG value" can be created in a number of ways at both a transaction and portfolio management level, for example and as highlighted in the case studies presented in this article; through improving the asset valuation process; enhancing early risk identification and post-acquisition risk mitigation; identifying upside opportunities, associated with business improvement through efficiency or innovation; and albeit less tangible, creating value through reputation enhancement or brand management.

ERM is currently surveying GPs and Limited Partners (LPs) who make direct investments in order to better understand how those with established ESG policies and processes have been able to benefit from value created within their invested companies, and to measure and quantify these impacts.

By learning about both the ESG successes and the setbacks experienced by investors, ERM can demonstrate what is being done well, and what lessons investors can apply for improved success in the future.

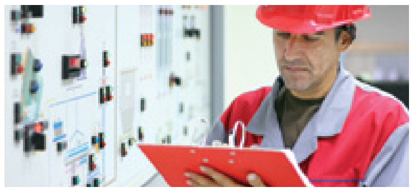
CASE STUDIES: FROM UNTAPPED VALUE TO UNLOCKED VALUE

Value unlocked: $27 million over 10 years

Sector: Industrial

Improving Efficiencies: we typically identify ~10% reduction in energy costs through low-cost or no-cost measures.

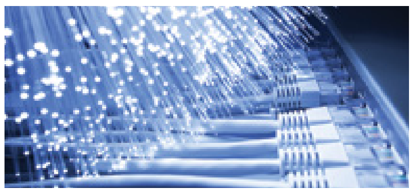
Value unlocked: $40 million (on exit)



Sector: Mining

Improved safety performance: reduces serious personnel accidents and avoids business interruption costs.

Value unlocked: $8 million savings



Sector: Telecommunications

Eco-design principles: applying a life cycle approach, client identified **significant savings** associated with products.

Value unlocked:
51% increase in on-time departures

Sector: Airport

Human factors techniques: can deliver significant improvement in productivity, for example, at an airport in South Africa, average on-time departure rate rose from **c.35% to c.86% of flights.**

WHERE IS THE EVIDENCE?

While it can be challenging to quantify the value of good ESG management, it is clear that investment firms which explicitly consider ESG issues are realising clear financial and non-financial benefits, both during portfolio ownership and at exit.

This view has been reinforced by various studies, including a 2015 Harvard Business Review article[1] presenting the results of a study on the types of socially responsible investments that make firms more profitable. In this article, the author concluded that "firms making investments and improving their performance on environmental, social and governance (ESG) issues exhibit better stock market performance and profitability in the future". He further suggested that for investors, there is substantial value to be gained from analysing non-financial data and incorporating it into decisions. The research also highlights the importance of focussing on the company-specific material ESG issues in order to enhance valuation, "firms making investments on material ESG issues outperform their peers in the future in terms of risk-adjusted stock price performance, sales growth, and profitability margin growth. In contrast, firms making investments on immaterial ESG issues have very similar performance to their peers suggesting that such investments are not value relevant on average".

Through a systematic portfolio approach, ERM has worked with its financial sector clients to unlock value throughout the investment lifecycle. The following are examples of how clients across asset classes, at both the portfolio and company levels, are working to realise the value from good management of ESG issues.

- **Improving ESG performance supports fund raising:** a European GP achieved top decile ESG performance amongst some of its key LPs based on initiatives they had put together with ERM's support over the preceding two years; this helped the GP to exceed its fund raising target.
- **Including ESG within the asset valuation process creates commercial negotiation opportunities:** an ERM GP client bought an industrial company at a discount, through significant price chips, after identifying material ESG issues during the due diligence. Other buyers were put off but this GP embedded ESG issue management in its 100 day planning. Through an in-depth understanding of these issues the GP was able to find effective solutions to the problems during its ownership and then sell the business at a significant premium. Overall, this approach to ESG through the investment process resulted in $30 million savings.
- **Focus on improved portfolio company ESG performance mitigates risk and also reduces business interruption:** costs in the order of $8 million, as well as business interruption, were avoided through enhanced health and safety performance within a manufacturing company. The safety performance improvement was represented by a 68% reduction in lost time incidents.
- **Reputation enhancement can deliver real returns for the portfolio business and for the investor:** ERM worked for a GP client to support a newly invested Asian seafood restaurant chain with removal of International Union for Conservation of Nature (IUCN) listed critical and endangered species from its menu, and with implementation of supply chain monitoring and management. This reduced portfolio risk exposure and demonstrated commitment to respond to changing societal expectations around social and environmental issues, both protecting and enhancing brand reputation.

Increasingly, company case studies which quantify the enhanced return on investment due to ESG, are being used by GPs to bring their responsible investment policies and processes to life and build trust with their LPs. LPs, through their increasing direct and co-investment with GPs, are now facing similar ESG and responsible investment challenges and case studies are a useful means to help LPs get comfortable with the credibility of their investment partner's ESG assertions and to differentiate between GPs.

Where GPs can provide such assurance of robust ESG risk and opportunity management programmes alongside meeting other financial and operational goals, ERM is starting to see LPs commit additional funds, or funds in preference to other GPs who have similar financial performance but which do not have similarly robust ESG programmes.

IT'S A JOURNEY

For any business it takes senior management leadership, as well as time and resources, to develop a mature approach to responsible growth, which encompasses and derives value from the ESG agenda. In our view we consider a 'mature' company approach as one which moves beyond environment and social compliance and value protection (environmental and social risk management), to one that embeds ESG in the core business strategy, such that the value of ESG is recognised and linked to the company's overall business performance in a systematic way. The leadership and supporting processes which a GP demonstrates and implements with its portfolio companies can play a very significant part »

ELEMENTS OF SUCCESSFUL ESG PROGRAMMES

Based upon ERM's experience of engaging with investors and their portfolio companies, as well as feedback from discussions at the 2015 PEI Responsible Investment Forum and PRI In Person events, there remain significant barriers to realising the value from ESG. The following represents elements of successful programmes.

Start early in investment to identify material ESG issues	Material ESG factors are aligned with company strategy and growth plans	Management think broadly about value creation potential	ESG programmes are monitored and quantified	Board level visibility of material ESG issues
Start early to identify 'material' ESG issues which are those with the potential to impact a company's value at the time it is bought as well as over the investment holding period, to the time of expected sale. Recognising the ESG issues which are material to your investment, and using your influence as an investor to encourage company management to focus on those issues, is the key.	**ESG programmes cannot be isolated from the wider strategy**, they need to be aligned with and factored into a company's value realisation and growth plans.	**Consider the potential depth and breadth of value creation:** saving energy saves money, health and safety improvements save lives and reduce bottom line costs, but what less obvious opportunities exist, for example a 'greener' product or service line?	**Quantify ESG:** The commercial benefits of ESG need to be quantified and wherever possible, monetised, to show that they generate material value to compete against other value creation strategies/ options.	**Successful and material ESG programmes must have Board-level visibility:** this will support sharing of best practice ideas across companies, as well enabling external reporting and leveraging the competitive advantage conferred from an enhanced reputation.

» in this journey for example; through embedding robust investment processes [2] which identify as part of due diligence for each invested company, the material ESG risks and opportunities, and ensuring that where relevant these issues are pulled into 100/300 day planning and valuation exercises, and form part of ongoing performance monitoring and associated communications.

Whilst each company will have its own priorities and journey to responsible revenue growth, ERM sees shared characteristics amongst our GP clients and their invested portfolio companies, as demonstrated in figure 1.

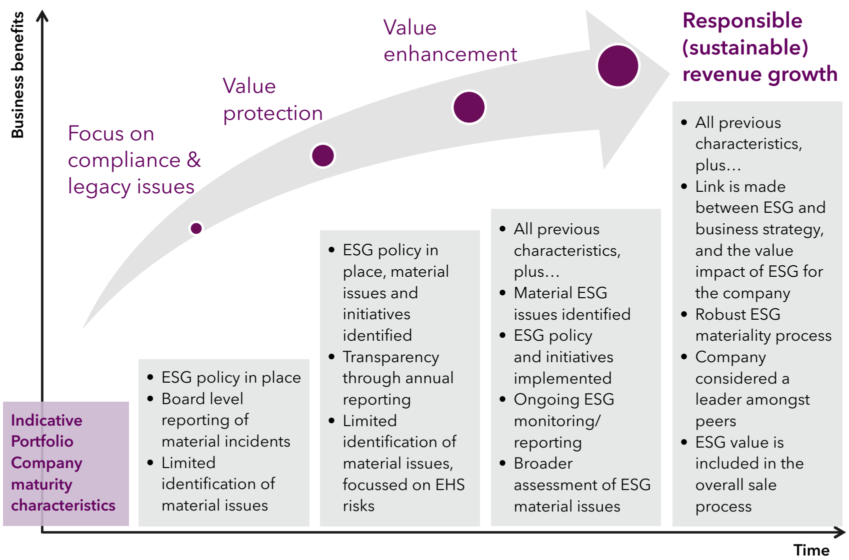
CONCLUDING REMARKS

Both ERM's experience and recent research recognise that companies which identify the material ESG issue(s) and build these into their core business strategy are able to proactively manage risk and increase their value. Barriers to ESG value enhancement should not be underestimated: firms need the right skills to identify ESG opportunities as well as risks, and to identify which are the material issues that should be prioritised; building and communicating a robust business case for ESG and integrating this within the company strategy requires vision and leadership. However, these barriers play to the strengths of the private equity responsible investment model, where value creation is driven by strong governance and active ownership.

It is ERM's belief that GPs are well placed to truly deliver operational value from ESG. For those that take up the challenge, we see not only the potential for direct financial rewards, but an increased ability to meet ESG data requests from institutional investors, for example as investors set sustainability targets for their investment portfolios, and the ability to develop enhanced relationships with investors.

In summary, the investment community is increasingly realising that ESG should not be considered as a distracting add-on or a compliance check box, but should instead be a core part of any business strategy that materially enhances existing investment models and helps to create environmental, social and governance success stories. ■

FIGURE 1: PE PORTFOLIO COMPANY, ESG MATURITY INDICATOR



[1] https://hbr.org/2015/04/the-type-of-socially-responsible-investments-that-make-firms-more-profitable

[2] For example, per those set out in the Professional Standards Handbook, Invest Europe, November 2015.

ERM

Adding value across the investment lifecycle

More than 25 years working with Private Equity (PE) firms and Limited Partners (LPs)

Over 250 ESG related projects annually for PE sector

4 years working with Invest Europe (formerly EVCA) on ESG training

Over 100 financial sector clients supported in the last two years

More than 40 years supporting corporate leaders in embedding sustainability

5,000 multi-disciplinary professionals globally

Over 160 offices in 40 countries

www.erm.com

ERM offers the following Environmental, Social and associated Governance (ESG) support across the investment lifecycle.

Raise funds and meet LP expectations

- ESG strategy and policy development
- Bolster ESG management framework
- ESG communication support

Explore opportunities

- Guidance to deal teams to identify ESG opportunities
- ESG capacity development and training

Pre-investment due diligence

- Holistic ESG Due Diligence on material issues that could impact investment thesis

Post-investment planning

- Investment integration support via 100 day planning to drive business value from effective ESG management

Enhance value

- ESG Portfolio review and monitoring
- Strategic Portfolio Assessments e.g. impacts of climate change
- Reporting process development and implementation
- Enhancement of portfolio company ESG policies, systems & performance

Exit

- Vendor disclosures to provide assurance to bidders on adequate ESG management
- Demonstrate value achieved through enhanced ESG performance

Asking the right questions

The UN PRI's guidance on ESG due diligence should make life easier for both LPs and GPs. Nicole Miskelly reports

At the end of November 2015, the United Nations-backed Principles for Responsible Investment (PRI) initiative finalised a standardised due diligence questionnaire that investors can use to evaluate fund managers on their commitment to environmental, social and corporate governance issues.

The UN's LP *Responsible Investment Due Diligence Questionnaire* (DDQ) was drawn up by a working group of PRI signatories comprising 41 LPs, funds of funds and general partners to build consensus around the questions already touched upon in various sources. These sources included the *ESG Disclosure Framework for Private Equity*, published in 2013, its own existing PRI LP guide and parts of the Institutional Limited Partners Association's existing DDQ.

After three months of what Natasha Buckley, manager of the private equity programme at the UN-supported PRI and author of the DDQ, describes as "stringent pressure testing" by a project group of PRI signatories a draft was launched for public consultation at the Responsible Investment Forum co-hosted by the PRI and *Private Equity International*, last June.

The questionnaire then entered a phase of feedback from an online consultation and various LP roundtables to determine whether the DDQ questions were necessary and fair, and, most importantly, whether the outcome would help LPs in their decision making.

A final version was published in November, alongside an accompanying guidance document to explain some of the trickier questions: in particular those around scope, due diligence and materiality.

As ESG has become an increasingly prominent factor in LP decision-making, GPs have been faced with an increasing variety of disparate information requests from among their prospective investor base. Different LPs ask different due diligence questions, often covering the same areas. At the same time, smaller LPs – or those whose ESG framework is still in the early stages of its development – have been seeking guidance on how they should tackle ESG diligence in a manner that is efficient for both them and the manager.

"A lot of LPs are only recently starting to look at [ESG] and don't know where to start. Now that they have a list of questions to send out, they need to understand why they are asking these questions and what they can do with the information once it comes back to them," says Buckley.

The DDQ should help address these challenges and go a step further, adds Buckley, as well as helping some LPs that are currently "struggling to understand what they should be doing with the information that fund managers send back to them".

> **A lot of LPs will still send in their own questionnaires, but the DDQ will provide them with the tools to help them shape the type of questions to ask**
>
> **Susan Flynn**

Thomas Kristensen, executive director of fund investor LGT Capital Partners, is a member of the DDQ signatory working group; his firm, he says, recognised "the need for an industry standard, a single questionnaire which LPs can send out to all of their GPs, to help them gain a better understanding of the GP's ESG polices, what GPs are doing well and how they can improve".

In reality, many sophisticated LPs and funds of funds already have responsible investment strategies in place, which include their own questionnaires. However, the purpose of the DDQ is to create one centralised questionnaire that can act as a starting point and reduce the amount of time GPs spend filling out separate forms.

"Despite having our own questionnaire, we realised that GPs receive a multitude of ESG questionnaires from a large subset of their LPs, which is not the most efficient process for them," says Kristensen.

APG, a Dutch pension fund with assets of €428 billon, has included ESG-related questions in its fund due diligence process for "a number of years", says Marta Jankovic, a senior sustainability and governance specialist at the scheme.

Jankovic, also a member of the DDQ signatory working group, says APG will integrate the DDQ into its wider ESG strategy: "We have been asking ESG questions in our due diligence of private equity investments for a number of years and now plan to use the new LP DDQ for this purpose, adding more specific questions we deem necessary."

Kick off: *the DDQ was launched at PEI's Responsible Investment Forum last year*

Susan Flynn, partner at secondaries investor Coller Capital and DDQ signatory working group member, believes many LPs will continue to send GPs their own questionnaires, but the existence of the DDQ will create a more standardised approach. "A lot of LPs will still send in their own questionnaires, but the DDQ will provide them with the tools to help them shape the type of questions to ask," says Flynn.

However, Jankovic adds that when it comes to how much information GPs should be disclosing, APG prefers quality (and depth) over quantity. "The final due diligence assessment for us really comes from the totality of the responses, where we focus on the quality of the information received, both via the DDQ and via direct contact with GPs. So if we get vague answers back in the DDQ then this is not going to be helpful and can result in more work for everyone involved," she says.

INCREASING BURDEN

The challenge for GPs, then, is the difficulty in collecting large amounts of data and the increased burden this places on the back office.

Kristensen believes, however, that this will be reduced with the introduction of a standardised DDQ. "These questionnaires have already increased the burden on GP back office staff because someone is responsible for filling them out, but hopefully over the next two to three years, with a standard DDQ, we can reduce this burden by everyone sticking to one questionnaire," he says.

LPs, meanwhile, should also be aware of how much information they can handle, warns Flynn. "The amount of information GPs have on ESG varies greatly and can sometimes be overwhelming. LPs have to consider what they will do with this information, and how to get it into a collated format that provides an overall picture of how their portfolio is doing," she says.

Buckley says the UN PRI has received plenty of positive feedback about the exercise itself and hopes that the document will help LPs and GPs find a common approach towards ESG.

However, according to Kristensen, during the drafting process some GPs questioned the practicality of the questionnaire and there was confusion around the amount of detail they should go into. "Some GPs were worried about the practicality of filling out certain questions, how detailed they should be and how much detail should come from portfolio companies," he says.

The UN PRI reiterates that the DDQ is intended to be used as a guide not a checklist, which Flynn says should be really helpful for smaller investors. "I think the DDQ will provide a really good guide for some of the smaller pension funds or investors that are just starting out on the ESG journey and want to do something but don't know where to begin," she says.

The creation of the DDQ comes at a time when ESG is becoming an increasingly important factor in private equity fund selection; 76 percent of institutional investors now have ESG on their list of selection criteria, according to research conducted by Mercer and LGT Capital Partners, and a similar number would reject a fund on ESG grounds, according to PwC. It is in the interest of GPs, therefore, to get their answers straight. ■

Making an imprint

Recent years have seen a sea change in how investors approach environmental, social and governance considerations in their portfolios. Goldman Sachs Asset Management's John Goldstein and Taylor Jordan discuss the evolution of ESG and impact investing, and how investors are approaching the space today

Q With more than a decade of experience in impact investing, what has motivated you in your ongoing work?

John Goldstein: Early in my career, I had spent quite some time observing what initially seemed like very different worlds: one, a set of investors that was using market mechanisms to invest across the asset class spectrum, and the other, folks who were looking to solve social and environmental problems, but were increasingly realising that philanthropic aid grant capital wasn't enough. It was two worlds with interesting potential to collaborate, but which spoke very different languages. There really was both a need and an opportunity to bridge this gap.

> ***[There is] growing awareness that considerations that may once have sounded like idealistic, nonfinancial concerns may in fact be material to performance***
>
> **John Goldstein**

Taylor Jordan, left, and John Goldstein are managing directors with Goldman Sachs Asset Management, based in San Francisco

Taylor Jordan: I'd add that whenever I've looked at the scope of the challenges we face, whether environmental or social, I've always felt that the rigour and scale of investment capital, alongside philanthropy, can help put a dent in these issues. And that's why I believe in ESG and impact investing.

Q ESG and impact investing can mean a lot of things: there's socially-responsible investing (SRI), there's ESG, there's investing with purpose, there's values alignment. Tell us a little bit about the taxonomy.

Goldstein: This is one of the really essential points, which is parsing the word cloud and understanding that there are different disciplines that are implemented in different ways. We really divide it into three core disciplines. The first is values alignment, which is about asking: "How does an investor get their values reflected in a portfolio without affecting the financial characteristics?" In liquid markets, it's really a matter of optimising units of alignment per incremental unit of tracking error relative to a standard benchmark.

The second is ESG integration. Whereas values alignment seeks to ensure that the impact of these considerations on investment returns is minimised, ESG integration is the opposite, asking: "How do I find a thoughtful investment manager that integrates ESG factors in an effort to outperform their peers and their market benchmark?" It's about finding ways that ESG considerations can represent a material advantage to potentially drive outperformance in active strategies.

The third bucket is impact, which focuses on how investors can have more of a direct, measurable impact on the things they care about. This generally occurs in private markets, with strategies that have both an investment piece as well as an impact component that's specifically aligned with a number of measurable and meaningful environmental or social outputs. Above all, it's important to remember that all three buckets of "ESG investing" are simply "investing", and not a special case.

Q Focus on ESG and impact investing has increased significantly. What are some of the drivers of this?

Goldstein: It's a sea change that's really accelerated markedly in the last 18-24 months, and I think it's the intersection of three factors that feed on each other. First is the growing awareness that considerations that may once have sounded like idealistic, nonfinancial concerns may in fact be material to performance. Resource efficiency, for example, which did not seem investment related a decade ago, now seems like a fairly commonplace consideration to have as part of an investment process.

Jordan: As investors increasingly recognise that ESG factors could be material to financial performance, we've really seen a shift away from simply using negative screens to remove stocks from a portfolio towards fully integrating ESG as part of a holistic approach to investment management. This has helped attract mainstream capital in situations where investors are simply looking for quality investments, whether they're expressly ESG-aware or not. And I think large financial firms, as well as SRI firms, are taking note and starting to respond by thinking more about ESG issues and developing their own products in this area.

Goldstein: The second factor we've observed regards consumer preferences, particularly of the millennial generation. They believe the financial thesis, but they also have a personal values thesis that motivates them – whether it's who they work for, what they invest in or who they invest with. It's a fundamental factor driving an ever more influential generation.

The third factor is growing stakeholder interest. Whether it's public pension plans, foundations or nonprofits, their stakeholders are increasingly asking if they are thinking about these issues.

> ***We've really seen a shift away from simply using negative screens to remove stocks from a portfolio towards fully integrating ESG as part of a holistic approach to investment management***
>
> **Taylor Jordan**

Q Some investors run into obstacles when first thinking about integrating impact into their portfolio. What is the typical learning process?

Goldstein: People often come to us because they're stuck. They're either *actively* stuck, because stakeholders disagree regarding different mental models, perceptions and understandings, or they're *passively* stuck, overwhelmed by the variety of choices and potential entry points. For us, step one is really about helping them understand the range of tools and disciplines. Investors need to understand the ESG investing landscape across asset classes and mission areas, as well as the variation in breadth and depth of quality managers in the market. When you bring those three things together, a crisp, executable entry point usually emerges, and I think that's what people need first.

It's also important to remind investors that this is an investing problem, not a philosophy problem. Dwelling on debates on "does this work" is not a particularly constructive conversation. You don't ask if investing works; you say, it's hard and let's try to do it well. ESG and impact investing is no different.

Q What are some of the challenges you face when developing a broad and diversified impact portfolio?

Jordan: Some ESG and impact strategies are thematic, which can lead to sector concentrations. There are also some gaps in the market where there just aren't sufficient opportunities for quality impact investments. But you don't need to be 100 percent impact from day one. You can start "conventional", then move into values alignment and ESG. And then, over time, as the market develops, you can really build »

» out a fully diversified impact investment portfolio.

Q As you construct and manage these portfolios, how do you measure the impact they're having?

Goldstein: Impact can be assessed at various levels, from a portfolio level to an asset class level, as well as to an underlying manager level. All of these are important. First and foremost, clients want to see their full portfolio progress towards what they care about. Within an asset class, they want to understand the capital efficiency of different capital tools to create certain environmental or social outputs. And then they want to know how managers are performing on impact metrics. This all goes into an annual impact report that needs to have the same rigor and robustness as financial reporting.

Q There seem to be two broad categories where investors can have an impact: *people* and *planet*. Can you share some examples of investments that you've made in each of those categories?

Jordan: In the people category, we look for managers and companies that are serving low-income populations in both developed and emerging markets. Initially these populations at the base of the economic pyramid need basic financial services, but there is also huge demand in adjacent areas like insurance, housing, etc.

On the environmental side, we made a number of investments in alternative energy, both in private equity as well as in real assets. Where we're seeing real growth is in areas such as solar development, where the price point has come down such that it has become much more competitive with traditional fossil fuels, and there is the potential to drive real financial value.

Q Local expertise and know-how is presumably of paramount importance for such investments. How do you think about evaluating impact managers in private markets?

Goldstein: As with anything in private markets, really good manager selection is absolutely paramount. For us, the common denominator is high-quality teams and focused strategies that can pass the full rigour of investment and operational due diligence, as well as engage in an institutional reporting and monitoring regime. It is important to look at teams and strategies that have a strong focus that correlates to a measurable social or environmental output. We look for where the investment thesis and the impact thesis are in sync with each other; it could be jobs created for low-income communities, megawatts of clean energy generated, land and forest preserved or restored – a whole list of very specific, quantifiable metrics that are material to the investment strategy.

Jordan: Evaluating impact managers looks a lot like evaluating conventional managers. If impact managers pass muster relative to the same criteria that guide regular selection, then we'll invest in them. And if they don't, we won't. That said, many ESG and impact managers are younger and have less-established track records. This necessitates additional due diligence to understand the team and the strategy, as well as the operational risks associated with these managers.

Q Over the next five years, what do you think will be the biggest trend that we'll see in ESG and impact investing?

Jordan: We expect ESG to continue to go mainstream and, over the long term, we think ESG will be fully incorporated into the investment due diligence process. ■

> ***It is important to look at teams and strategies that have a strong focus that correlates to a measurable social or environmental output***
>
> **John Goldstein**

John Goldstein *is a Managing Director at Goldman Sachs Asset Management, based in San Francisco. He co-founded Imprint Capital Advisors, a leading institutional impact investing firm acquired by Goldman Sachs in 2015, with Taylor Jordan in 2007 to help foundations, families and financial institutions create and manage impact investing programmes and portfolios. Previously, he co-founded Medley Capital Management (MCM), a private investment firm, and before that he was a management consultant at Andersen Consulting (now Accenture). John has been an advisor or board member to a diverse set of organisations in the impact space, including the US National Advisory Board (NAB) of the G8 Social Impact Investing Task Force, the Global Impact Investing Network's (GIIN) ImpactBase initiative, McKinsey's working group on Social Impact Bonds, and the UN Capital Development Fund.*

Taylor Jordan *is a Managing Director at Goldman Sachs Asset Management, based in San Francisco. He co-founded Imprint Capital Advisors with John Goldstein in 2007 and, in his capacity as CIO of Imprint, designed Imprint's investment programme and chaired its Investment Committee. Previously, he served as Director of Investments at RSF Social Finance, a San Francisco-based social finance organisation, where he oversaw capital markets and designed and managed a multi-asset class impact investment programme. Prior to impact investing, he served as the Executive Director of a nonprofit membership organisation and co-founded a multimedia technology company. He received a BA in Economics from Colorado College.*

A gap between continents

Investment professionals say ESG integration is more developed in Europe due to limited partner pressure, writes Annabelle Ju

More than a decade ago, Kofi Annan, then the UN secretary-general, gathered a group of institutional investors from around the world to develop the UN's Principles for Responsible Investment (PRI). Today there are 1,380 signatories comprising asset owners, investment managers and services providers representing $59 trillion in assets under management.

The environmental, social and governance (ESG) factor within private equity investing is still in its nascent stage: in continuous development driven mostly by LPs, particularly those in Europe.

Mirja Lehmler-Brown, senior investment manager at Aberdeen, leads ESG efforts for the private markets team and has categorised the evolution of the private equity value creation model into three phases.

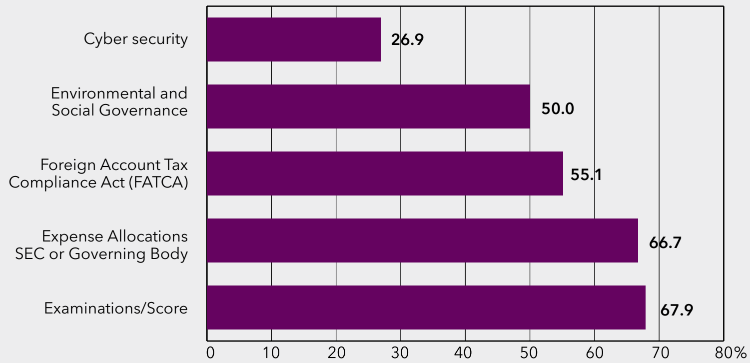
The first was financially focused and the second operationally focused. In the second phase newly-hired operational partners were tasked with achieving cost and efficiency savings. Having progressed through these phases, private equity managers are able to focus more on sustainability issues, with the third (and current) phase concerned with achieving long-term sustainable growth.

"Europe is ahead of the US and Asia when it comes to ESG issues, with most European general partners actively incorporating ESG topics into their investment processes," says Lehmler-Brown. "While some of the larger US GPs have incorporated ESG into their policies, it has not yet trickled down to the smaller firms.

"My understanding is in the US there are lots of firms that still don't have a [ESG] policy. It's larger scale rather than grassroots activity."

QUESTION OF PRIORITIES

Which of the following have become a part of your standard operational due diligence questionnaire/process?



Source: PEI Research & Analytics

In a *Private Equity International* survey of 73 LPs last year, 50 percent of all respondents said ESG was part of their standard operational due diligence questionnaire. Regionally, however, divisions could be seen. In Europe, 77 percent of respondents acknowledged ESG, compared with 33 percent and 32 percent in Asia and North America, respectively.

The same survey found that eight of the 30 European investors ranked "adherence to ESG principles" as one of the top three criteria when selecting a fund manager. In contrast, only one Asian investor of the 12 who answered, and none of the 31 North American investors, selected ESG.

Hamilton Lane managing director Ana Lei Ortiz sees a missing puzzle piece for industry-wide ESG implementation.

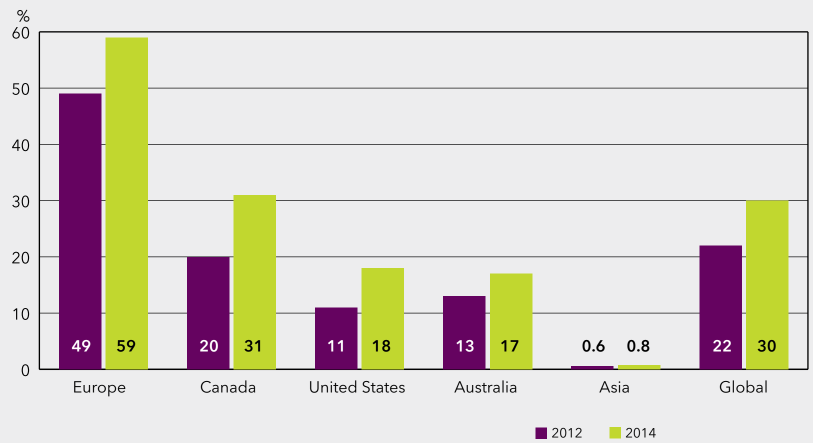
"Larger GPs have a lot of resources, while the smaller ones are figuring out where they want to be thinking about ESG, because all LPs approach it differently," she says. "If we can help standardise ESG due diligence a little bit, in terms of types of questions and metrics, it would make it more likely that more GPs would respond and begin integrating ESG into their processes. Smaller GPs are being overwhelmed for information around ESG."

The geographic discrepancy may also be tied to different regulatory environments, according to Candice Brenet, CSR [corporate social responsibility] officer at Ardian in Paris. The relative advancement of European investors' ESG integration could be owed to more prescriptive regulations – such as those surrounding employment – than those faced by their US counterparts. Indeed, Lei Ortiz »

> *If we can help standardise ESG due diligence, in terms of types of questions and metrics, it would make it more likely that more GPs would respond and begin integrating ESG into their processes. Smaller GPs are being overwhelmed for information around ESG*
>
> Ana Lei Ortiz

ESG TAKES OFF

Proportion of SRI relative to total managed assets



Source: 2014 Global Sustainable Investment Review

» said the discussion around ESG is more political in the US than Europe.

"The higher adoption rate [in Europe] may be because there's less debate here around certain things," she says. "In the US, there's more discussion around 'what does ESG mean?' and 'do we really want to introduce this?' but certainly, the high profile US LPs are vocal on ESG."

According to TorreyCove Capital Partners' *ESG and Private Equity Survey* from December 2015, the proportion of socially responsible investment (SRI) relative to total managed assets was the highest in Europe. In 2014, 59 percent, or $13.6 trillion, of total European AUM accounted for SRI, compared with $8.6 trillion in 2012. In the US, the portion was slightly lower, at 31 percent ($6.6 trillion).

Brenet says she notices an increasing interest across all LPs, and ESG due diligence is becoming "pretty common".

The same TorreyCove report found that, globally, more than half (57 percent) of private equity firms surveyed indicated they made a "formal public commitment" to ESG, and 55 percent had implemented a formal ESG policy, citing investor pressure as a large incentive for general partners to do so.

In fact, according to the report, outside pressure from investors coupled with risk management – rather than a simple question of firm culture – are the main factors fuelling ESG interest among fund managers.

"We see a wide diversity of questions raised by the LPs that shows their level of understanding and maturity," Brenet says. "But I think there is one common theme: LPs really ask GPs to integrate ESG in their investment process."

Aberdeen, Ardian and Hamilton Lane are three of the 1,380 signatories to the UN PRI. There are 328 signatories in the US and Canada including Puerto Rico, 781 in Europe, 72 in Asia, 62 in Latin America, 135 in Australia and New Zealand, 12 in the Middle East and 55 in Africa, according to the UN PRI website. ■

Carbon-related risks and opportunities

Thierry Déau explains why environmentally responsible infrastructure is vital for both planet and portfolio

***Déau**: Meridiam calculates both direct and indirect carbon emissions*

Climate change and carbon-related issues are vital to factor in when considering infrastructure investment, both in terms of risk and opportunity. Climate change and carbon are increasingly discussed in the investor community with various approaches to this subject.

From a risk perspective, it is essential to engage in carbon-related issues. It is key to include an analysis of climate and energy risks as well as opportunities during the investment phases of projects. As an integrated part of the investment process, a qualitative assessment of the energy, carbon, and climate-related risks which have potentially negative financial, operational, commercial, or reputational impacts on the project should be undertaken on the basis of a systematic analysis framework.

For instance, one of the first risks to consider is the likely effects on a portfolio's performance engendered by increased fuel prices and/or stricter regulation relating to carbon pricing. A second concern would be the significant reputational risk that is associated with carbon-heavy projects, which would deter responsible and ethical investors from otherwise valuable projects. This can ultimately leave certain types of projects "stranded".

From a risk perspective, preparing for climate change and extreme weather events to which projects may be exposed is also crucial. In addition to the deterioration that can be caused to such assets, factors such as the continuing usability of the infrastructure, increases to operational or maintenance costs or increase of insurance premia are factors that need to be considered.

Before making the decision to invest in a project, a detailed carbon, energy and climate change risk analysis should therefore be carried out. This risk analysis should take into account matters such as how a project's energy supply will be managed throughout its life, how that project is exposed to energy pricing volatility, and how a project will react to climate change and extreme weather events. A rail project, for instance, in low-lying fields near to an area prone to flooding will obviously have to take into account the threat over the next decades of rising sea levels. A road in the Gulf of Mexico will have to forecast likely effects on the road of climate change-related increases in the frequency and severity of heavy storms that will damage the project's infrastructure.

The analysis should examine a given project's plan to transition to a low-carbon economy. This will not just affect projects which might be expected to be the most 'carbon-exposed' in the layman's imagination, such as roads, but every project. The analysis of the transition to a low-carbon economy should try to forecast the impact of increased costs driven by weightier requirements in the context of tightening carbon regulation, and also the impact of policy changes induced by carbon markets and changes in carbon taxes. It should also forecast the impact of greenhouse gas emissions from a given project. By doing these analyses and synthesizing them into one coherent one, it is possible that an investor can make a helpful risk assessment of a project that will go some way towards whether to invest in it and if a 'Go' decision is subsequently made, how these risks can be managed and mitigated over a project's lifetime.

In addition to the approach mentioned above, a number of investor initiatives refer to carbon footprinting of portfolios. Given the importance of infrastructure projects

> **From a risk perspective, preparing for climate change and extreme weather events to which projects may be exposed is crucial**

(especially when considering the full scope of impacts and including indirect emissions) and the ability to estimate future carbon footprints with some accuracy as the objects are well defined, this dimension should be included when considering infrastructure investment. Meridiam reports on the carbon footprint of its projects to allow our investors to report on it to their own stakeholders should they wish to do so.

There are ways whereby an investor can work with stakeholders in a project – procuring authority, contractors, local community groups to name only a few – to plan how to approach carbon matters in a systematic and easy-to-understand way, such as some well-developed and sophisticated carbon calculation tools.

In the interest of transparency and completeness, Meridiam has taken the decision that in each of its carbon footprint calculation tools, both direct and indirect emissions will be taken into account.

Scope 1 emissions of greenhouse gases (GHG) are the most obvious; GHG emissions which are directly related to a project's activity, such as combusted fuel used on a tunnel boring machine for instance. Scope 2 emissions are more indirect; GHG emissions from the generation of purchased electricity that is needed for a project's activity (generators for contracted builders' accommodation for example). Scope 3 emissions are yet more indirect, and are emissions that result from the production of materials purchased from other parties and used in the project's activity, such as the steel used to make a rail track or such as employee business travel or waste disposal.

At Meridiam we take into account all three of these levels in the interest of transparency and corporate responsibility. This approach also makes more sense from a risk analysis point of view. On one social infrastructure project, for instance, we found that despite the construction phase's carbon footprint being relatively low, the forecasted footprint for the operational phase was very high. This was because the facility was built 20km away from a train station, meaning that the vast majority of its users travelled to it by car; an indirect emission that added greatly to the footprint. This kind of emission can of course be mitigated by the introduction of car sharing incentive systems and suchlike.

Once the relevant data has been compiled for a project, the next step is that it must then be compared to a reference situation, which is defined as the situation that would occur without the project. 'Net' emissions of the project are then assessed to be the 'gross' emissions of the project minus the emissions that would take place in the reference situation. Obviously a greenfield social infrastructure project will not have a reference situation, but for brownfield road projects this is a useful and simple aid to help determine if a project is likely to have a positive or negative net impact on carbon emissions.

> **Meridiam reports on the carbon footprint of its projects to allow our investors to report on it to their own stakeholders should they wish to do so**

By adopting and utilising the approaches above – a carbon risk analysis and a carbon footprint impact assessment – a responsible investor can determine whether or not to invest in a project and, should the decision be made to do so, how best to deal with the challenge of addressing the issues presented. Meridiam believes that any long term investor should incorporate this into their investment strategy on a systematic basis in order that they are aware of carbon issues and so manage their portfolio investment decisions accordingly.

In turn, once an asset has been acquired, the asset management team must be required to report at regular intervals on the carbon-related matters of a given project to investors. This will therefore become of salient importance to those they report to (their own clients or investors) and sensible and sensitive carbon management may therefore become a benchmark within infrastructure investing. It is not only a prudent strategy that will reward those who take it on in terms of excellent reputational risk management and mitigation, but also one that will improve the lives of communities globally and will fit in very well with increasing demand for environmentally responsible infrastructure. ■

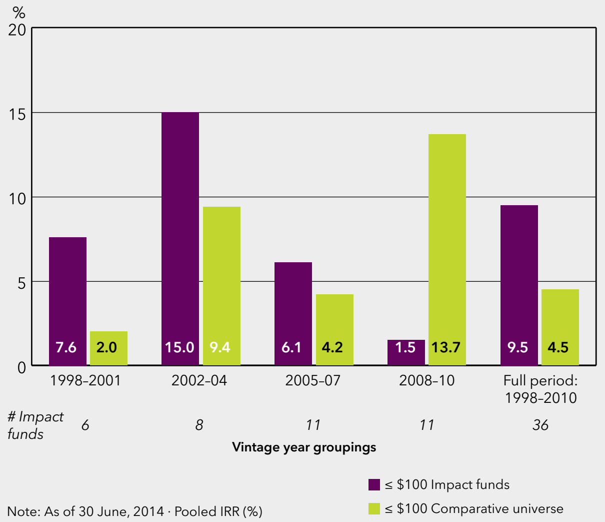
IMPACT INVESTING

On a level

A new benchmark shows backing impact investment funds needn't require a financial sacrifice

IMPACT INVESTING …

IRR by vintage year and fund size: ≤ $100m

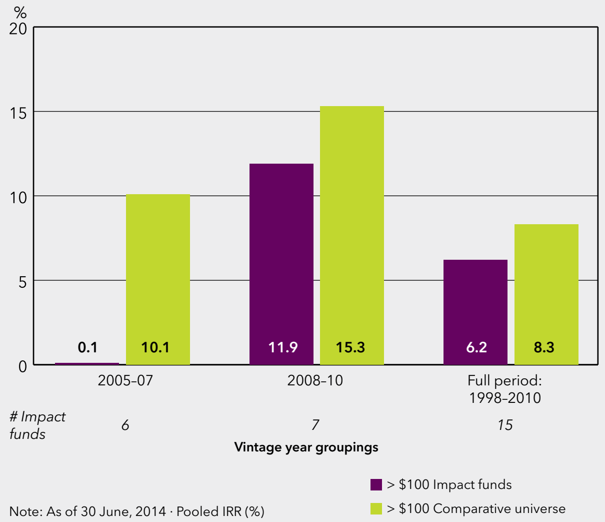


Note: As of 30 June, 2014 · Pooled IRR (%)

Source: Cambridge Associates/Global Impact Investing Network

… CAN PAY OFF

IRR by vintage year and fund size: > $100m



Note: As of 30 June, 2014 · Pooled IRR (%)

Source: Cambridge Associates/Global Impact Investing Network

It has been a commonly-held view among some investors that backing impact-focused funds requires a sacrifice on the side of financial returns. However, an impact investing benchmark developed last year by Cambridge Associates and the Global Impact Investing Network may well lay these rumours to rest once and for all.

The benchmark compares 51 impact funds with $6.4 billion in combined assets under management (AUM) against a comparative universe of 705 funds, with a combined AUM of $293 billion, all raised between 1998 and 2010.

The research found that across all vintage years the pooled internal rate of return (IRR) for the impact funds is 6.9 percent, compared with 8.1 percent for the funds in the comparative universe.

However, vintage year had a significant effect. Impact funds raised between 1998 and 2001 delivered a pooled IRR of 15.6 percent, compared with 5.5 percent for the comparative universe. The performances were in line for 2002-04 vintage funds. However, 2005-10 vintage impact funds have lagged.

Emerging markets impact investing funds – the most represented geographic group in the study – raised between 1998 and 2004, whose investments have largely been realised, had a pooled net IRR of 15.5 percent. Those in the comparative universe have a net IRR of just 7.6 percent.

As with the overall picture, the more recent story is not so rosy; 2005-07 vintage emerging markets impact funds delivered a net IRR of just 2.8 percent, compared with 11 percent for the comparative universe. In the period between 2008 and 2010 the gap narrows to 9.8 percent versus 13.0 percent. However, as the benchmark notes, 2005-10 vintage funds are still largely unrealised (DPI is 0.3x while TVPI is 1.2x) and therefore it's too early to draw conclusions.

Impact investing funds under $100 million delivered an IRR of 9.5 percent, compared with 4.5 percent for the comparative universe. Meanwhile, those over $100 million delivered a 6.2 percent IRR in aggregate between 1998 and 2010, versus 8.3 percent for the comparative universe.

It's still early days for impact investment funds, but this initial analysis bodes well for investors seeking to satisfy both financial and social goals. ■

LP's PERSPECTIVE

The USS approach

In an extract from The Guide to Responsible Investment, David Russell, co-head of the responsible investment team at USS Investment Management, explains how the £48bn pension scheme integrates non-financial considerations into its private funds programme

Russell: *many funds providing additional information*

The nature of the limited partner structure means it is essential that LPs have processes in place to ensure that detailed due diligence is undertaken of the GP prior to any investment decision and that monitoring processes are put in place to track performance post investment.

To ensure that this happens, USS has developed a process to assess how the GPs in which we could and do invest address extra financial issues in their own investment processes and portfolio management. This process is designed to both integrate extra financial information into USS's internal processes and to ensure that our GPs are addressing them in theirs. In terms of the latter, this can be considered 'engagement' with the private equity sector in a similar way that engagement with publicly listed companies has evolved.

Private equity funds also tend to be blind pools. In most cases the LP is asked to invest in the investment idea that the GP has presented, as there are no underlying assets at the point of the investment. Due diligence in private equity, therefore, focuses on the processes that will be used by the GP in its due diligence and its management of assets in the future.

DUE DILIGENCE

The first step in the process for USS occurs during the scheme's due diligence assessments of potential GPs. Private equity is not just buyouts, where the private equity firm takes control of a company. The LP/GP structure is used for a range of asset types including, among others, debt, infrastructure and mortgages. As a result, while the process USS has developed for undertaking due diligence has some core aspects, it has to be flexible and adaptable to account for differences in the underlying assets.

USS undertakes its own traditional due diligence into GPs and once a prospective fund has passed an initial evaluation, a more detailed assessment is undertaken by the internal private equity managers. As part of that process, and before the investment decision is made, the RI due diligence is undertaken. This process is relatively simple, involving a brief questionnaire followed by either a meeting or teleconference between the GP, internal private equity staff and the USS RI team.

USS has developed its own questionnaire, which is sent to all potential GPs. This questionnaire focuses on the following four areas:

1. How RI issues are considered at the due diligence stage.
2. How extra financial issues are managed in the overall management of assets.
3. Communications associated with ESG issues.
4. Views on UN-supported Principles for Responsible Investment (PRI) and other ESG frameworks.

The aim of these questions is twofold:

1. To ensure the GP is aware that USS is interested in how it manages these issues and is prepared to answer questions around them.
2. To identify areas for further discussion during the second phase of the due diligence (that is, a teleconference or meeting).

It is now unusual not to receive written responses to these questions and it is rare for USS not to receive at least basic information from potential GPs. Indeed, many funds now also provide additional information including ESG policies and case studies as to how ESG issues have been incorporated into investment processes. USS is also seeing increased inclusion of ESG information in Due Diligence Questionnaires (DDQs) – the reports that GPs provide to potential investors as part of the marketing process. While this is frequently very limited information, it does indicate that the private equity sector is becoming both more used to seeing requests for information on ESG issues and more »

The story does not end once USS has invested with a private equity manager. As a responsible investor, USS monitors the GPs to which the fund has allocated capital

» proactive in providing it. Inclusion of such information, in DDQs for example, demonstrates how far the sector has moved in recent years.

The second phase of the process – the follow-up call or meeting – is extremely important. During these calls or meetings, USS asks for more detailed explanations as to how extra financial issues are assessed in the due diligence process, how they are managed across portfolios and how these issues are then communicated with LPs and other stakeholders.

In order to prepare for these meetings, USS reviews previous investments made by the GP to identify where ESG issues may have arisen in a portfolio company or asset. This generates specific questions that will usually be sent to the GP in advance of the call to enable them to prepare responses and to ensure that the appropriate people are available during the call to respond to the questions. The due diligence process then drills down to how the potential GP assessed those risks in their due diligence and managed them post investment. If it is a new fund (that is, a first-time fund or new GP), USS will even look back to a potential manager's investments at previous funds to identify appropriate detailed ESG questions.

Finally, USS – as a strong supporter of the UN-supported PRI – asks GPs for their views around the PRI as a framework for addressing these issues. USS does not require its GPs to be signatories to PRI, but does expect potential GPs to have processes in place to assess and address ESG risks and opportunities. USS does, however, encourage GPs to sign up to the PRI and a number of USS's GPs have become signatories to the Principles. In fact, the PRI already has a disproportionate number of private equity-focused funds as signatories at about 15 percent of its membership (this is higher than the average asset allocations to the sector by pension funds).

Based on the outcomes of these calls/meetings, responses to the questionnaire and other materials provided by the GP, the RI team provides a written opinion on the level of RI activity within the fund. This opinion is then discussed with USS's internal private equity team to identify any outstanding ESG risks concerns. This report includes, where relevant, the identification of issues for further engagement if USS decides to invest in the fund. This final opinion is then incorporated into a final report on the fund (a deal qualifying memorandum or DQM) and submitted to an internal Private Markets Investment Committee (PMIC), which takes the final decision on investment in GP.

ONGOING ASSESSMENT

The story does not end once USS has invested with a private equity manager. As a responsible investor, USS monitors the GPs to which the fund has allocated capital. The aim of this programme is to ensure that all of USS's GPs are assessed on a regular and ongoing basis (every two to three years) while the fund is investing in a particular private equity fund. This is irrespective of the type of private equity fund in which USS is investing (for example, secondary funds or buyouts). It may also be the case that due diligence is undertaken on new funds offered by the private equity manager; in such due diligence, USS would assess how RI has been incorporated in any previous funds' investments.

For each of these ongoing assessments, as with the initial due diligence, research is undertaken into the portfolio companies in which the GP has invested, to identify relevant ESG risks or opportunities that can be interrogated further. A member of the RI team then meets with representative

USS RI PRIVATE EQUITY QUESTION DATABANK

Key subject areas are:

- GP policy (or policies) relating to ESG factors.
- ESG risk/opportunity evaluation and management.
- Communication.
- Governance issues:
  - corporate governance of fund; and
  - corporate governance within portfolio investments.
- Social issues.
- Environmental issues:
  - climate change;
  - land use;
  - water;
  - air pollution; and
  - waste.

MORE IN-DEPTH QUESTIONS

Depending on the companies in the portfolio, different areas of questioning will be relevant for further detailed analysis (for example, retail companies and supply chain management, and energy companies and climate change). The following are examples of sample questions relating to climate change:

- How material do you believe risks associated with climate change (both weather related and regulatory) are for your portfolio companies and how are you assessing this?
- What share of your portfolio companies are in carbon-intensive industries (for example, cement, aviation, power generation, oil and gas)?
- How are carbon risks managed?
- What share of portfolio companies operate in markets where a carbon emissions trading scheme is operational or planned?
- How does the company monitor relevant climate change and carbon-related regulation?
- Do the company's activities include significant use of transport? In what ways might carbon emissions from this source be reduced?
- Has potential business disruption associated with extreme weather events been assessed?
- Have you assessed the flood risk associated with fixed assets at portfolio companies?
- Do you aggregate carbon emissions across the entire fund/across the GP? ■

members of the GP and questions the processes, actions and outcomes associated with the management of extra financial issues within the portfolio. These assessments are undertaken within the context of the LP/GP relationship, where the GP has ultimate responsibility for investment decisions and the management of its portfolios. As a result, USS does not become involved in managing issues at a portfolio or asset level.

USS believes its role as a responsible investor is to encourage its managers to integrate these issues into their management of assets and to be able to explain how these issues are being managed. Portfolio management is left to GPs as this is where their expertise lies. That said, USS does on occasion meet with portfolio companies to discuss management of environmental and social issues; this will usually be arranged by the GP.

> **“USS does on occasion meet with portfolio companies to discuss management of environmental and social issues**

This process is in the early stages of its implementation. Over the years the fund has seen approximately half of its 30 private equity fund managers and is continuing to roll out this programme to the others. Within the half it has already seen, USS has covered a significant proportion of the actual capital it has invested in the asset class.

To aid the fund with both its due diligence and ongoing assessment, USS has developed an internal databank of questions on extra financial issues to ensure that the effectiveness of meetings with GPs is maximised. This eight-page document covers the broad range of ESG issues, providing questions under the headings listed in the box, above. ■

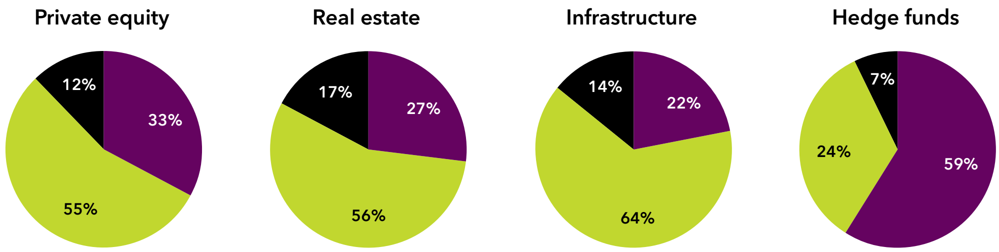
And finally…

What they said and what it meant for the responsible investment industry

To what extent does a manager's ESG approach factor into manager selection?

- Significantly
- To some extent
- Not at all

Source: LGT Capital Partners/Mercer



42%
Proportion of institutional investors who have introduced ESG criteria into their fund selection during the last three years *(LGT Capital Partners/Mercer)*

9th
Where 'climate change and environmental damage' ranks among concerns of global CEOs, behind 'over-regulation', 'geopolitical uncertainty', 'exchange rate volatility' and others *(PwC)*

34%
Institutional investors who believe the inclusion of ESG criteria has 'no effect' on risk adjusted returns. 57 percent said it increased returns *(LGT Capital Partners/Mercer)*

1/3
Proportion of institutions who say a manager's ESG approach has a significant effect on private equity manager selection *(LGT Capital Partners/Mercer)*

420
LP and GP members of the UN PRI's private equity 'work stream' established in 2008

"In reality if you look at ESG, it's about income generation, cost saving, avoidance of delays and building a more motivated staff which will help with turnover. There is a small piece of ESG that links to compliance, such as regulatory compliance regarding environmental permitting, but that's a very small part of ESG."

Actis' **Shami Nissan** tells *PEI* that the concept of ESG are often misrepresented (*PEI*)

"I think Africa is ahead of a lot of the developed world because the whole industry was started by DFIs. From day one we've reported on ESG, from day one we've reported on impact."

Runa Alam of Development Partners International tells *PEI* that African private equity leads the way in terms of measurement and reporting (*PEI*)

"More than three-quarters of Japanese [institutional investors] listed nuclear power generation in their top three ESG issues."

The authors of *Global Insights on ESG in Alternative Investing* highlight the effects of the Fukushima Daiichi nuclear power plant accident on investor trends (LGT Capital Partners/Mercer)

"In a more informed and principled world, there is pressure."

Former BVCA head **Mark Florman** explains why his external rate of return (ERR) metric will catch on (*PEI*)

"Within the last 12 months, I've had conversations with CEOs of major corporates [about climate change] in Europe and they just say, 'It's not real, it's not something I should be bothered about'."

Katherine Garrett-Cox, the CEO of investment firm Alliance Trust *(Guardian)*

"In many cases energy regulation, pensions regulation and insurance regulation are simply not integrated. The IIGCC has been engaging with the European Commission about the perverse impact that well-intentioned regulation might have, for example, on issues around energy unbundling and pension and insurance fund solvency."

Donald MacDonald, chairman of the Institutional Investor Group on Climate Change, tells the *PEI* Responsible Investment Forum that the regulatory environment needs to improve if investors can help tackle climate change (*PEI*) ■

PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

GLOBAL EVENTS CALENDAR 2016

Private Equity International specialises in hosting premier events for the alternative asset class all over the world.

As the leading voice in private equity investment, our events offer an excellent combination of education and interaction which will enable you to gain practical and strategic knowledge whilst developing your private equity network.

2016 DATES

CFOs and COOs Forum	27-28 January	**New York**
Direct Investor Summit	14-15 April	**Hong Kong**
Operating Partners Forum: Europe	19-20 April	**London**
Global Investor Forum: Asia	19-20 April	**Tokyo**
Private Fund Compliance Forum	10-11 May	**New York**
Family Office & Private Investor Forum	10 May	**Hong Kong**
Responsible Investment Forum	25-26 June	**London**
Investor Relations and Communications Forum	14-15 June	**New York**
PE/VC Finance and Compliance Forum: San Francisco	October	**San Francisco**
Operating Partners Forum: New York	19-20 October	**New York**
Family Office & Private Investor Forum: Singapore	November	**Singapore**
GIIN Investor Forum	7-8 December	**Amsterdam**
Women in Private Equity	December	**London**

www.privateequityinternational.com/events

NOTE: This is a provisional calendar and dates, locations and events may be subject to change at the discretion of the organisers.