



How can GPs integrate ESG? An LP's perspective

By Maaïke van der Schoot, AlInvest Partners

Across the corporate landscape, there is a growing recognition that good corporate behaviour promotes stronger management, enhances stakeholder relationships and creates better-performing companies in the long term. As significant investors in a wide variety of companies, general partners (GPs) are well positioned to ensure that companies deal adequately with environmental, social and governance (ESG) matters. This may not only have a positive impact on the businesses themselves but also on the value that is created for the shareholders.

Besides the financial interest they have in maximising value creation in their portfolios, GPs can also be motivated to adopt and pursue responsible business practices in their organisation and the companies in which they invest by their responsibilities as a shareholder, by their responsibilities vis-à-vis their limited partners (LPs) and other stakeholders and/or by regulatory requirements.

A growing number of institutional investors, many of whom are LPs in private equity funds, believe that ESG factors can impact the performance of their portfolios to varying degrees across companies, sectors, regions, asset classes and through time. Good management of ESG issues could protect or significantly enhance profitability and the value or attractiveness of their investments from various perspectives. Applying ESG principles may avoid embarrassing situations that can harm a company's reputation and brand value, as well as potentially adversely affecting the reputation of general and limited partners. Furthermore, they believe that good management of ESG issues can lead to the avoidance of future costs or significant savings. Lastly, they think an improved focus on ESG can also create business opportunities. For these LPs, companies and GPs that focus on ESG are more attractive investments.

AlInvest Partners, on behalf of its investors, has committed over €28 billion to private equity funds of more than 220 GPs in the last decade. Following the formulation of its own corporate social responsibility policy in 2008, ESG has become an integral part of AlInvest's due diligence process for new investment opportunities. Having sought active dialogues with both GPs and portfolio companies to encourage them to improve their own ESG approach, AlInvest is well positioned to offer a broad analysis of some of the best practice GP activity on ESG integration.

The growth of the private equity industry in the last decade has sparked an increasing interest from politicians and the general public. They focus both on financial parameters of private equity ownership like leverage levels, as well as non-financial aspects, for example, labour relations and governance structures. Furthermore, public policy and regulation around ESG issues is growing worldwide, for companies as well as the investors that control them. Paying insufficient attention to compliance can lead to high costs and suboptimal value creation in private equity portfolios.

Although many investment professionals may be reluctant initially at the thought of including additional requirements to their organisation's processes and procedures, they should realise that many GPs already incorporate risk management and a reasonable level of ESG due diligence in investment decision making. Often this is concentrated on compliance and ESG-related liabilities, and is performed in an ad hoc manner. For those investors it is not a big step to start taking a more structured and strategic approach to integrating ESG, which can ensure that these issues are managed consistently, risks and opportunities are more easily identified and information can be communicated effectively to stakeholders. Such an approach consists of several stages, including the formulation of a responsible investment policy, the integration of the policy into the organisation and processes, and ESG reporting.

Defining a responsible investment policy

A well-defined responsible investment policy gives guidance and support to ESG decision making in investment processes and portfolio management. It will also act as a basis for reporting and responding to ESG inquiries from LPs and other stakeholders.

The starting point is the GP's own vision and ambitions. However, in defining the policy, the requirements of its key stakeholders should also be taken into consideration as well as its overall business strategy. Due to the vast differences between organisations, there is not one uniform responsible investment policy that can be formulated for the whole private equity sector. Each GP will have to decide which approach to take and will most likely find that it may have to adapt its strategy and ambitions as responsible investment becomes more fully integrated and the external environment changes. However, there are a number of questions that a GP can ask itself and the answers to these may serve as the basis of formulating its policy (see table below).

Formulating the responsible investment policy

- Why do we believe ESG is important?
- Will we focus on all aspects of ESG or just a subset?
- What ESG attention do the industries in which we invest require?
- What do our key stakeholders require?
- How do the geographies in which we and our portfolio companies operate affect our responsible investment policy?
- What is our typical investment type?
- Will the responsible investment policy only cover (potential) investments or also the management firm?
- Do our ambitions match the resources we have available?

Why do we believe ESG is important?

Is this investment-driven, based on ethical beliefs, due to regulatory obligations, required by LPs, and/or something else? Once this has been established, the scope of the ESG efforts can be determined: will it only be a focus on regulatory compliance, or also on reputation management, risk management and/or creating business opportunities?

Will we focus on all aspects of ESG or just a subset?

As ESG covers a very broad number of aspects, GPs may choose to (initially) focus on a subset. This could, for example, be driven by resource constraints, knowledge available in the firm, most urgent issues in the sector in which the GP typically invests or fundamental beliefs. However, from a risk management perspective, it would make sense to cover all three elements. If a GP is focusing on the environmental aspect only, for example, it is potentially ignoring risks in other categories. Furthermore, LPs and other stakeholders may expect that eventually all three ESG pillars are addressed by GPs and their portfolio companies, where relevant.

What do our key stakeholders require?

Some LPs may have certain geographies, sectors or activities they cannot invest in, like controversial weapons or countries with doubtful human rights reputations. Certain investors will require extensive ESG reporting, whereas others will not require any. A GP could have portfolio companies to which the policy must be tailored, for example, a GP that invests in clothing shops could decide it wants to be certain that there are no links to child labour in its investment portfolio, but it is very difficult to guarantee this as retailers typically do not have full control over their supply chain. In this case, it would be better to formulate certain ambitions and to assist the portfolio company in continuously improving its visibility and control of its supply chain.

How do the geographies in which we and our portfolio companies operate affect our responsible investment policy?

In some respects, a functioning system of appropriate regulation, oversight and enforcement is a risk mitigation tool on which a GP is implicitly dependent. However, these systems can differ significantly in different regions. While it may be safe to assume that, for example, the French and German labour codes are robust and will be monitored effectively, labour conditions in certain developing markets are much more difficult to assess. In these situations, a GP should ideally create a guideline, defining what it deems to be acceptable labour conditions. When the GP then considers an investment in the future, this guideline will clarify what information is needed to make a proper assessment in due diligence and in monitoring the situation thereafter.

What ESG attention do the industries in which we invest require?

Each industry faces different ESG risks in varying degrees. At a software company, the number and extent of potential issues can be relatively small, including, for example, office energy efficiency, employee engagement and intellectual rights. A chemical operator on the other hand, could potentially face a large number of issues that can have a bigger impact, including various environmental challenges (water, pollution and noise), as well as social issues (health and safety) and regulatory requirements.

What is our typical investment type?

Being the majority shareholder, a GP can exercise more influence on a company's ESG performance than when they hold minority positions. Also, larger companies typically face different ESG challenges from smaller companies. Venture capital start-ups, with a limited number of employees and small offices or operational sites, will typically have few or no ESG issues. However, in managing their assets, venture capital firms should be aware that ESG issues could increase as their portfolio companies grow in size. At the other end of the scale, large companies, with a high number of employees and one or more large operating sites, need to be more considerate of how ESG impacts their business at various levels of the organisation. Also, people often have higher expectations of larger companies and, through their public exposure, they are likely to attract more attention from NGOs and the media than smaller businesses. Increasingly, NGOs appear to bring ESG issues at private equity portfolio companies to the attention of LPs in the fund, asking them to take action. From this respect, AlpInvest were contacted a number of times in 2010 regarding labour and supply chain situations.

Will the responsible investment policy only cover (potential) investments or also the management firm?

The key ESG aspect for GPs in their own organisations is probably the human resources policy. This also matters to its investors, as many LPs will ask questions regarding employee retention and corporate culture when undertaking due diligence of a fund. As professional services firms, with limited staff numbers and office locations, the environmental and social impact of GPs is usually relatively small. However, by aiming to be good corporate citizens and taking their ESG responsibilities seriously, they can be an example for their portfolio companies. Opportunities for improvement, either small or large, will exist in many GP organisations, from strategic choices in communication with stakeholders to more practical matters such as office supplies recycling. Internal focus on corporate responsibility will help raise employees' awareness for the matter, which may positively impact the focus on ESG in the investment processes as well.

Do our ambitions match the resources we have available?

If resources do not match ambitions, GPs will need to prioritise. From an investment perspective, it would probably make most sense to first focus on aspects that can have a substantial negative impact on the investment performance, like risk management and reputation damage, before addressing positive value drivers including identifying operational efficiencies and new business opportunities. A large buyout firm may have dedicated operations professionals assigned to the task or larger funds that it can deploy for external advice than a smaller venture capital or private equity firm but, on the other hand, these GPs typically pursue smaller, less complex investments for which it may be easier to make a good ESG assessment.

In addition to the above, a GP can seek expert advice, for example, from consultants, and/or can look at existing ESG standards for inspiration and guidance. Examples could include general responsible investment principles, for example UN-backed Principles for Responsible Investment (PRI), Private Equity Growth Capital Council responsible investment guidelines, ILPA governance principles, as well as more specific ESG business principles and guidelines, like the UN Global Compact, the Global Reporting Initiative (GRI) and the many industry sector codes that are available. However, these standards are to be used as a starting point for defining and implementing a responsible investment policy that suits the GP organisation and adopting them should not be an aim in itself.

Implementing the responsible investment policy

Successful integration of ESG into the organisation, investment process and portfolio management requires internal buy-in and awareness across the whole organisation of how the firm's responsible investment policy will affect their roles and responsibilities.

Organisational requirements

As with any company ambition, it starts at the top. Commitment of senior management to the responsible investment policy is critical for a successful rollout throughout the organisation. Therefore, it is preferred that one of the senior partners takes overall responsibility for the execution and continuing development of the policy. This role can also partially be delegated to a wider committee of partners and managers that regularly discusses progress made and actions that need to be taken.

Those carrying overall responsibility for the responsible investment policy, do not necessarily need to be the ones implementing it on a day-to-day basis. This responsibility can be delegated to one of the investment professionals or a staff member, for example, a dedicated responsible investment officer, ESG expert or a legal counsel. This choice will depend on the agreed strategy and the resources available and within the industry GPs are already seen to be approaching this in different ways.

Once it has been determined how ESG will be integrated into the firm's investment practices, employees can be trained on how to apply this in their day-to-day activities. More on integration of responsible investment in the investment and portfolio management processes can be found in the sections below. Successful training should result in enhanced awareness of ESG issues and their relevance to the investment portfolio, which will facilitate implementation of the firm's responsible investment policy. Besides detailed explanation of the new ESG-related process requirements, it can be useful to include practical examples and case studies. For most GPs the key objective will be to ensure that investment professionals are sufficiently equipped to identify the magnitude of specific ESG risks and opportunities and call in experts when they need further information. The employees also need to be informed on the inclusion of responsible investment in their job descriptions and/or performance evaluation criteria.

Investment Process

Responsible investment considerations can play a role in each stage of the investment process, from transaction sourcing, through due diligence and to the final investment decision.

The most obvious way in which transaction sourcing can be impacted is if the responsible investment policy includes negative screening elements, that is, restrictions that prevent the GP from investing in certain industries or geographies. Another way sourcing can be impacted is if the GP applies positive screening and is specifically looking for companies with a good responsible investment profile like cleantech companies or has a certain view on sectors where they believe they can create substantial value by focusing specifically on ESG. For many LPs, responsible investment goes beyond this investment selection process, and their main focus is on ensuring that all material ESG risk and opportunity factors are integrated into the investment decision and in portfolio management.

With respect to the due diligence process, the key objective is that the target's ESG performance and its potential consequences for the business case are well understood. The scope of the due diligence process will vary depending on the nature, location and activities of a business as well as the GP's responsible investment policy. However, in order to ensure that all current and reasonably foreseeable ESG risks and opportunities are identified, a holistic approach is recommended that goes beyond focusing on regulatory compliance and obvious potential liabilities like hazardous waste contamination or trade union relations. Such a holistic approach could include a focus on aspects like inherent ESG risks and opportunities associated with the sector(s) and/or geographic location(s) of the target's operations; the existence of an ESG policy at the target that satisfactorily incorporates relevant topics; an assessment of the management's attitude and the company's reputation with regards to ESG issues; and the impact of ESG issues on the business model. For example, a fish processing company should consider the longer term effects of overfishing and stricter fishing regulations on its supply chain and may therefore need to look for more sustainable sources of fish to ensure its future.

Depending on a GP's due diligence processes, ESG can be incorporated in various ways in the procedures of the investment analysis. Whichever way is chosen, it is important that the approach is structured so that all potential areas, as defined by the responsible

investment policy, are covered and satisfactorily answered. The output of the approach should be that at the time the investment decision is made, the team is able to present an overview of ESG risks and opportunities and their magnitudes.

In order to ensure maximum take-up by investment professionals, the ESG procedures must be designed in such a way that they fit logically into a GP's existing transaction approach and do not require disproportionate attention within the whole deal process.

Tools that could facilitate ESG due diligence include standardised or sector-specific questionnaires, ESG assessment tools and checklists covering typical ESG focus areas per sector. A number of GPs, including KKR, Carlyle and 3i, already have ESG frameworks in place to support their investment professionals in assessing ESG matters. ESG information can be collected from various sources, including the deal data room, the management of the company under consideration and public research. Depending on the internal resources and expertise available, it may be necessary to seek external expert advice to make sure that certain ESG issues relating to a specific company or sector issues are adequately covered.

Ideally, the GP has the full ESG picture prior to finalising the transaction. However, due to timing issues, constrained resources or limited access to information this may not be achievable. In that case, initial due diligence should focus on identifying those ESG risks that can have a material negative effect on the investment performance, either from a cost or a reputation point of view. Risks differ per company but could, for example, include clean-up costs for historical land contamination, poor labour relations leading to strikes, rising commodity prices as a result of climate change, changes in environmental regulation or child labour in the supply chain. Even unlikely events should not be ignored if they may potentially have a high impact, such as the explosion of an oil platform. The investment team may gain additional comfort if it can determine that the existing ESG culture at the target company is good. ESG aspects that were not investigated during the initial due diligence process can then be addressed postinvestment, offering potential to tackle smaller risks and opportunities for value creation, like operating efficiencies and new business opportunities early on.

It would be advisable to put one team member in charge of the ESG due diligence workstream, including the liaison with specialist advisers. This person can either be one of the investment professionals or an in-house responsible investment specialist. Although involving a specialist can bring relevant knowledge and allows the rest of the team to focus on other aspects of the business case, there is a risk that ESG is not perceived as an inherent part of the investment strategy and essential ESG knowledge is not shared with the rest of the firm. Also, certain organisations, particularly smaller GPs and venture capital firms, may lack the resources to appoint such a dedicated responsible investment professional. It should be emphasised that whoever is appointed in charge of ESG, this does not release other team members from their responsibilities to signal ESG issues and opportunities they encounter.

The investment proposal, or any other document that is prepared for the purpose of making an investment decision, should include an overview of all relevant and material ESG aspects of a transaction. Although individual aspects could be included in other parts of the investment analysis (for example, as part of the analysis of operational risks, the legal review, or underpinning of value creation opportunities), a dedicated section gives focus in the due diligence process and provides a complete picture of the ESG status of a target at the moment the investment decision is made. This may be especially beneficial when a GP is relatively new to responsible investment and the organisation needs to further familiarise itself with ESG issues. Such an approach can also help in embedding RI into the system. A structured approach, preferably with a measurable output, can also serve as a baseline for future reporting.

ESG performance is just one of a whole series of factors that GPs will consider when making investment decisions. Investors should not consider a company's ESG performance in isolation but rather how it may affect cash flow, revenues, profits and, hence, return on capital. If the outcome of due diligence is a low ESG scoring of an investment target, this is not necessarily a deal breaker. On the contrary, if the investment team identifies areas of

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ESG improvement potential, and is in a position to address these, together with management, following acquisition, this could represent a significant driver for value creation in a transaction. Some examples of this include reducing costs, improving governance or brand value, identifying new business opportunities and decreasing staff turnover.

Once a transaction has completed, the GP will start to work with the management of its new portfolio company to ensure maximum growth and value creation. ESG will be one of the factors that need to be considered in this process. The responsible investment policy in combination with the information that was gathered as part of the due diligence process, and recommendations that followed from this process, can be used as a baseline from which future strategies should evolve. The actions required will depend on the nature of the issues and opportunities that were identified.

As a starting point, the GP needs to consider whether the company has an ESG code that sufficiently addresses all aspects relevant to the company and the sector(s) and geography(ies) in which it operates. It is also important that this does not conflict with the GP's principles and values and, if necessary, the existing code should be adjusted or a new code established.

In the process of identification and tackling ESG issues, company management plays an important role. They will need to ensure compliance with any ESG code and will oversee implementation of the value enhancement measures. Depending on how effective the ESG approach of a company has been so far, the GP can take a more or less active role in overseeing and guiding management. If necessary, the GP can support management by providing ESG resources to the company, either from an internal or external ESG expert or from other companies within the GP's portfolio. Sharing of knowledge and good practice, either industry specific or more general ESG insights, can be beneficial for both portfolio companies and GPs. Especially in ESG, an area that is often relatively new to GPs, experienced management teams can add value to both the GP itself and to other investments in the portfolio.

In order to ensure that the GP can effectively monitor ESG progress in the portfolio company, it is important that management is aware of the GP's objectives and that the GP ensures that key ESG metrics are included in management reporting. It may also be advisable to put a manager of the portfolio company in charge of overseeing all ESG responsibilities. Throughout the holding period of their portfolio companies, GPs should keep themselves updated with changes that would affect the ESG performance of these businesses, thereby potentially impacting their value. These can include changes in consumer and investor preferences, regulation and technology. For example, as a result of the UK's Bribery Act 2010, companies were required to update any existing codes of conduct to ensure they were sufficient in light of the new regulations.

Besides implementing ESG for new investments, a GP may want to consider reviewing existing investments in order to be able to assess the key ESG risks and opportunities in its overall portfolio. Similar to new investments, the actions that could follow from this identification effort will depend on the possible effects on the value and saleability of each of the portfolio companies. For existing investments the envisaged holding period also plays a role as there will be more opportunity to implement changes if the company is still a few years away from the envisaged divestment. However, even for companies closer to exit it could prove valuable to review ESG practices in order to best prepare them for a sale or listing.

In preparing for an exit, it is advisable that a GP determines at an early stage whether there are ESG issues that need to be addressed before the divestment process can be started. Addressing these issues prior to this process commencing may help to maximise value and to be prepared for any information requirements during the sale process. At exit, it may be beneficial to present an integrated ESG story to prospective buyers, highlighting the current status of the company and the progress that has been made during the holding period. The original ESG due diligence can serve as a good starting point to make such an ESG assessment. In cases where no comprehensive ESG due diligence was undertaken as, for example, the investment was made before the GP had drawn up its responsible

investment policy, a more extensive assessment may be required. In case an IPO is the pursued exit route, sellers should be aware that listing regulations of stock exchanges increasingly include ESG disclosure requirements. Strategic buyers that are listed entities can also be affected by this.

Reporting

Increased transparency is at the heart of the requirement for improved ESG focus of asset managers. As part of the overall responsible investment programme, sufficient attention should therefore be given to the information that is shared with stakeholders, including LPs and the general public.

GPs should ensure that they receive relevant information from portfolio companies in order to be able to monitor and improve ESG performance. Based on this information, stakeholders of both the GP and the portfolio companies can be informed.

LPs can be interested in ESG information from various perspectives. This can include information on ESG incidents as well as evidence that their money is invested responsibly. The GP needs to agree with the LP in which instances and how they will be informed. ESG incidents can have an immediate effect on the reputation and/or valuation of the portfolio company. Ideally, LPs are informed as early as possible (that is, before it hits the newspapers) of these situations and actions can be taken to minimise impacts for the business and its investors. This also helps ensure they are prepared to answer any critical questions from journalists or their (pension) beneficiaries and they are able to assess the valuation impact. Information that shows LPs that their money is invested responsibly, in line with the agreed ESG investment policy requirements, can take the form of an overview of key achievements and metrics in regular quarterly reporting and portfolio reviews. A GP can make this information only available to those LPs that have expressed an interest in ESG. However, if the GP views ESG as a core element of its overall approach to risk management and/or its value creation strategy for portfolio companies, it needs to consider if and how it will communicate the ESG status and progress made to its whole investor base – including to those LPs who are indifferent or who do not (yet) believe in the intrinsic value of incorporating ESG as an investment consideration.

Besides LPs, there probably is a wider group of stakeholders that is interested in the ESG performance of the GP and the companies in which it invests, including employees, consumers, government, regulators and non-governmental organisations. As part of any ongoing dialogue with these stakeholders, GPs should consider the benefits of publicly reporting on ESG issues and other aspects of their business, either online or in print.

Conclusion

Private equity investors are well positioned to benefit from the increased focus on ESG matters. As long-term, majority shareholders, they can make changes and benefit from the impact of those changes at exit. Developing a responsible investment policy and ensuring that this becomes firmly embedded in the firm's processes and procedures, is a first step to gain maximal benefits from a responsible investment approach. It makes it easier to involve employees and portfolio companies in the identification and management of ESG issues and it facilitates the dialogue with and reporting to the various stakeholders. Over time, responsible investment requirements of the GP, its portfolio companies and stakeholders will change. Through regular reviews, the GP should ensure that its responsible investment policy remains relevant and up to date.