British Private Equity & Venture Capital Association

Guide to Responsible Investment

Putting Principles into Practice

Authored by

pwc

MARCH 2015

Contents

"Our Statement of Investment Principles reflects our commitment to consider ESG issues when making investment decisions. For Private Equity investments, we assess the GP's policies, processes and systems to identify any ESG related value drivers and to consider ESG related risks pre-investment."

Jonathan Ord,
Investment Manager, LPFA

"The Private Equity market has moved significantly in the last 6 years in engaging with the responsible investment agenda, partly because some LPs are asking pertinent questions. The imperative for this became stronger last year when the UK Law Commission made it clear that as part of their fiduciary duty pension funds should incorporate consideration of ESG issues in their investments where they are material. The message is clear: demand for Responsible Investment from pension funds is likely to increase."

David Russell
Co-Head of Responsible Investment, USS Investment Management

Preface

Value creation is at the heart of private equity. It is not surprising, therefore, to see more and more BVCA members embrace the responsible investment agenda. The focus by our members on measuring, managing and mitigating environmental, social and governance (ESG) risks as well as on seizing the opportunities has grown substantially in the five years since the BVCA published its first Responsible Investment Guide in 2010. So too has appreciation of the advantage for company valuation that a responsible approach to investing can provide.

This increased focus on responsible investing has, in part, been encouraged by demands from Limited Partners representing many of the world's major institutional investors and by greater regulatory pressures, as the quotations in this Supplement demonstrate. The real impetus, however, has come from the recognition by increasing numbers of private equity and venture capital firms that value is created from sustained stewardship that encompasses active engagement with ESG factors.

To help nurture this approach further within our industry, the BVCA has published a series of case studies in this supplement to our Responsible Investment Guide to showcase notable examples of best practice from a diverse range of member firms. These case studies, drawn from entries to the BVCA's Responsible Investment Awards over the last couple of years, demonstrate how responsible investment can be an important competitive asset.

More importantly, these case studies illustrate that responsible investing is not an ancillary activity that our members undertake as part of a calculated PR strategy. As the examples shared here highlight, the application of responsible investment principles can deliver real value at each stage of the investment cycle. From due diligence through to exit, member firms are employing coherent and structured frameworks to manage the risks and secure the opportunities that help deliver enhanced value.

The firms that are leading the sector show that when you strip away jargon that can sometimes cloud the responsible investing agenda, the underlying principles involved are fundamental to how the private equity and venture capital industry conducts business. Our members seek to build great companies by reducing risks, improving operational efficiency, nurturing human capital, identifying new markets, and by articulating and executing strategic vision.

As active portfolio managers, they understand that short term trading performance alone does not guarantee long-term success. Increased productivity and competitiveness are best achieved by addressing the diverse range of ESG factors that influence a company's performance.

As these case studies demonstrate, those firms that successfully translate responsible investment to their advantage can create value for the long-term. We hope this will reach the widest possible audience.

Tim Hames

Director General, BVCA

Jeremy Lytle

Investor Relations Partner, ECI
Chair, BVCA Responsible Investment Advisory Board

With thanks to:

Adam Black
Doughty Hanson

Phil Case
PwC

Alison Hampton
HgCapital

Patricia Hamzahee
Integriti Capital

Simon Holland
3i

Beth Houghton
Palatine Private Equity

Penelope Latorre
Waterman Group

Calum Paterson
Scottish Equity Partners

Tim Pryce
Terra Firma

Dushy Sivanithy
Pantheon

Garry Wilson
Endless LLP

Scottish Equity Partners CASE STUDY

Context

Scottish Equity Partners (SEP) actively promotes Responsible Investment (RI) best practice. Recognising that RI can impact business value and investment risk, SEP will not invest in companies pursing unethical business activities such as gambling, tobacco production or the supply, manufacture or distribution of firearms.

Consideration of RI issues takes place across all aspects of SEP's investment process from deal origination through to execution and portfolio management. SEP's RI statement is publically available on its website.

SEP keeps up to date with ESG issues through industry briefings, and regular updates from its legal and accountancy advisers. The firm participates on the GP Responsible Investment Group, which seeks to improve standards within the private equity industry.

Approach

SEP assesses ESG risk factors as an integral part of its due diligence on new investment opportunities. Through this process SEP seeks evidence of appropriate internal policies, employment, pension and other benefits, environmental issues, insurance, compliance with laws and regulatory matters, and data protection.

Prior to making any new investment, SEP requires the completion of a management questionnaire which focuses on the background of the management team and its awareness of governance issues. Key risks and sensitivities are assessed and evaluated as an integral part of the investment approval process. SEP also utilises external due diligence specialists as appropriate.

SEP takes a pro-active approach to portfolio management, regularly contributing to strategy, recruitment, employee incentives, and budget-setting. SEP partners take up board positions in portfolio companies and participate in remuneration and audit committees, encouraging ESG performance improvement. SEP nominated directors are required to ensure that ESG considerations are regularly discussed at monthly board meetings and that good corporate governance is adopted and maintained.

SEP's limited partners are kept appraised through quarterly reports, which include specific updates on RI matters.

All SEP partners and employees are aware of the importance of RI, which is enshrined in SEP's fund management processes and operational procedures. These are further realised through induction and on-job training. In addition, SEP has a specific anti-bribery policy, and the prevention, detection and reporting of bribery is recognised as a key responsibility of all partners and employees.

Rationale

SEP is fully aware of how the attitude it takes to ESG issues impacts on its reputation and trust with its limited partners, investee companies and other stakeholders. ESG issues subsequently can influence value creation within SEP's portfolios and in turn affect SEP fund performance and future fundraising potential.

SEP's Perspective

"Our core values as responsible investors are fundamental to the way we operate. Having strong principles has enabled us to secure a blue chip limited partner base and to attract high quality investment staff. For both new investment opportunities and the companies already in our portfolio, we place a lot of emphasis on comprehensive and robust corporate governance. We believe this leads to greater sustainability for the companies we invest in, better staff retention and increased shareholder value."

Calum Paterson,
Managing Partner, SEP

3i CASE STUDY

Context

“Responsibility” is a key feature of 3i’s corporate values, with Responsible Investing being an integral part of their core investment policy.

Pre-investment is the first opportunity in the investment lifecycle for 3i to actively consider and action ESG components. 3i employ a detailed due diligence process, which is consistent for both minority and majority equity investments across its Private Equity and Infrastructure investment businesses.

Approach

3i’s Responsible Investment Policy requires that, in appropriate cases, potential investments are assessed against the IFC Performance Standards. Furthermore, all new opportunities are screened against 3i’s “exclusion and referral” lists, which identify businesses and activities in which 3i will not invest and those which are particularly sensitive or potentially involve material reputational issues and may necessitate more in-depth due diligence or risk assessment.

An initial assessment of all new equity investment opportunities is carried out using an online proprietary ESG due diligence tool to check the company for high level ESG risk areas (including environmental, labour and bribery and corruption risks) which may require more detailed due diligence. The software allows all staff, regardless of location, to carry out a consistent ESG assessment based on the IFC Performance Standards.

If potential ESG risks are identified, 3i commissions “deep dive” due diligence involving external experts. If the diligence identifies material ESG risks, 3i may require the company to commit to implementing appropriate measures to mitigate those risks. Such measures may include meeting relevant International Standards (over a reasonable time frame). 3i will support the company by developing action plans with appropriate targets, timetables and resources.

Where appropriate, conditions are inserted into the investment agreement and relevant actions are addressed in the 180 day post-investment plan.

Following completion of the investment, an independent ESG review of each investment process is completed by an external consultant, with the following outputs:

- An evaluation of the ESG due diligence conducted and the 180 day plan;
- A report of the material ESG risks and opportunities impacting the investment;
- A completed ESG questionnaire which 3i then uses for ongoing portfolio monitoring purposes.

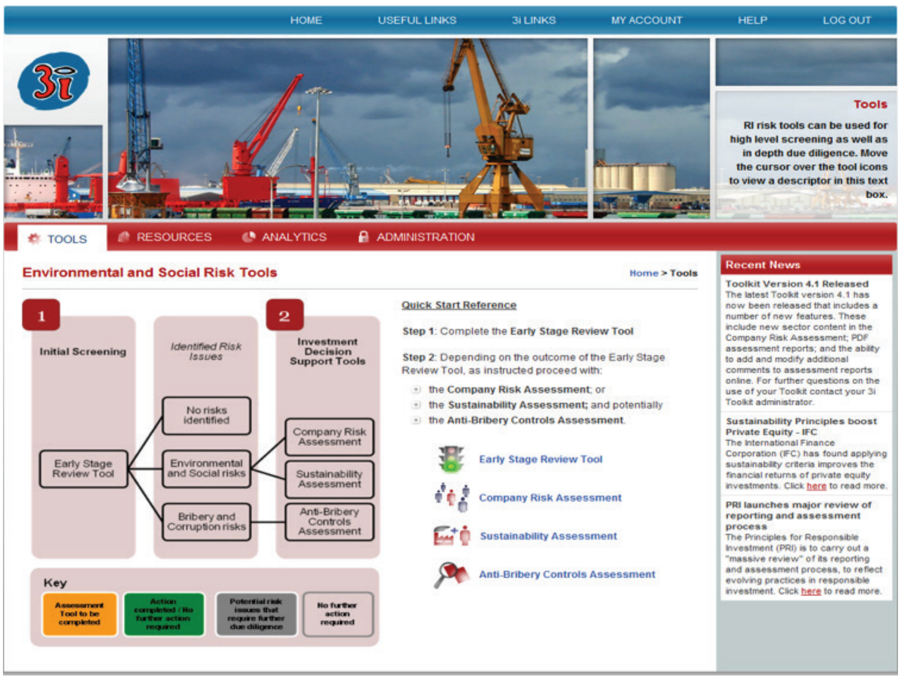
Rationale

3i believes that incorporating ESG matters into their pre-investment approach makes sound business sense because not only does this reduce risk, but it also helps identify potential opportunities to add value to the company and to generate wider benefits to stakeholders.

3i’s Perspective

“3i utilises a range of tools to ensure that all Private Equity and Infrastructure investment opportunities are screened against potential ESG risks and that any identified risks are re-assessed and monitored on an ongoing basis during the lifetime of 3i’s investment.”

Simon Holland,
Director, Strategy Implementation, 3i



HgCapital Manx Telecom CASE STUDY

Context

HgCapital takes an active interest in how its portfolio companies manage ESG issues. Since 2013, HgCapital has carried out ESG diligence on all main buyout fund investments prior to acquisition. This diligence procedure was first trialled with Manx Telecom.

HgCapital (along with CPS Partners and management) acquired Manx Telecom from Telefonica in the summer of 2010. Manx Telecom is the primary fixed and mobile telecom operator on the Isle of Man, providing telecommunication and data services to commercial and consumer customers. On 10th February 2014 Manx Telecom successfully floated on the Alternative Investment Market of the London Stock Exchange.

Approach

During the three and a half year ownership of Manx Telecom, HgCapital led a significant transformation of the business and helped to deliver improved profit growth. Following the results of its diligence, HgCapital contributed to a number of specific ESG initiatives within Manx Telecom, particularly:

- Strengthening governance arrangements, and the composition of the audit committee to provide a robust review of the control functions;
- Encouraging the development of an anti-corruption policy (which at the time, was not a requirement for an Isle of Man company) and the roll-out of training to all relevant staff;
- Supporting the company in a project to increase the levels of employee engagement and satisfaction – with a limited pool of potential employees on the Isle of Man, the company recognised the importance of being an attractive employer and HgCapital was able to provide expertise to assist with employee engagement improvement; and
- Supporting the infrastructure investment made by Manx Telecom, including a programme of burying cables and the construction of an energy-efficient data centre.

Rationale

HgCapital's interest and concern in ESG issues was in itself viewed positively by the company, which, with a highly unionised workforce, was keen to demonstrate that its owners were looking to create value from long-term growth rather than from short-term cost cutting measures. Furthermore, the involvement of Manx Telecom as a trial study helped HgCapital refine their diligence methodology for use on other portfolio companies.

HgCapital's Perspective

"Manx Telecom delivered strong growth under our ownership and for the year ended 31 December 2013, the business grew revenue by 5%. Manx Telecom is an Isle of Man success story whose operations touch the lives of almost every individual and business on the island, and its commitment to positive ESG initiatives has undoubtedly played a part in that success."

Nic Humphries
Senior partner,
HgCapital

Terra Firma The Garden Centre Group CASE STUDY

Context

Terra Firma recognises that its investments have impacts beyond financial returns and also understands the importance of considering the wider human, environmental and community impacts of their portfolio companies' activities, since these factors can influence the investment returns achieved.

In 2012 Terra Firma acquired The Garden Centre Group (TGCG), now known as Wyevale Garden Centres, and since then has driven the business to take significant steps forward in its ESG strategy. Wyevale is the largest garden centre operator in the UK, employing approximately 5,000 staff across more than 140 sites. Wyevale centres are often local landmarks, with strong local connections and a local customer base.

Approach

On acquisition the business already had various Corporate Social Responsibility (CSR) activities in place, but Terra Firma encouraged the further development of a range of ESG initiatives within Wyevale including:

- Bringing in external expertise to work with the business in developing a new corporate responsibility strategy, which involved identifying the Environment, Marketplace, Community and Workplace issues most relevant to the business;
- Promoting sustainable gardening practices, such as encouraging customers to use water butts, to grow their own fruit and vegetables, and recycle plant pots;
- Approving investment projects which brought both environmental and financial benefits, such as real-time water meters, capillary matting and £3m on LED lighting and light sensors;
- Launching an Employee Assistance Programme, providing staff with access to anonymous financial and legal support;
- Having worked with Terra Firma on strategies for each centre, appointing a network of charity and environment champions to help integrate the business with local groups and charities;
- Tripling charitable donations to over £350,000 during 2013 and holding an employee vote to choose a national charity partner; and
- Initiating, in 2014, a Terra Firma cross-portfolio project (in which Wyevale took part) to engage and survey all employees to measure and benchmark organisational effectiveness.

Rationale

Terra Firma views ESG issues as relevant to Wyevale's relationship with customers, employees and suppliers. It aims to be the leader in its industry, and has environmentally-aware customer and employee bases.

These issues can also bring financial benefits. For example, the new LED lighting installed in 2013 was found to use 60% less energy than the old fluorescent tube lights, and by increasing the proportion of waste which is recycled by over half, Wyevale reduced its waste management costs by 14% in 2013.

Awareness of environmental developments (such as increasingly volatile weather, the impact of peat and timber use, or changing pests and diseases) has also allowed Wyevale to educate customers and adjust its product mix, making it easier for customers to buy the right products and maximising sales.

Terra Firma's Perspective

"Following our acquisition we brought in a new leadership team for Wyevale and together we identified a number of ESG factors that had direct impacts on Wyevale's operations and financial performance. This coincided with our wider efforts to improve ESG implementation, measurement and reporting across our portfolio. We are very pleased with the strategic way in which Wyevale have embraced CSR and the positive results that they have shown. In fact, we now use them as an example of CSR implementation across our portfolio."

Tim Pryce
Terra Firma CEO and Chair, Sustainability Committee

Doughty Hanson LM Wind Power CASE STUDY

Context

Doughty Hanson implements and monitors ESG activities at all their portfolio companies, regardless of ownership status. They choose to focus on their detailed and bespoke active ownership approach.

LM Wind Power (LMWP) was formed in 2009[1] and has been a Doughty Hanson asset since inception through a merger of two companies. The company is a major global independent wind turbine blade manufacturer and has operations in 25 locations across 12 countries, employing over 5000 staff.

Approach

Doughty Hanson choose not to simply focus on the significant positive impact the company has in combatting climate change each year by virtue of its products. Instead, the firm asked LMWP management to consider operational environmental and health and safety (EHS) risk and opportunity, and how corporate responsibility and sustainability really impacts LMWP and their customers more generally. In particular, Doughty Hanson instigated and led several ESG initiatives and continues to actively support LMWP on a wide range of others, including:

Instigated and/or led:

- Creation of a new role of Global Head of HSE & Sustainability;
- Advising the CEO and supporting management to recruit health and safety expertise for a Group behaviour based safety initiative;
- Detailed EHS reviews of blade manufacturing plants globally;
- Introducing a full product life cycle assessment initiative;
- Instigation of a sustainable sourcing initiative, initially focusing on timber related products but later on rubber and other materials as well;
- Undertaking a Group-wide carbon footprinting exercise;

Actively support and advise upon:

- Establishment of a Group sustainability strategy;
- Supporting the LMWP global waste reduction and energy management initiatives;
- Development of new to market low solvent coatings, reducing air emissions by more than 50%;
- Supporting management in establishing a new Brazilian factory including provision of local EHS contacts and permitting requirements; and
- Initiating community outreach projects focusing on local impacts.

Rationale

ESG issue management is especially important to sustainable energy companies and sustainability now forms a core component of the LMWP corporate strategy. ESG initiatives help LMWP and Doughty Hanson manage risk, and at portfolio company level, help to improve the working environment and be a valued employer in the communities in which the company operates. In financial terms, LMWP's ESG credentials across all aspects of its business will help to sell more products by helping to make the company a supplier of choice to customers.

1. LM Wind Power was formed in 2009 when the world's largest independent wind turbine blade manufacturer (acquired by Doughty Hanson in 2001) merged with leading supplier of braking systems for the wind industry, Svendborg Brakes (acquired by Doughty Hanson in 2008).

Doughty Hanson's Perspective

"Even before our acquisition, LMWP had some strong ESG programmes but Doughty Hanson has helped LMWP continuously raise the bar and place sustainability firmly at the foundation of their corporate strategy. We act as mentors and allies in driving the business towards improved sustainability performance. Since starting work with LMWP in 2010, our efforts to reduce waste and energy have resulted in over €20m savings and our safety efforts have resulted in a 42% reduction in accident frequency rate."

Adam Black
Partner and Head of Sustainability, Doughty Hanson

Endless LLP Crown Paints CASE STUDY

Context

As a specialist transformational investor, Endless LLP believes active management of Environmental, Social and Corporate Governance (ESG) issues is central to its mission to enhance companies and secure jobs.

Endless considers ESG matters at all stages of its investment process, from initial investment guidelines through to oversight of its portfolio companies. It sees a direct link between managing ESG issues and ultimate financial performance and exit delivery. This focus on improving operational efficiency, while investing in new products and services, is core to Endless' ability to create sustained value.

Endless' strategy with Crown Paints provides an excellent example of responsible investment driving enhanced value.

Approach

Endless acquired Crown Paints, the UK's number two paint brand, in 2008. On acquisition, Crown Paints was a heavily loss making subsidiary of Akzo Nobel. There were a number of environmental issues to be addressed as well as a lack of strategic direction and investment following an EC directive requiring its disposal within a short time frame.

While environmental issues identified within Crown Paints' manufacturing processes and product formulations dissuaded some prospective buyers, Endless recognised that addressing ESG issues would be an important catalyst to a successful turnaround strategy. Working with the senior management team, Endless invested time and capital in the company's environmental agenda to secure greater employee engagement and satisfy customer needs.

Examples of some of the specific environmental projects included:

- Innovations in R&D to reduce the environment impact of products and operations. Proactive development of water based (low VOC) paints, to meet and often exceed legislative requirements, reduced solvent consumption in solvent based manufacture by 26%;
- Development of the Earthbalance range to reduce the impact of some carbon intensive raw materials, winning the 'Sustainable Innovation Award' from the British Coatings Federation; and
- Waste, water usage and carbon reduction strategies. Examples included investment in four state-of-the-art chemical tanks and significant reductions in inefficient distribution practices backed by a commitment to 'Zero Waste' to landfill and the UK Government's Carbon Reduction Commitment.

Endless' strategy did not only address Crown Paints' environmental issues. It also viewed strengthened corporate governance as vital to a successful turnaround and a prerequisite to a profitable exit. Focus was placed on building a more flexible, responsive organization with a new Board structure, clear management reporting processes, stronger cross company employee communications and improved union relations.

Rationale

For Endless, failure to address the ESG issues it identified on acquisition would have been a serious impediment to a successful exit. Endless' improvements to environmental performance, governance and organisational approach were fundamental to the growth in profitability, the creation of shareholder value and the successful sale of the business to Hempel A/S in 2011. It is testament to Endless' approach that no ESG concerns were raised during the sale process with many improvements cited as assets and enhancing value.

Endless's Perspective

"On exit, we left a business with a motivated, engaged workforce and a sustainable business capable of further growth and development. One year on, Hempel acknowledged the value these strong foundations had given the business despite tough market conditions. We see responsible business behavior as an inherent part of daily operations rather than a standalone response to compliance requirements."

Garry Wilson
Managing Partner,
Endless

Palatine Private Equity CASE STUDY

Context

In 2011, Palatine published its Responsible Investment Code, to set out the context, commitment and Principles for the firm's work around ESG matters. Palatine places great importance in actively following these Principles through its operations and amongst these, there is a strong commitment to conduct rigorous monitoring and reporting.

The Code also established The Palatine Six Pillar RI framework, which expands out the meaning of E, S and G into themes that are readily recognisable in the world of business (e.g. Human Resources under "S"). These Pillars ensure consistency in the way Palatine looks into ESG, including the monitoring and reporting on the performance of their portfolio companies. They have been derived after careful consideration of Palatine's values and the nature of their portfolio and are regularly reviewed to ensure they remain useful and meaningful.

Approach

All of Palatine's Portfolio (and the firm itself) go through a thorough ESG baseline review, conducted by its specialist RI Advisors usually within the first few months after acquisition.

Following dialogue with Palatine's Limited Partners, it was considered essential that these reviews identified the material ESG matters for each company, against their performance in them - i.e. how well the companies are addressing the issues that really matter. This brings extra rigour into the reviews and subsequent investor reports that are derived from them. Importantly, the ESG reviews, place emphasis not only on risk areas but also on using the ESG agenda to create value and competitive advantage in each business.

The findings of each company's review are documented in a detailed report, which is used to help engagement on ESG between Palatine and its investee companies. Reports are presented to each of the businesses Boards for discussion, using both visual information techniques for quick-fire understanding of the performance standards and accompanying narrative to explain issues, opportunities and recommendations. There is a strong emphasis on moving the companies forward to address findings and pursue recommendations.

These fuller reports are then further distilled into one page summaries to be shared with investors annually. The investor reports provide visual representation of materiality and performance, as well as a summary of the recommendations made to minimise risk and/or improve performance. This enables quick comparison of performance across the portfolio and on a year by year basis.

Ahead of each Annual General Meeting, Palatine prepares an ESG report which explains their overall approach, new initiatives introduced during the last year, highlights of ESG activities in the portfolio and finally a full set of updated one page summaries for the whole portfolio.

Rationale

Palatine believes that rigorous monitoring and reporting is beneficial not only to improve communications and relationships with its own investors, but also to monitor and acknowledge the results of the hard work conducted by both the firm and the companies on ESG.

Palatine's Perspective

"At Palatine we believe that responsible business is an essential way of operating for our portfolio companies to optimise value while managing risk. We have always believed in doing 'good business' and our house policy and strategy for ESG now formalises a consistent, high standard approach to achieving this. We have been pleased to gain recognition for our approach as BVCA Responsible Investment Award winners for the past two years."

Beth Houghton
Investment Director,
Palatine Private Equity

"Pantheon is encouraged by the ESG reporting that some GPs have already proactively introduced. However, we would hope this to be standard practice for all our GPs within the next two years."

Dushy Sivanithy
Principal and Co-Chair
Pantheon Responsible
Investment Committee

"As a long term investor, at the PPF we want to see our investments delivering long term sustainable growth in a responsible manner. Engagement and reporting provides an important means of keeping abreast of ESG risks. We can then use this to ensure that the returns we expect on behalf of our members and levy-payers are not undermined by ESG issues. Engagement also provides the opportunity to exercise our influence to address these issues as they arise."

Alan Goodman
Senior Portfolio Manager,
Pension Protection Fund

British Private Equity & Venture Capital Association
5th Floor East, Chancery House, 53–64 Chancery Lane, London WC2A 1QS
T +44 (0)20 7492 0400 bvca@bvca.co.uk www.bvca.co.uk