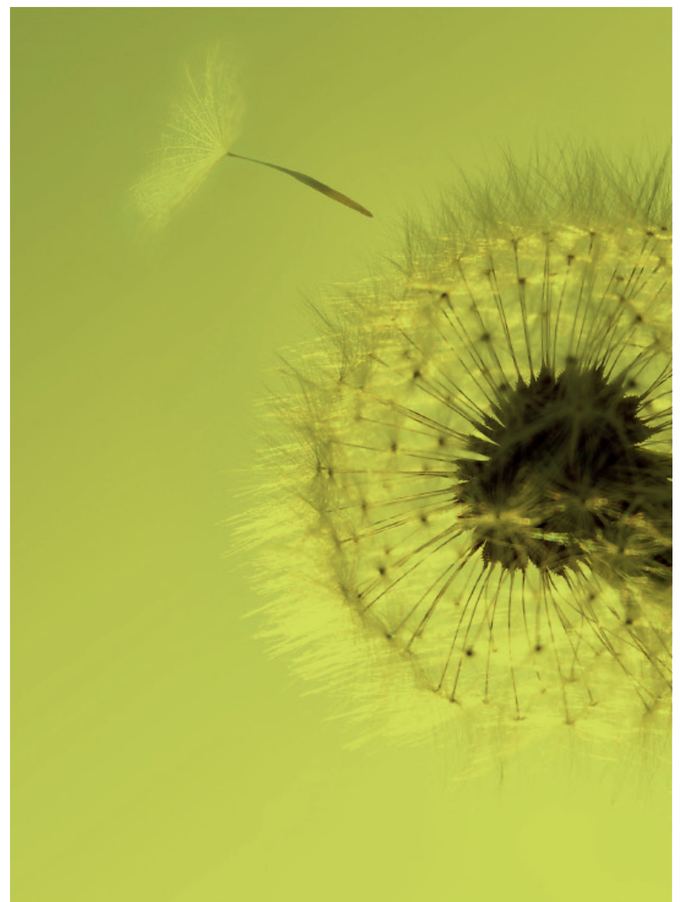
British
Private Equity &
Venture Capital
Association

Responsible Investment

A guide for private equity and venture capital firms



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Private equity firms are seeking to improve their ability to manage the risks and opportunities arising from environment, social and governance issues. This document provides some guidance on current best practice.

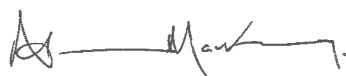
Preface

Private equity and venture capital are increasingly recognised as a force for good in the UK, and in high growth economies around the world. By aligning the interest of owners and managers, and bringing additional strategic, financial and operational expertise to help grow companies, the private equity business model helps build better companies. Increasingly, private equity combines this strategic, financial and operational expertise with close attention to managing environmental, social and governance (ESG) issues, to best ensure strong and sustainable growth.

Private equity has always focused on ESG compliance. However the ESG focus has in recent years moved to a more ambitious benchmark – the pursuit of strategic value through the active management of ESG opportunities. In parallel with this more ambitious approach there has been an increasing expectation from major private equity investors such as pension funds, for private equity houses and private equity managers to demonstrate non-financial performance. In the widest sense this is universally called 'the Responsible Investment approach'.

Within global private equity and venture capital the BVCA has been, and continues to be, at the forefront of the Responsible Investment approach, first publishing a Responsible Investment Guide in 2009 and now with this 2012 edition taking the guidance offered to a more detailed and practical level, throughout the life cycle of private equity and venture capital investments.

We would like to take this opportunity to thank all the individuals and organisations listed on the right, from within and around private equity and venture capital, who have all contributed to the preparation of this Guide, in particular Adam Black, John Gripton and Claire Wilkinson, and our special thanks to Phil Case of PwC and Penny Lattore of Waterman who have been lead contributors on every edition of this Guide.



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Executive Summary

Increased stakeholder pressure and new regulation has forced the rise of the Responsible Investment (RI) agenda within the private equity community. This agenda encourages investors to better evaluate the environmental, social and governance (ESG) implications of their decision-making, both in areas they directly control and also in areas over which they can exert a strong influence.

In the marketplace, ESG issues can have a real impact on business value and investment risk, and a well-founded approach to these issues can be a means by which private equity (PE) houses and portfolio companies can balance risks, create opportunities and, ultimately, differentiate themselves from their competitors. But many General Partners (GPs) are just starting to understand and act upon this agenda. Many portfolio companies, particularly consumer facing businesses, in fact recognise that a strong ESG focus can enhance their brand value and reputation. They communicate beyond their products and services to emphasise their positive social, economic and environmental impacts on the societies in which they operate.

As part of our role in supporting the PE community to face new industry challenges, the BVCA has put together guidance to help our members understand the RI agenda and to embark on the next stage of their ESG journey.

Starting Out

From a GP perspective, it is essential that there is a structured and strategic approach to ESG issues, taking into consideration the PE house's market positioning, its ESG ambitions, its stakeholder needs and its internal resource availability. Based on our experience, the most effective ESG issue management comes from this strategic planning stage, in which GPs clearly evaluate their own RI values and principles, setting out intentions on how they will perform future business under a documented framework. This would ordinarily include decisions on how to evaluate ESG risk generally and in the context of an investment, appetite for ESG risks and a means to evaluate future performance.

Effective ESG issue management also sees GPs considering the potential issues at all key stages of the investment lifecycle, including as wide a value chain as possible, to ensure that risks are readily identified and opportunities maximised. This includes the need to understand long-term value creation in the context of cross-generational ESG issues (i.e. the sustainable development agenda) which may transcend the immediate investment horizons, but which may ultimately impact value creation opportunities for subsequent buyers, and beyond.

Responsible Investing

In a deal context, ESG evaluation can include:

- Top level screening – high-level checks to help GPs understand a potential acquisition and its alignment with the defined PE house ESG vision;
- Business profiling – taking into account inherent sectoral and/or geographical ESG risks and opportunities relative to the target's commitments, capacity and track record; and

- Due diligence – effective acquisition due diligence to understand a target's performance in greater detail in relation to current and reasonably foreseeable ESG issues.

During the ownership period, active management of ESG issues will be required, and this could include actioning of issues arising from due diligence or from supplementary detailed reviews. It is the GP's role to encourage the adoption and integration of responsible business practices into portfolio companies' day-to-day activities including the identification and effective management of key ESG risks. Ordinarily this may require the determination of how a portfolio company can be incorporated within the existing PE house ESG framework and establishing requirements for management, monitoring, measuring and reporting.

Exit

Exit planning should ideally start prior to an investment being finalised to ensure as smooth an exit as possible. Once an exit strategy starts to form, the early review of likely ESG requirements and key portfolio performance elements can be extremely useful, allowing the GP to deal with any potentially material issues in an up-front manner. Consideration should be given as to the likely ESG disclosure requirements which will help to maximise portfolio value – this may depend on the type of exit under consideration.

A Note on External ESG Advisors

External advisors are frequently used to provide expertise on ESG issues, and to supplement internal PE house resources. GPs should not be solely reliant on this external support, and should seek to internalise at least some of this knowledge where appropriate. However, the use of external experts may be appropriate in certain situations, like detailed site reviews, where internal competencies are insufficient. This will need to be determined by each GP as part of its own ESG strategy.

Introduction

Evidence is mounting that private equity and venture capital firms (PE) view responsible investment (RI) as important. This publication is intended to increase General Partners' (GPs') awareness of the RI factors to consider when determining strategy and policy, and throughout the investment life cycle.

According to the PwC publication *Responsible Investment: creating value from ESG issues,* 88% of private equity firms expect attention to RI to increase in the next five years. Further evidence of rising recognition is seen in a survey conducted by the British Private Equity & Venture Capital Association in August 2011, which revealed that 63% of respondents thought that active management of sustainability issues made a company more attractive to investors.

The PE model has traditionally been recognised to be inherently strong on governance issues. Yet, just a few years ago, other ESG issues (particularly, those more aligned to the "E" and the "S") did not typically feature as business priorities for the houses. So what has changed?

Development of the ESG agenda

Financial firms originally viewed ESG issues purely from the perspective of reputational risk. Today, they increasingly recognise their effect on business and financial risk, as well as the opportunities for investment, new business and market access. Additionally, stakeholder expectations regarding good practice in RI are rising fast, with financial services firms increasingly held accountable for their business practices.

Investors are becoming more socially and environmentally aware. They are avoiding or selling investments seen to be materially harmful or likely to suffer negative commercial or reputational impact. The recent economic crisis has exposed certain ethical concerns in the financial services sector (e.g. mis-selling scandals) and dramatically lowered public and stakeholder trust. Restoring that trust has become a key priority and RI presents an important way of beginning to address that need.

The banking sub-sector is, arguably, the most advanced in considering ESG issues within its business operations. Banks began integrating ESG issues into risk management and exploring opportunities related to ESG themes over a decade ago, and the practice is now embedded among the majority of banks in industrialised economies. Investment is akin to lending from the ESG viewpoint (except that a controlling interest in an investee company brings an opportunity, and arguably a responsiblility, to make a real difference). PE firms can use banks' experiences to shorten their own learning curves.

"Doughty Hanson was an early advocate of responsible investing within the private equity asset class and continues to champion its potential for value creation. The work we are doing alongside our management teams continues to yield tangible results across many of our portfolio companies and forms a core part of our strategy for building better businesses."

Stephen Marquardt
CEO, Doughty Hanson

Development of responsible investment in the PE sector

Outside banking, specialist financial services firms such as Actis, Generation Investment Management and Earth Capital Partners were amongst the first to focus specifically on ESG issues. Asset managers investing in publicly listed companies pioneered the practice of firstly negative screening, then more recently positive engagement and influence, concentrating on the regulatory and reputational risks arising from poor ESG management in portfolio companies.

Traditionally, privately-held companies and their investors faced less scrutiny than their publicly-listed counterparts. However, investor and market expectations, regulatory requirements and business risks and opportunities have evolved rapidly in recent years. Managers of privately-held investments are, therefore, also increasingly integrating ESG considerations into their businesses. This is partly because their controlling interests, Board representation and detailed operational knowledge, afford opportunities to firstly understand ESG aspects and impacts in detail, and then to make changes to improve ESG performance.

PE houses have started focusing on the impact of environmental issues such as climate change, on business and investment risk. Within the corporate world as a whole, there are well-known examples of ESG issues impacting both companies and their investors. Climate change is the current hot topic but others that have been significant include: labour issues in the supply chain, health and safety (e.g. BP), and corruption (e.g. Siemens).

PE houses are becoming increasingly active in the renewable energy and clean technology markets. A growing number of GPs, including those mentioned above, plus US Renewables Group, Triodos Investment Management in the Netherlands, and Hg Capital Renewable Power Partners in the UK, see investment potential in environmentally sound technologies and energies. The sector increasingly views RI as, potentially, a means to differentiate portfolio companies, balancing risks and creating new business opportunities. While approaches to RI may differ across the sector, dependent on the size and strategy of the PE House, the importance of the agenda applies across the entire spectrum of GPs, from small venture capital managers through to large PE houses.

The UN Principles of Responsible Investment (UNPRI) form PE's primary framework for RI, providing a voluntary and aspirational structure for the incorporation of ESG considerations into investment decisions. Today, over 900 asset owners and investment managers are signatories to the UNPRI, up from 38 since 2009. This includes leading UK PE houses such as Actis, BC Partners, Bridges Ventures, Cinven, Doughty Hanson, Silverfleet Capital Partners and Triton Advisers. As an increasingly high profile initiative, a key milestone for the PE sector was the creation in September 2008 of the UN PRI Steering Committee on Private Equity.

Recent developments show how RI is gaining in importance. The US Private Equity Growth Capital Council (formally the Private Equity Council) whose members are among the world's best known private equity firms, published a set of Responsible Investment Guidelines in 2009 and PE associations representing the US, UK, Australia, France, Brazil and Europe have established permanent working groups.

The UNPRI has also published a guide which is aimed at supporting LPs in their RI decision-making, much of which is focused on their relationship with GPs.

Many PE houses already consider certain ESG issues during pre-acquisition due diligence, particularly focusing on compliance and potential ESG-related liabilities.

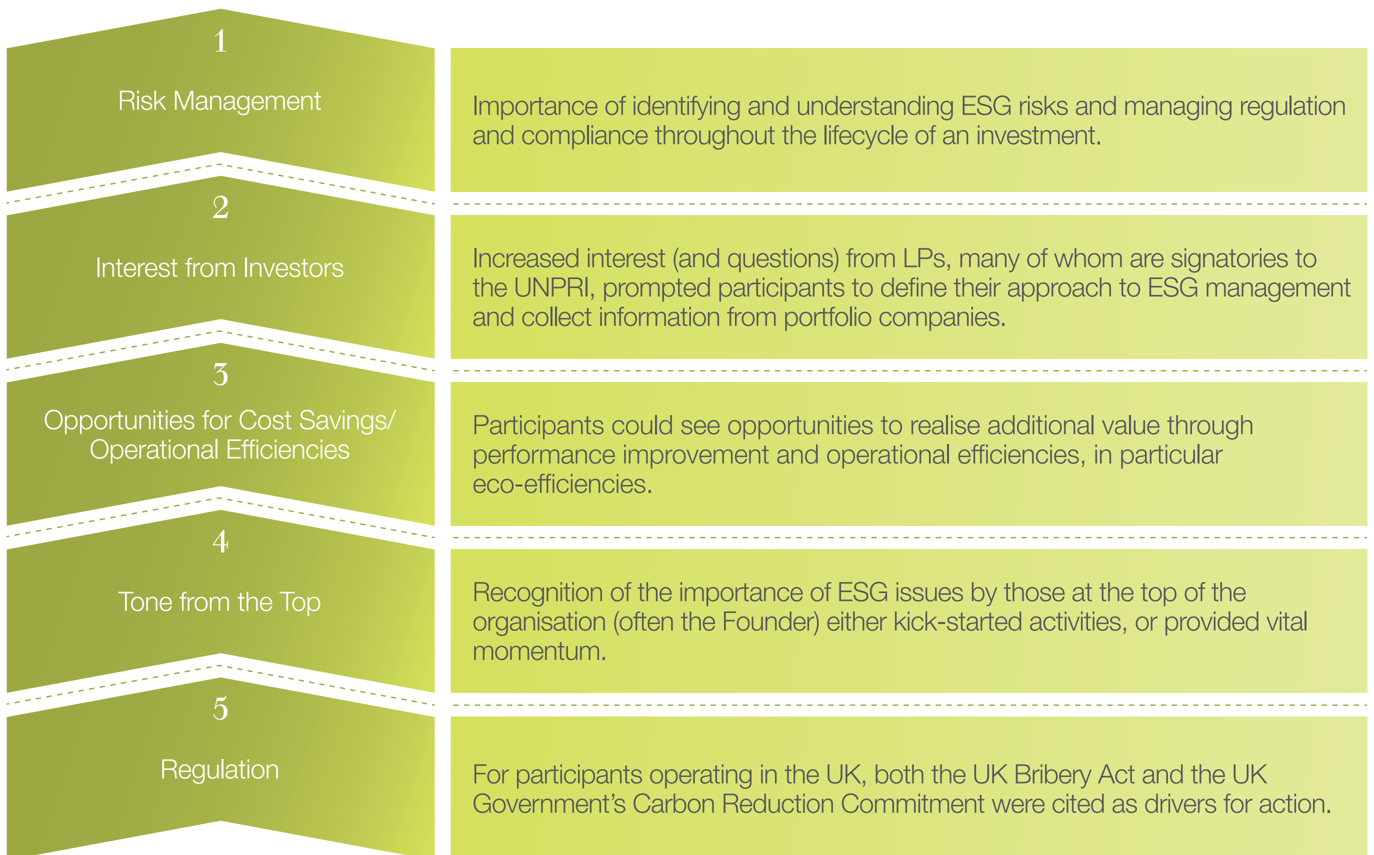
Some PE firms are working towards a more structured and strategic approach under an over-arching sustainability strategy, linked to the firm's business strategy.

Drivers for action on the ESG agenda are examined in the box below, but two dominate all others:

1. The growing interest and pressure from investors, and
2. Regulatory developments – for example, the UK's CRC Energy Efficiency Scheme legislation, the UK Bribery Act, and mandatory carbon reporting from April 2013 (which may affect those PE firms looking to exit investments via an IPO).

An example of multiple drivers is seen in the growing response to climate change. Investments can be impacted by both actual climate change and the policy responses to it such as carbon caps. Energy-intensive industries are particularly affected. Public policy, which is increasingly encouraging new technological developments, can stimulate business opportunities and investments. There is growing market demand for technologies that address climate change.

Drivers for Action



Source: **PwC, Responsible Investment: creating value from environmental, social and governance issues**

Strategic management

Most GPs have some element of ESG consideration in their investments, but sometimes this is executed in an ad hoc manner. Taking a more strategic approach can ensure that opportunities are maximised. GPs should stop to consider:

- Why am I devoting resource to these activities?
- How do I want my efforts to be perceived by stakeholders?
- What progress do I want to have achieved in three-to-five years?

A defined strategy can significantly support ESG-related decision-making during the investment life cycle, but can also give support during fundraising activities by providing a framework for meaningful responses to LP enquiries, and by helping to demonstrate a proven RI track record.

When planning their RI strategies, PE firms should consider the following success factors:

Ambition – A firm should have a bespoke ambition and vision, which guides its approach and risk appetite. Having defined the desired outcome, a firm can plan the progressive actions and structures needed to achieve this. There is no single right answer, scenario or means of implementation. Each firm should decide its own path based on its level of ambition, which may change over time as the RI programme becomes more fully integrated. RI should also be aligned with the firm's overall business strategy and risk management procedures.

Suitability to stakeholders – A firm interested in developing an RI approach to its investment strategy should consider matching this not only to its own values and principles but also to those of its key stakeholders, particularly investors and its diverse portfolio companies. Some investors may, for example, require certain sectors or activities to be excluded – such as alcohol, tobacco, defence industries, etc.

Leadership – Identifying a firm's future ambition requires the commitment of senior management and boards – this is critical to the success of any RI strategy. Articulated from the top, RI strategy should be intrinsically linked to the firm's overall objectives. This allows a consistent message to be conveyed throughout the firm and to be reflected over time in its overall business strategies.

Defining a policy or policies – Having established a broad strategy, PE firms should consider defining and communicating not only principles of investment (for example the UNPRI), but also a more specific ESG policy, or series of polices covering different aspects of the agenda, such as climate change, bribery and corruption etc. Careful consideration should be given to whether policies will cover only investments or the management firm as well, with many stakeholders expecting the latter (please also see page 8).

Defining a governance framework – Implementation of an RI approach requires effective governance to outline ownership of the strategy and ESG policies, as well as to define who is responsible for RI management activities within the investment cycle. Governance should extend to portfolio companies, with primary ESG contacts being established, and reporting arrangements being agreed in advance (e.g. by integrating ESG metrics/KPIs into Board reports or balanced scorecards).

CASE STUDY

Vision Capital

BrightHouse

Vision Capital is able to actively support all of our portfolio companies' ESG activities. Using our seats on the board we can influence responsible investment decisions and policies. Activities at BrightHouse, the UK's leading rent-to-own retailer, are an example of this.

Vision Capital bought BrightHouse in 2007. In the same year, and encouraged by Vision Capital, BrightHouse launched its first major recycling project.

The key aims of the initial project were to:

- turn "end of life packaging" into product for the commercial recycling market
- process over 800 tonnes of waste per year, including metals, glass, paper, cardboard, plastic and polystyrene
- recycle washing machine motors, PCB boards, wood and cables
- reuse as many working components as possible of products beyond repair

The initial investment in the projects of £120,000 now saves £430,000 per year. This return on investment enables BrightHouse to run a national recycling centre in Manchester at zero net cost and, in addition, the BrightHouse service division now operates at zero landfill.

Many other ESG projects have also been implemented by the BrightHouse/ Vision Capital team, including:

Transport: the BrightHouse transport fleet 'backhauls' for other companies, to reduce costs and carbon footprints for both parties.

Packaging: BrightHouse's packaging materials and processes are constantly reviewed. Wherever possible, packaging blankets are used to protect goods. Where this is not practicable, foam packaging has been replaced with recyclable bubble wrap.

Charity: BrightHouse works with three charities for homeless people, by donating mattresses and furniture still in good condition but no longer for sale. These are then given to people as they start life in new homes.

Active support by Vision Capital for BrightHouse's recycling focus was recognised in July 2012 when BrightHouse won Retail Recycler of the Year at the National Recycling Awards.

Internal engagement – Successfully integrating RI into the business strategy and daily operations of a PE firm requires internal buy-in, as well as the enhanced awareness of employees and management about the issues and their relevance. Firms that succeed in developing and executing an effective approach to RI have staff who are trained and fully committed, regarding this as an integral component of their daily roles and responsibilities.

Integration into core business – Procedures should be set out, outlining how a firm plans to integrate RI into its strategic approach to investment. They should show how the firm's overall RI ambition will be integrated into the existing investment cycle, from investment screening to portfolio management and, finally, exit. The ultimate goal is to integrate RI into the firm's investment cycle, making it central to the firm's investment approach.

Engagement with Portfolio Companies – GP expectations of portfolio company management teams in this area should be set from the outset, and support provided to develop strategies and implementation programmes that deliver clear ESG performance improvement. "Support" in this context might involve assistance with setting an effective governance structure, recruitment or provision of ESG expertise, and support in building a business case for investment in eco-efficiency measures or in new "responsible" products designed to increase top line income.

Measurement – PE houses and portfolio companies need to measure progress to understand how they are enhancing value, satisfying stakeholders and growing businesses in key sustainability areas. Measurement and upwards reporting is also critical at the strategy level, to facilitate evaluation of the house's progress in meeting objectives. This enables the house to assess whether it needs to correct its course or to adjust its ambition and goals.

Reporting – In an era of increasing transparency and accountability for the PE sector, consideration should be given, from the outset of designing an RI programme, to the nature of information that should be divulged to stakeholders, when and in what format (for example, online, in annual reports etc). Only by considering desired reporting outputs from the beginning, can necessary inputs (data, performance metrics, case studies etc) be collected over time.

Responsible Investment Policy

It is fundamental for PE and VC firms to first set out clear RI values and principles, which will inform their investment strategy and which will allow assessment of any given potential investment against these principles. Setting out the RI values and principles is best achieved by drawing up an RI Policy, with separate E, S and G sections.

The Policy should, as a minimum, include:

- A commitment to **compliance with all relevant legislation**;
- A commitment to "**continuous improvement**" in ESG performance;
- Any **excluded activities or sectors**.

  Some investors specify sectors in which funds cannot be invested, or the PE house makes a policy decision to avoid certain sectors e.g. gambling and adult entertainment sectors.

CASE STUDY

3i

In 2011, 3i initiated a project to review and improve its approach to responsible investing. The net result was a refreshed policy supported by "on the ground" tools, resources and procedures to enable the policy to be embedded into 3i's investment process.

Main features of this new policy include:

- clear statements of 3i's commitment to mitigate adverse environmental and social impacts and uphold high standards of business integrity and good corporate governance;
- an exclusion list of businesses and activities in which 3i will not invest;
- a referral list of activities that 3i may invest in which may be particularly sensitive and may require additional scrutiny; and
- a set of minimum ESG standards that 3i will seek to implement during the term of its investment.

The policy is supported by a:

- set of updated responsible investment procedures that enhance the wider investment process;
- new online toolkit that provides screening and risk assessment tools for environmental, social, and anti-bribery and corruption risks;
- series of refreshed guidance notes for investment teams, covering key issues and sectors, with links to case studies, international norms and standards and information about specific emerging markets;
- list of preferred ESG due diligence suppliers; and
- "one-stop shop" portal that provides access to all the above mentioned resources.

3i's Vision and the Responsible Investing policy

3i believes that:

- Effective assessment and management of environmental, social, business integrity and corporate governance matters has a positive effect on the value of its investee companies and of 3i Group itself;
- Compliance with local laws and regulations may not be enough to meet global expectations, deliver value and enhance 3i's reputation and licence to operate;
- It is vital that 3i seeks to identify all material ESG risks and opportunities through its due diligence and effectively manage them during the period of 3i's investment.

In addition to these excluded sectors, some leading PE houses are now specifying "referral sectors" as well – i.e. sectors which give rise to concern on environmental, social or ethical grounds, but which may not be specifically excluded provided there is further review and justification; and

- The **ESG standards** which the PE house will apply in judging potential investments.

  For some, this will simply be "legal compliance" even in developing countries, where national regulations are neither as stringent nor as well-enforced as in developed countries. However some stakeholders may prefer to see a commitment to consistently high ESG standards across the PE house's investments – for example, a commitment to work towards alignment with the IFC Performance Standards and related Sectoral Guidelines*.

  Note that setting such standards does not necessarily imply the need to comply with them from the outset: compliance may be expressed to be "aspirational" – i.e. a commitment to achieve specified standards during the period of the PE house's ownership of the portfolio company.

* The International Finance Corporate (IFC) is the private sector arm of the World Bank group. The IFC Performance Standards are intended to provide a reference for businesses in emerging markets for environmental and social standards. They also include a section on appropriate assessments and management systems to identify and address social and environmental risks with a view to ensure the continuous improvement of the sustainability performance of a business within the limits of its resources. Associated with the IFC Performance Standards are the World Bank group's general and industry specific Environmental, Health and Safety (EHS) Guidelines. The EHS Guidelines are technical reference documents with general and industry-specific examples of good international industry practice.

Responsible Investment Approach at the Pre-investment Stage

Decisions made during the pre-investment stage can be critical to influencing a GP's ESG impacts. Where GP strategies exist on ESG issues, pre-investment evaluation of a target company should assess whether the proposed transaction would, in principle, create synergies, conflicts or opportunities in relation to these strategies.

Decision process

During the investment process, the PE house will need to make decisions about how to evaluate ESG risks and opportunities across the value chain. This approach will depend on:

- The PE house's vision and level of maturity of RI approach (see options in the diagram overleaf);
- The PE house's RI Policy commitments – e.g. the standards set for ESG performance and/or the existence of any sectoral "exclusions";
- The materiality of the ESG risks and opportunities in terms of the magnitude of their expected effect on the financial 'bottom-line' as well as on other stakeholders including employees, customers, and the environment and society at large.
- The PE house's strategy for building ESG expertise, in terms of the balance between internal or external evaluators. If an internal strategy is preferred, then staff need to be equipped with tools to aid ESG issue evaluation and be trained for the role. Training should include an understanding of where a higher level of expertise is required – that is, when to bring in a competent ESG professional – which should not only be confined to situations where the law requires it;
- The PE house's views of the ESG risks and opportunities which are inherent to the sectors and geographies involved in the potential investment. To take a simple example, an investment in a chemicals manufacturing company

"We believe that integrating environmental, social and governance matters into our investment approach makes sound business sense. In doing this, not only do we reduce risk but, we are also able to identify potential opportunities to add value and benefit our stakeholders and wider society. This is why we have implemented a responsible investment policy"

Guy Zarzavatdjian,
Managing Partner for
Developing Markets, 3i.

based in a developing country would be expected to have higher inherent ESG risks and opportunities than a consultancy services company based in a developed country, and hence require more extensive ESG risks and opportunities evaluation.

Note that it is important to consider "top tier" suppliers' countries of operation when considering inherent geographic ESG risk – see the "value chain" comments in the Top-level Screening section on page 13; and

- The timing of the evaluation and the level of ESG information available. ESG evaluations could begin as soon as the investment opportunity is identified, with the depth of the evaluation being dependent on the amount of information available. However, many PE houses understandably only commission external due diligence assistance at the "exclusivity" stage.

Setting the PE House Position on ESG Values and Principles

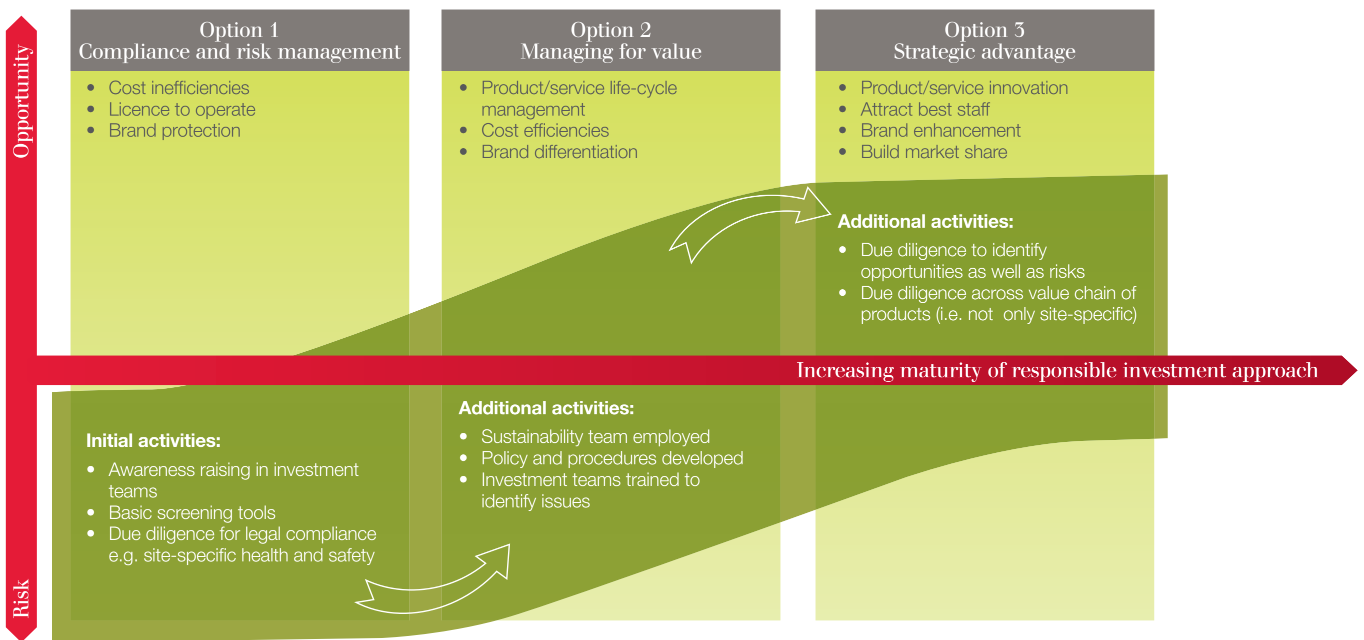


Fig 1: **This diagram illustrates the choices to be proactively made with respect to a PE house's desired market positioning on RI and the respective extent of ESG management / due diligence required.**

CASE STUDY

Doughty Hanson

Balta Group

Doughty Hanson is committed to responsible investment and part of the firm's strategy to achieve this is to regard ESG considerations as being integral to the business, particularly in respect of the activities of the company's portfolio. The PE firm works across the full spectrum of ESG issues, ranging from environmental efficiencies and improved health and safety, through to product development, supply chain sustainability and longer-term business process management.

The activities at Balta Group, a leading European manufacturer of wall-to-wall carpets and rugs, are representative of Doughty Hanson's approach to responsible investing and typical of its work at the portfolio company level.

Balta Group has evolved from a small family business to become a market leader in interior decoration. The group manufactures rugs, wall-to-wall carpets, carpet tiles, laminate flooring and MDF boards for sale across Europe, Asia, the US and the Middle East. The company has manufacturing operations in Belgium and Turkey, a distribution centre in the US and exports its products to more than 80 countries.

In late 2010, Balta acquired Domo Group, adding market share, a broader product range, access to the contract market and vertical integration through yarn production. Prior to the acquisition, Balta identified significant potential synergies in the areas of sales and marketing, procurement, manufacturing and working capital reduction. In addition, environmental and health and safety (EHS) issues were investigated at due-diligence and included within the business integration plan for the company, resulting in additional sustainability initiatives associated with product research and development and enhanced safety practices.

Impact

The PE firms responsible investment approach involves working in partnership with company management to validate existing initiatives and implement new ones where required. On completion of a baseline review by the PE firms in-house Head of Sustainability, and subsequent workshop and visits, the PE firm gained a more complete understanding of the business from the perspective of EHS and broader sustainability. Notable initiatives and achievements arising from these interactions include:

- Addressing energy efficiency and installing on site solar power (resulting in cost savings and additional revenues of €1.7 m a year and saving some 4,750 tonnes carbon annually). There continues to be an on-going effort to reduce energy use, including the replacement of co-generation units, which create energy from waste heat, at two plants in Belgium
- Tackling waste minimisation (resulting in a reduction of over 409 tonnes of solid waste to landfill in 2011 versus 2009)
- Enhancing recognised standards of good management practice (resulting in better governance and risk management)
- Providing training and improving safety culture (resulting in improved performance and reduced lost time and amounting to costs savings of €1.6 m since 2009)
- Addressing supply chain and product range sustainability, through for example, the use of timber from certified sustainable sources, development and sourcing of more environmentally benign production techniques and raw materials, and the development of products with reduced ecological footprints (resulting in total annual revenues of some €4m)
- Enhancing the existing management and governance of occupational health, safety and environmental (HSE) matters through input on organisational change and through support during the search for and recruitment of senior HSE Executives for the company.

"Balta Group has long held the view that strong environmental and health and safety performance makes sound business sense, and as the market leader, we are committed to enhancing our health and safety performance and to reducing our environmental impacts. We believe the work we are doing in this area is good for our business from a risk reduction perspective and also as a means of reducing cost and helping to grow the top line. Doughty Hanson has been actively involved in and strongly committed to our work in this area by providing in-house sustainability and HSE expertise to support our management team, validate some of our efforts and to identify new areas of focus at an operational and strategic level"

Carl Verstraelen,
Interim CEO, Balta Group

The Pre-investment phase

A 3-step pre-investment process

Note on decision-making

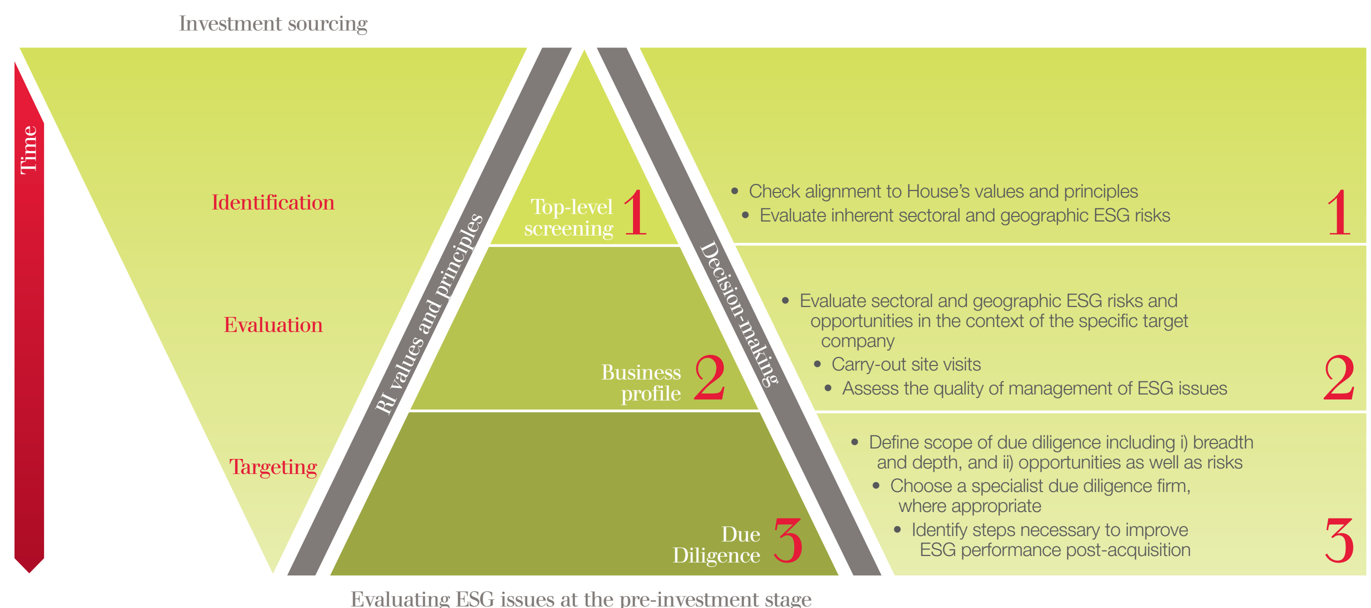
In this section, we describe ESG activities in the pre-investment process, however please note that ESG issues evaluation should be considered at all decision points, particularly where inherent environmental or social risks are high. In this way, the need for external specialist support can be identified at an early stage and funds can be authorised to meet the cost. To facilitate this process, leading PE houses now include sections for ESG evaluations at each stage of their process documentation, and require the ESG issues evaluation to be recorded alongside other material issues.

Once the ESG evaluation is complete, and fully understood by the investment team, it needs to be considered in the context of the overall investment. ESG issues should certainly feature in the post-acquisition improvement planning process. All too often, such issues are ignored at this important stage, as "more pressing issues" consume management attention. However, this is exactly the right time to view company improvement plans through a "sustainability lens", to overlay consideration of ESG issues as part of all planned work streams.

Ideally, early agreement should be reached with the management team, not only on the actions required to improve ESG performance, but also on the starting point or "baseline" and the metrics by which progress will be judged. Only then can the PE house be sure that sound foundations are being laid to improve ESG performance over their ownership period, such that value can be maximised on exit.

Fig 2: **As the investment sourcing process focuses down onto fewer investment targets, the corresponding evaluation of ESG issues needs to become more thorough. The PE house's RI values and principles must be considered at all stages of the ESG issue evaluation. The results of the evaluation should be fed into the decision-making process all stages.**

ESG Evaluation Process



Evaluating ESG issues at the pre-investment stage

1. Top-level screening

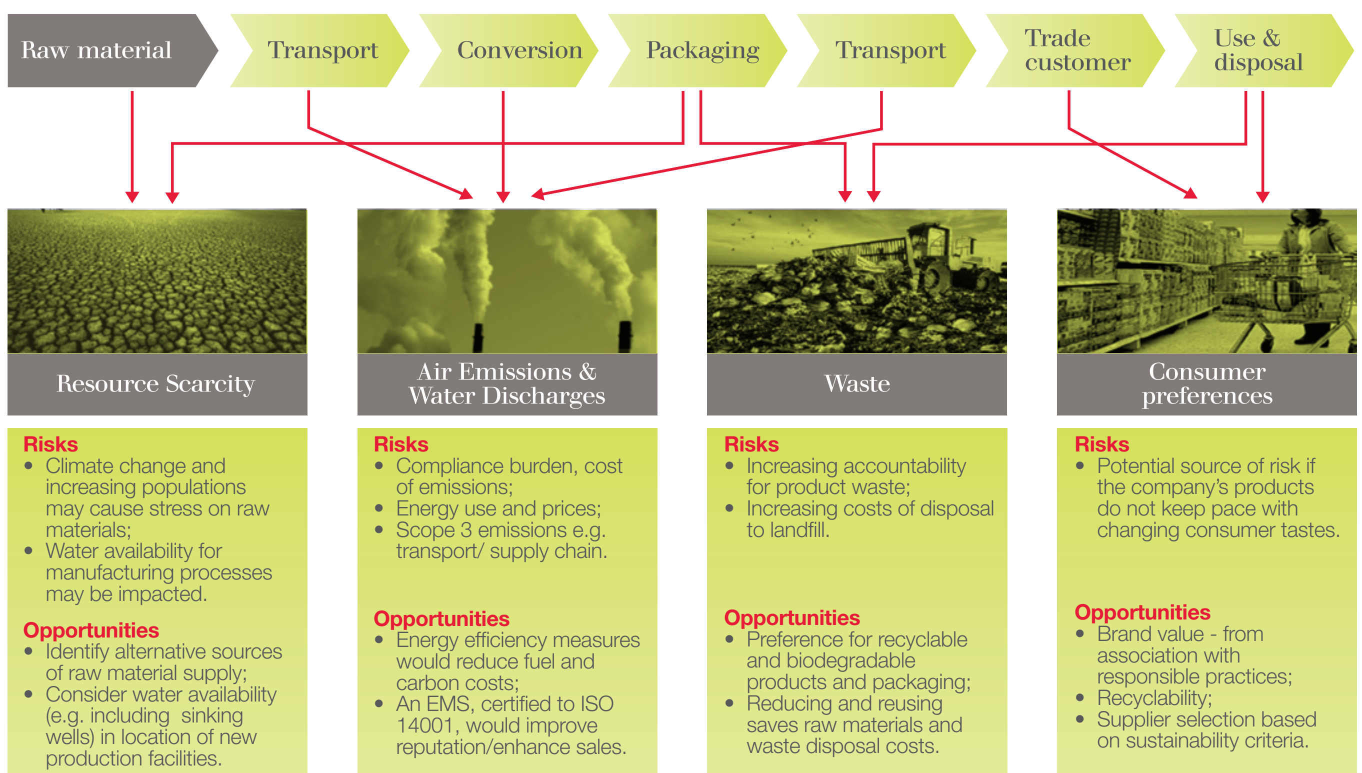
At this initial stage, when very little company-specific ESG information is available, the ESG assessment approach needs to be light touch.

Simple checks should be undertaken to ensure alignment to the PE House's values and principles. This prevents time/expense being put into evaluating a potential acquisition which simply cannot proceed on ESG grounds. An example might be an investment in a sector which is specifically excluded by the RI Policy. PE houses should ensure that their RI Policies are well-communicated and available internally, preferably on-line and embedded into investment memorandum templates, to facilitate such checks.

Inherent sectoral and geographic ESG risks should be evaluated at this early stage. Many PE Houses rely either on checklists or ESG sector briefing notes to guide investment professionals on the level of inherent risks by sector or geography. Internal investment procedures are often then aligned to these pre-set inherent risk levels – e.g. for investment opportunities in a "low" inherent ESG risk sector, internal policy may be to take no further ESG evaluation action (on what are likely to prove to be immaterial issues). Conversely, a "medium" or "high" inherent ESG risk rating may dictate the need for further investigation at a later stage.

It is important to consider ESG risks and opportunities in the light of the target company's entire "value chain". That is, the target company may operate at a relatively benign part of the chain from an ESG perspective – e.g. a packaging company in the example used on below – but may still be exposed to higher risks in the upstream or downstream parts of the same chain. Where supply chains are based in developing countries, inherent ESG risks are likely to be higher.

EGS Risk and Opportunity – Manufacturing company



Where top-level screening checks indicate that further consideration of ESG issues is warranted, there are again two main options: either continue evaluating the target company internally, or commission external ESG due diligence (see due diligence section on page 15).

2. Business Profiling

Internal evaluation may take the form of "business profiling" – i.e. considering the inherent sectoral and geographic ESG risks in the context of the specific target company. Are the company's actual activities typical of the sector, or are there activities which raise or lower the inherent ESG risk level accorded? For example, a company may have been accorded a "high" level of inherent ESG risk at the top-level screening stage because of a belief that the company is involved in manufacturing. However, on closer examination, the activity may actually be found to be assembling components – a lower order of inherent risk.

Site visits may be required at this stage to gain a full understanding of the business. In certain circumstances, for example, where the sector and/or geography of the target company is known to carry high inherent levels of ESG risk, it is essential to engage the support of external specialist consultants in evaluating ESG risks and opportunities. However, ESG expertise is not always essential to make such a visit worthwhile. Much can be gleaned by asking simple questions, for example:

- what raw materials are used and what wastes are produced? And are these labelled as hazardous?
- are environmental permits or licences required to operate?
- is the workforce based in developing countries, large, non-unionised or involves a significant element of temporary or migrant labour (all of which raise concerns over labour standards)?
- are material contracts negotiated with public officials?
- is there currently any consideration of ESG issues in the company's supply chain?

Having established exactly what the company's operations involve, and having identified the ESG aspects of those operations (a process which may be deemed to require external specialist support), the next consideration should be to evaluate the quality of management of ESG issues. After all, PE houses are in the business of accepting known risks in the anticipation of a return, and ESG issues should be treated no differently: if external ESG due diligence suggests that ESG risks are being managed well, then the overall risk profile may be considered acceptable.

Known poor ESG performance of a particular target does not necessarily prevent investment if the potential for substantial improvement can be demonstrated. On the contrary, this may represent a significant opportunity to add value by reducing costs, identifying new business areas, improving staff loyalty, improving reputation and ultimately boosting marketability. However, carefully scoped due diligence may be necessary to ensure that legacy ESG issues are fully understood, so that material risks can be anticipated and allowed for within the business model.

Three facets of ESG management should be evaluated:

i. **Commitment**: are senior management committed to a sustainability agenda? How is this evidenced? What is the "tone from the top"? Many companies have statements of Values or Principles, or specific policies covering "Business Conduct" and/or "Corporate Responsibility" which will help to answer these questions.

ii. **Capacity**: are specific human resources allocated to managing ESG issues – e.g. a sustainability director, a corporate responsibility team, or an environment, health and safety manager? If so, are these specialists well trained to perform their roles?

iii. **Track record**: what does available information reveal about the target company's track record in managing ESG issues (e.g. from an internet search or from discussions with customers)? Is this consistent with what management have disclosed? Sometimes, NGO campaigns against the target company, community unrest, or pending environmental prosecutions are revealed which cast the company in quite a different light.

3. Due diligence

Whatever the proposed investment, consideration should be given to effective ESG due diligence during acquisition. The overall aim of due diligence is to understand the target's ESG performance in greater detail, including associated risks and opportunities that could impact either the overall business case or the business value. While some issues can be unique to a particular sector or even a business, many core principles will apply across sectors and investment opportunities. In addition, the weighting of each issue will depend not only on the target's location and activities, but also on the GP's defined RI principles and strategy.

GPs should ensure that the due diligence scope identifies ESG risks and opportunities as effectively as possible. The scope will vary depending on the nature, location and activities of a business e.g. businesses with significant operations in some developing countries may present more ESG risks/opportunities for performance improvement than those with operations in developed countries, and hence due diligence scope may need to be broader and deeper. Some issues to consider when defining the scope are included in the table on page 30. Where internal resources or expertise do not adequately cover ESG issues and/or the particular sector under consideration, external consultancy support is likely to be essential. The BVCA has developed an approved panel of appropriately qualified consultants for this purpose.

Due diligence should consider both current and reasonably foreseeable ESG issues, so providing maximum visibility of the risks and opportunities. The scope should cover not only legal compliance but also non-regulatory issues. This could include recognised reporting standards like the Global Reporting Initiative,[1] sector-specific concerns (e.g. carbon foot-printing for the food sector or social capital for the service sector), and/or investment community agreements (e.g. the UNPRI and the Equator Principles[2]).

1 www.globalreporting.org.

2 www.equator-principles.com.

GPs should try to allow sufficient time and access for ESG due diligence wherever possible, as this will maximise the opportunity for a comprehensive asset assessment. They should encourage both positive and negative due diligence reporting, which provides as holistic a picture of the asset as possible. Additionally, ensuring that reports cover both the inherent business risks and existing mitigation strategies allows a full evaluation of effective management procedures.

If possible, one team member should have responsibility for the ESG due diligence workstream. This person should ideally have a detailed understanding of the identified issues and liaise with external advisors in good time (so avoiding any last minute "surprises").

External support will be required where either a decision has been taken to sub-contract consideration of ESG issues from the outset, or where internal ESG evaluation has concluded that certain aspects of the target company's business would benefit from further specialist evaluation.

The **choice of specialist firm to employ is an important one**, and should depend not only on the nature of expertise required (environmental, health and safety, supply chain expertise etc), but also on the scale and reach of the consultancy's office network and the "fit" with the target company's geographic operations. Some PE houses are now establishing "panels" of preferred ESG due diligence suppliers so that help is available at short notice when needed.

Traditionally, ESG due diligence has focused on legal compliance liabilities liabilities – typically at a site level. Contamination liabilities, asbestos risks and environmental regulatory compliance are all examples of issues which have been at the centre of specialist investigations in the past – mainly to check whether there are any financial implications which may impact investment economics.

This type of due diligence still has its place. However, the **scope of ESG due diligence is now beginning to change** – in two key respects:

i. **Breadth and depth**: ESG due diligence should consider the target company's whole value chain (please see page 13 of the Guide), as, for example, broader environmental issues – such as climate change or water scarcity – might have an impact on the quality, availability or price of raw materials in the future.

ii. **Opportunities as well as risks**: due diligence should also include consideration of the upsides so as to evaluate the potential for, among others:

- **New markets or income streams**: development of products designed to respond to climate change (e.g. renewable energy, clean tech products) or to changing consumer tastes. Examples of the latter include consumer labels such as Fair Trade or organic products, or sustainably managed timber or fish resources;
- **Eco-efficiencies**: simply "doing more with less" makes clear business sense by saving money from using less energy or raw materials, whilst benefiting the environment; and
- "**Industrial ecology**": one company's waste product can be another company's raw material. By identifying the potential synergies, the first company can save on waste disposal costs, whilst the other has a source of cheaper raw material – whilst both companies benefit the environment and can gain brand value or reputation enhancement by communicating their approach through sustainability reporting.

External ESG due diligence, covering both opportunities and risks, should be commissioned prior to the investment being made. However, unless there are known ESG problems which need to be investigated fully (when an early external appointment would be appropriate), external **ESG consultants should generally be commissioned at the "exclusivity" stage** of the investment, when incurring such expenditure can be justified in the context of the likelihood of completing the transaction.

In this exclusivity "window", much can be achieved by consultants accessing data rooms for information and by discussing ESG issues with the target company's management. That is, **it is often not necessary to undertake exhaustive enquiries,** incurring high costs and tying up valuable investment team and target company's management's time, **to arrive at valid and valuable conclusions** about the target company's ESG risk/opportunity profile. Equally, where access to management, and/or the data available, is limited, the gaps in knowledge and understanding should be flagged to Investment Committees, with a view to ensuring that these are addressed post acquisition, and that the research findings are integrated into the post-acquisition planning.

Crucially, a good ESG due diligence report should clearly articulate not only the risks and opportunities in both qualitative and quantitative terms, but also **identify the steps necessary to be taken to improve ESG performance post-acquisition**. Only then can ESG action plans be properly integrated into the company-wide work streams that are created as part of the post investment ownership process.

Note: the above ESG due diligence steps are equally important where "bolt-on" acquisitions to existing investments are being considered, as such acquisitions can have the effect of materially altering the ESG risk profile of the original investment.

Key messages

- The approach at the pre-investment stage should be aligned to the value and principles of the PE house.
- Evaluation of ESG risks and opportunities needs to start pre-investment so that:
    - Compliance with a RI Policy can be checked; and
    - Any actions arising from the evaluation can be integrated with the strategic and operational post-acquisition performance improvement plans.
- The 3-step process of i) top-level screening, ii) business profiling and iii) due diligence may provide a suitable framework to evaluate ESG issues at the pre-investment stage.

CASE STUDY

Blackstone

Blackstone imbeds a commitment to corporate responsibility in every investment decision made by its Private Equity and Real Estate funds. Before making any investment, the firm performs a rigorous analysis of the relevant environmental, public health, safety and social issues and continues to monitor those issues during its ownership period. Sustainability is a vital consideration for achieving lasting value for both our fund investors and successor owners of companies within our portfolio.

Blackstone's Sustainability Value Creation Program was formed to focus on company-specific efforts to track energy consumption, develop and integrate emission reduction programs. Blackstone's Operations Directors work with portfolio companies to assess their current efforts, devise strategy plans and monitor success and goals. Through this program, Blackstone helps portfolio companies implement practices that result in rapid, measurable and sustained environmental improvement with significant financial upside. Blackstone's near-term goal is to achieve over $100 million of energy and other cost savings while reducing our energy use by over 10% at the respective companies.

In Europe, preparing for the UK Carbon Reduction Commitment provided a catalyst to bring together Blackstone's portfolio companies to discuss energy saving, as one topic in the broader ESG agenda. With the sponsorship of the companies' boards and executives, several Blackstone-sponsored forums were held where company representatives shared approaches and key learnings. Some companies were already well down the ESG path, and others found they could learn from their counterparts. This process ensured that appropriate accountability was in place at each company, emissions were centrally benchmarked and a cross portfolio action plan developed. The Blackstone Procurement platform also allowed companies to leverage our purchasing scale in buying items like Automated Meters.

Blackstone's Sustainability Value Creation Program in Europe has delivered sustainable results across many portfolio companies. Examples include:

Tragus Group, one of the UK's largest restaurant operators with brands including Café Rouge, Bella Italia and Strada:

- Comparison of energy usage / sq ft between every restaurant to identify best practise and which sites were under-performing. Tackling these delivered over £500,000 in savings.
- State of the art electricity meters were installed in over 280 restaurants to measure and transmit energy usage ensures on-going measurement and a focus on energy reduction.
- Trials of LED lighting solutions and energy efficient air conditioning underway

United Biscuits, the UK's leading manufacturer of biscuits and snacks including brands such as McVitie's, Jacob's, Carr's, McCoy's and Hula Hoops:

- Achieved a 10.8% reduction in Absolute CO2 since 2007
- Reduced its water use by 43% equating to a reduction of over two million cubic metres of water
- Since 2005 has taken 18 million lorry miles off the UK roads through improved packing of product cases, pallets and loads, together with load sharing with suppliers, customers and competitors

Center Parcs, the UK's leading holiday and short break provider:

- Invested over £1 million in high efficiency boilers, a combined heat and power unit at Whinfell Forest, installed solar panels at three of four villages and fitted efficient LED lighting across all four villages.
- Roll out of fleet of electric vehicles across all villages
- In 2011, the carbon footprint was reduced by 7.3%
- Continued ambitious carbon reduction target of 20% by 2020

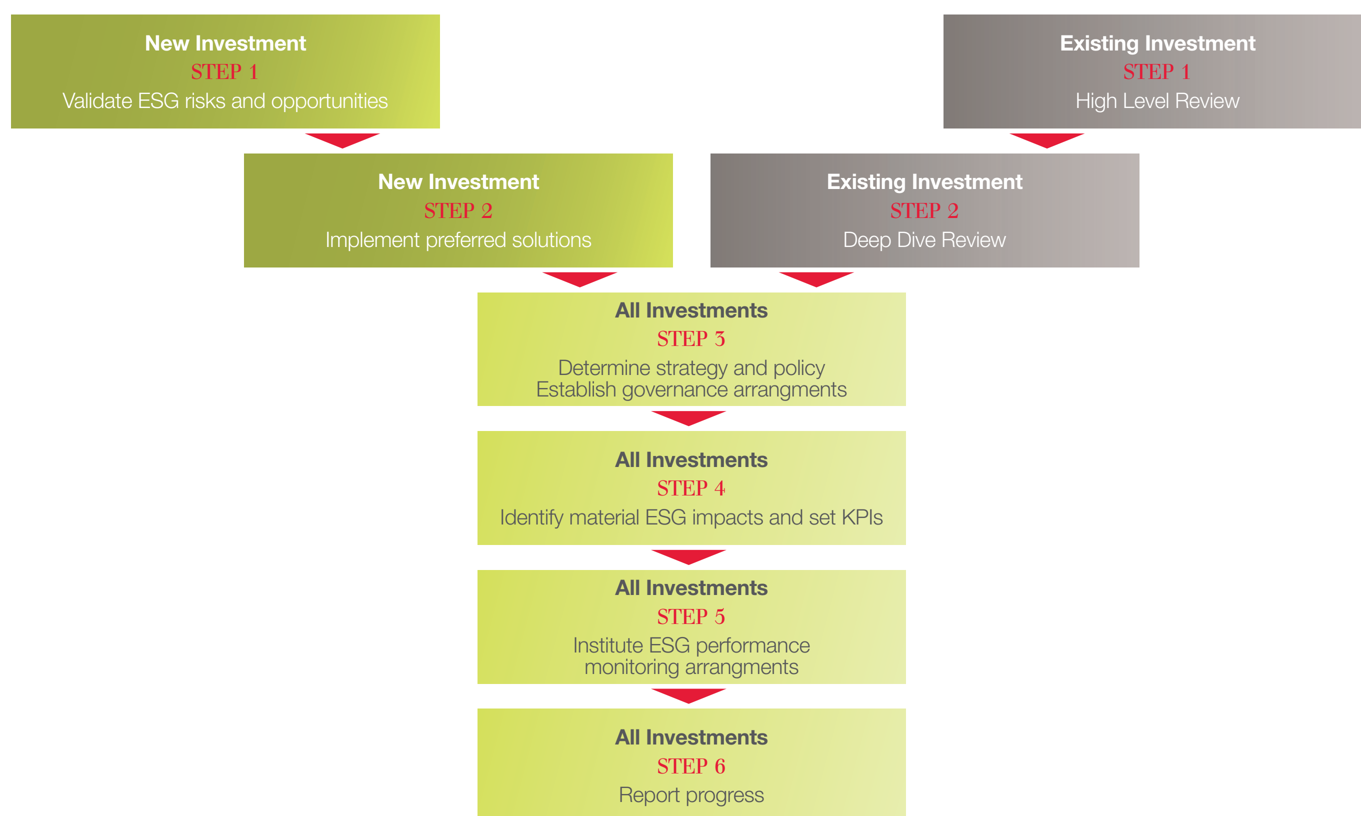
Hilton Hotels:

- Developed a proprietary sustainability measurement system called LightStay™ to calculate and analyse sustainability performance by measuring utility and operational metrics such as (but not limited to) energy, water, carbon, housekeeping, paper product usage, waste, chemical storage, air quality and transportation.
- LightStay™ is now tracking more than 450,000,000 square feet of build space across more than 3,900 properties. In 2011 this has resulted in a reduction of carbon output by 10.9%, waste output by 23.3%, energy use by 9.7% and water use by 7.5%.

The Ownership phase

Managing ESG Issues during the Ownership phase

The actions required to manage ESG issues during the ownership phase will vary depending on whether the portfolio company is a pre-existing asset, or newly acquired. Nevertheless management steps do share common elements, as shown in the diagram below:



Immediately post-investment

ESG issues are rarely so material that they prevent an investment progressing, but their significance could merit inclusion in key items within the post-acquisition performance improvement plans to form a start point from which an ESG strategy can evolve. Working closely with portfolio company management teams to adopt the following plan is recommended, to ensure that the potential value identified pre-acquisition (from proactively managing ESG issues), is actually realised:

1. Validate ESG risks and opportunities identified during the pre-acquisition phase:

Whatever the identified issues, pre-acquisition due diligence provides the information for a baseline from which future strategies should evolve. Correspondingly, revisiting recommendations made in the relevant ESG assessment/due diligence report(s) is

urged as part of the post-acquisition performance plan. For example, a number of potential ESG risks or opportunities may have been identified in pre-acquisition reports, but these are likely to have been based on only limited information and/or restricted access to management, given the time and/or cost constraints involved. It follows that further work is needed, immediately post-acquisition: firstly to validate the scale of a perceived ESG risk, and the likelihood of it crystallising, and secondly to validate the "size of the prize" for a perceived ESG opportunity. The validation process should involve:

- Early discussions with portfolio company management representatives. It is likely that the company's management team will not have seen pre-acquisition reports before, so it is important to check that the ESG risks and opportunities identified are, in their view, realistic and theoretically valid;
- The identification of options for implementation of initiatives designed to address ESG risks or leverage ESG opportunities. Inevitably, there will be several implementation options to address each ESG risk or opportunity identified, and discussions with internal (and potentially external) specialists are advisable to identify them. For example, say that one opportunity identified was to improve the energy efficiency of a data centre, aimed at simultaneously saving money and improving the "carbon footprint" of the business: options might include the separation of "hot aisles" from "cold aisles", server virtualisation, or simply the installation of more energy efficient hardware.
- The quantification of costs and benefits (whether financial, environmental, social or reputational) and therefore the returns available on any investments required. This will support the identification of preferred solutions.
- Prioritisation: quite often, what starts out as a "long list" of potential ESG risks and opportunities can be whittled down to a "short list" of actionable items through the validation process.

2. Implement the preferred solutions from point 1 above, taking care to integrate ESG activities with those other activities being initiated as part of bespoke portfolio action plans (e.g. the 100 or 180 day plan).

New Investment
STEP 2
Implement preferred solutions

- To use the above example, if an investment in a data centre is being planned anyway, it clearly makes sense to ensure that the investment results in as "green" a centre as possible. Aside from achieving the twin aims of operational cost savings and a reduced carbon footprint described above, there is also the potential for a reputational benefit, through being seen by key stakeholders to operate a "responsible business".
- Conversely, if ESG work streams are not integrated in this way, there is a high risk that planned actions will be implemented without due regard for ESG issues (at best, an opportunity missed), and that ESG initiatives will simply be shelved or even abandoned as being insufficiently urgent, or of low priority.

Once the immediate post-acquisition ESG priorities have been successfully progressed through the above actions, the management of ESG issues during the ownership phase should follow the remaining four steps described in the "Post-Investment stage" section overleaf.

Post-investment stage

As significant shareholders, and custodians of LP capital, GPs have a responsibility to encourage the companies in which they invest to adopt and pursue responsible business practices. Moreover, they have a clear financial interest in so doing: overseeing the management of ESG issues during the ownership period of an investment has the potential to protect or significantly enhance profitability, and value/saleability on exit.

It is likely that any ESG due diligence undertaken at the time of purchase will have been limited in its scope. This is because traditional due diligence in this area has focused on:

- ESG legal compliance issues only (the "E", and some of the "S" of ESG);
- risk and liability concerns only (rather than opportunities too); and
- site specific issues (rather than issues covering the whole value chain of the company).

As a result, GPs may not have sufficient insight into the ESG risks and opportunities affecting companies in their current portfolios. To remedy this, GPs may wish to consider the following two steps:

1. High Level Review

Existing Investment
STEP 1
High Level Review

If the above due diligence scenario is recognised to be case, the immediate question which arises is "where do I start?" After all, a full ESG review of the existing portfolio of companies (which would most likely need to involve an external specialist) would be a costly and time consuming exercise. A high level review of the portfolio through surveys, management interviews or audits may, however, be a solution. It can be a useful tool to determine:

- Which companies to focus attention on: this can be determined by considering inherent ESG risks in the existing portfolio, which will likely vary by sector and by geography.

  For example, companies operating in manufacturing industries present inherently higher levels of environmental risk than those operating in service sectors. Equally, companies with supply chains extending into developing countries will likely represent higher inherent levels of social risk (through concerns over labour standards) than those operating in, say, western Europe. Finally, the geographic location, coupled with the nature of a company's business model (e.g. whether sales agents are used, whether government contracts or licences are features and so on) will be key determinants of inherent bribery and corruption (i.e. governance) risk.

  Applying a high level "sieve" for these inherent ESG risk features will help eliminate those portfolio companies that are unlikely to require immediate attention from the ESG risk perspective, and will also serve to focus attention on those companies that would repay the investment of time, and potentially money, in reviewing the management of material ESG issues.

  Having identified the universe of portfolio companies on which to focus attention, the High Level Review recommended can then help to determine:

- How ESG issues relate to each company: what are the ESG issues, and which of these is material, demanding management attention?

- Management attitudes and actions taken to date on ESG issues: what is the “tone from the top” at each priority portfolio company in respect of ESG issues? Are Board members kept up to date on material issues, such as the company’s health and safety record?

- Areas of unmanaged risk: occasionally, ESG risks have not even been identified, let alone well managed. It is important to take stock of the quality of risk evaluation and management, and then to improve the companies’ “corporate radars” so as to be able to identify areas of stakeholder concern in this area, well in advance of ESG issues crystallising as problems (by which stage a company’s ability to manage an ESG problem will most likely be impaired by the need to “fire fight”).

- Areas of unrealised opportunity: aside from leading edge PE Houses, this is frequently an under-researched topic. It often takes time and some investment to realise gains from ESG opportunities, so identifying potential well in advance of exit is essential.

Once a High Level Review is complete, and a (typically small) number of companies have been identified where further action to effectively manage ESG issues is required, a “Deep Dive Review” can be implemented.

2. Deep Dive Review

Following a High Level Review, or where detailed ESG due diligence has identified issues which should be tackled outside of the 100-day plan, GPs can focus resources on those companies and supply chains with the most unprotected and unrealised value. This may take the form of:

Existing Investment
STEP 2
Deep Dive Review

- Site audits – the High Level Review may not have included a site visit. If not, this is highly recommended at the Deep Dive Review stage. A site visit or audit will help to understand the context in which management will be striving to manage ESG issues effectively, and the risk management procedures currently being followed. If expertise is not available internally to conduct such a visit, and there is no appetite for commissioning external support, a simple site visit checklist may help to identify key issues systematically.

- Discussion with Board representatives and those responsible for managing ESG issues on site. It is important to establish the extent of Board involvement with and knowledge of ESG issues (please see Step 3 below), as well as to understand how risk and opportunity management procedures are applied in practice. Only then can the overall picture be compared with good management practice in the sector concerned, and for any gaps to be identified which require attention.

The remaining steps required to institute effective ESG risk and opportunity management arrangements are common to both New Investments and Existing Portfolio Investments. Please see steps 3 to 6 below.

3. Determine strategy and policy Establish Governance arrangements.

All Investments
STEP 3
Determine strategy and policy
Establish governance arrangments

- Determine portfolio company ESG strategies. ESG issue management should be a strategic consideration for a portfolio company, and also for a PE house owner – as it is a key driver of value protection and enhancement. Value cannot be maximised without integrating consideration of ESG issues into the way a company is governed and operates – to be sustainable, it needs to become simply the way business is done.

This step should involve the same considerations as for the GP: in what remains a largely voluntary agenda, there are choices to be made, proactively, as to each company's desired market positioning, and within what timeframe this is to be achieved. Please see Figure 1 on page 10 for an illustration of the range of strategic approaches currently deployed in the market.

- Develop a sustainability (or ESG) policy: GPs will wish to ensure that portfolio companies have robust sustainability policies which reflect their own values (so as, inter alia, to help protect both the portfolio company and the GP from reputational risk). As a minimum, it is recommended that policies contain:
  - A commitment to compliance with all relevant legislation; and
  - A commitment to "continuous improvement" in ESG performance.
- Secure Board level sponsorship: as with other strategic issues, Board level sponsorship and oversight of the ESG management programme is essential. As owners, often with Board representation, Private Equity houses have an ideal opportunity (and arguably a responsibility) to influence the "tone from the top". Articulating a company's values and ethos is important to demonstrate to all staff (and there will inevitably be laggards, as well as leaders, to be engaged) the importance of ESG issues to the company's future success.
- Allocate responsibility for managing ESG issues to designated personnel at portfolio companies. Where internal expertise is insufficient or unavailable, and expertise cannot be made available from the Private Equity house owners, this may merit the support of expert consultants.
- Consider capital expenditure budget requirements. Implementing effective ESG initiatives (such as those identified through the prioritisation process described in New Investments, Steps 1 and 2 (on page 21) will often require an up-front investment, which should be planned for and budgeted.

4. Identify what ESG impacts need managing, establish a limited number of Key Performance Indicators (KPIs) covering the full ESG agenda, and collect baseline data on each.

All Investments
STEP 4
Identify material ESG impacts and set KPIs

- It will clearly not be possible to track ESG performance improvement over the period of ownership without relevant data. But what should be measured? Clearly, one place to start would be measurement of progress under the initiatives identified in New Investment, Step 2 above. However, it would be sensible to think more broadly: the key is to consider each aspect of a company's operations from an ESG perspective, before identifying the impacts arising from those aspects. For example, energy consumption (an environmental aspect), may contribute to climate change (an environmental impact). Or, off-shoring a call centre (a social aspect), may give rise to labour or human rights concerns (a social impact).
- Once all relevant impacts are mapped, appropriate criteria should be used to consistently determine the materiality of the impacts - such as regulatory requirements, the financial consequences of a failure to manage the issue, and so on. Finally, **material** ESG impacts should be the subject of objectives and targets, underpinned by KPIs. This process is the foundation of any formal management system for ESG impacts (such as ISO 14001 for environmental impacts, OHSAS 18001 for health and safety impacts and so on).

- Some large blue-chip companies set dozens of ESG KPIs: Marks and Spencer, for example, has set 180 ESG commitments to achieve by 2015. However, this is unlikely to be appropriate for the SME businesses that make up the majority of PE house investments. Generally 10-15 KPIs would be more the norm, covering the full scope of ESG issues. Some PE Houses are now setting “core” ESG KPIs, which all portfolio companies are required to track, plus “sector specific” KPIs, recognising that some sectors have particular ESG issues to manage. All KPIs should be “normalised” to take account of business growth or contraction: examples of core KPIs (with the normalisation factor shown in the right hand column) might include:

Issue	KPI	Metric / Measurement Unit
Environment: climate change	Greenhouse gas intensity	Tonnes of CO2 pa/$revenue
Social: employee attraction and retention	a) job creation or b) employee turnover	a) net no. of jobs created or b) no. of jobs replaced
Governance: bribery and corruption	percentage of employees (for which bribery and corruption is a relevant issue) who have completed training.	total percentage of employees (for whom bribery and corruption is an issue) that have completed training in the last 12 months.

- Beware of over-enthusiasm! A common trap to fall into, once momentum for action to manage ESG issues has been gained, is to start managing material ESG impacts, without first establishing a baseline of performance – that is, where have you started from? Without an accurate baseline it is difficult to track progress over time, so as to quantify benefits and report achievements.

5. Initiate a regular ESG performance monitoring programme, linked to the chosen ESG KPIs.

All Investments
STEP 5
Institute ESG performance monitoring arrangments

- At a practical level, an ESG performance monitoring programme should be put in place, preferably linked to existing Board reporting systems – it is important that the Board (and not just the ESG specialists) have access to regular performance monitoring data. For example, a “balanced scorecard” approach should be used wherever possible (combining weighted financial and non-financial metrics), so that ESG issue management is integrated into general strategic business management.

- Where monitoring processes show that ESG performance is off track, action should clearly be taken to really understand, and where appropriate, remedy, the situation. For example, a decrease in CO2 from business travel might indicate a positive switch to video-conferencing, but might equally simply reflect a downturn in business activity levels (and commensurate reduction in business travel). If the latter, supporting the portfolio company in reviewing the appropriateness of the “normalisation factor” would be a good place to start in rectifying the misleading reporting. Action would then be needed to address any underlying failure to reduce normalised CO2 levels.

- Communication. ESG performance improvement is normally achieved through a combination of equipment/process change and behaviour change. It follows that incentives are required for staff to change their behaviour (even to simply “switch it off” to save energy). Incentives need neither be complex nor expensive: for example, tracking and regularly communicating performance internally, coupled perhaps with engendering competition between teams, can deliver real results.

6. Report ESG performance improvements and, if possible, the value added.

All Investments
STEP 6
Report progress

- Relatively few GPs are currently reporting their own stance on Responsible Investing. Rarer still are those who are gathering sufficient data from portfolio companies to be able to provide a comprehensive picture of portfolio-wide ESG performance, alongside financial performance. However, market pressures are likely to force a change. For example:
  - Some LPs are increasing pressure on GPs regarding ESG disclosures: The US Institutional Limited Partners Association (ILPA) created the "Private Equity Principles", and standardised reporting templates. CalPERS developed a "Manager Assessment Tool" to help its manager selection process by ranking managers on key ESG issues.
  - The UNPRI has been consulted on changes to their "reporting principle" which is likely to result in signatories being required to divulge higher levels of ESG information in a standardised way.
- As a first step towards ESG reporting, consider preparing information specifically to meet investor interest (only). This could take the form of placing anonymised ESG due diligence reports, or ESG portfolio review reports, in a data room during fund raising. Alternatively, a standard statement could be prepared on the GP's ESG ethos, policies and procedures – to be deployed in response to investor interest: this would perhaps obviate the need to complete the increasingly detailed ESG Questionnaires now being used by growing numbers of LPs to elicit information.
- The journey towards full ESG reporting needs to be carefully considered. There is inevitably an expectation from key stakeholders that reporting will be repeated at regular intervals (often annually). This means that progress has to be demonstrated between report dates, requiring underlying active ESG issue management programmes and effective upwards reporting to the GP (using agreed metrics rather than simply case study examples). Where relevant data is available, however, transparent ESG disclosure can add real value, both in terms of reputation and enhanced investor relations.
- Quantifying the value added does however, remain a challenge. Although the private equity industry is showing increasing appetite to understand the impact on ESG issues on value, there is no generally accepted methodology for quantifying the financial value of ESG initiatives to companies and their shareholders. Nevertheless, it is now possible to quantify the value derived from ESG issue management by using a range of proven techniques.

Key messages

- For new investments, revisit ESG due diligence reports, and integrate ESG actions, as part of the post-acquisition performance improvement plan
- For existing investments, consider what ESG due diligence was conducted on acquisition. If insufficient, carry out a high level ESG portfolio review, followed by "deep dive" reviews for those companies where this would likely add value.
- Correct or mitigate any major regulatory non-compliance representing a significant immediate business risk.
- Where possible, begin to develop the structure which will support development of future ESG initiatives.

CASE STUDY

BRIDGES VENTURES

The Hoxton Hotel

The Hoxton Hotel is a 208 room boutique hotel located in Hackney, East London. Its designed-led, yet price-competitive approached has gained it industry recognition having won several prestigious awards - including the Best UK Hotel Award at the Guardian and Observer Travel Awards in 2009, 2010 and 2011.

Bridges Ventures backed The Hoxton in 2004 as a start-up concept and played a leading role in its construction and ongoing success. The initial investment in The Hoxton was made through Bridges Ventures' Sustainable Growth Funds, which aim to deliver both positive financial returns and social and environmental benefits. The Hoxton fulfilled one of Bridges' key impact themes - investing in underserved areas. The hotel was built on a brownfield car park site in Hackney, an area in the most deprived 3% of England.

Once described as one of the '100 Best Things in the World' by GQ magazine, The Hoxton has consistently achieved 90% or greater occupancy since its initial opening. Since the original construction, 3 additional rooms were added in 2010 and, at exit, the hotel was forecast to deliver £10.7m of sales and £5.8m of EBITDA for 2012.

Bridges sold the Hoxton in May 2012. The exit delivered a return of £13.3m to Bridges Ventures Sustainable Growth Fund I, representing an IRR of 47% and 8.8x the total investment.

The hotel played a critical part in the regeneration of Shoreditch and Hackney (in the 3% most deprived areas of England), with 76% of The Hoxton Hotel staff living in underserved areas (to whom over 70% of the total wage bill accrued) and an 85% supplier-spend in the local area.

CASE STUDY

KKR

Green Portfolio

In May 2008, KKR launched the Green Portfolio Program (GPP) in partnership with Environmental Defense Fund (EDF) — a leading nonprofit organization with more than 700,000 members worldwide. The GPP is an operational improvement program that uses an "environmental lens" to assess critical business activities for KKR's participating private equity portfolio companies.

Since 2008, KKR has worked with enrolled portfolio companies to cost-effectively improve efficiency, reduce waste and address environmental impacts, such as greenhouse gas emissions, the use of priority chemicals, waste generation or water consumption.

How It Works: The GPP applies KKR's approach of assessing, measuring, and optimizing performance to help its portfolio companies manage their environmental impacts while also improving their business. KKR's team of operations experts — KKR Capstone — partners with KKR's portfolio companies to help make this program work.

KKR has also built a number of resources for the GPP participants, including a portal where portfolio companies collect data and report performance and a paybook of best practices for improving performance.

Portfolio Company Involvement:

Promoting practices that are more sustainable for the environment and provide cost savings has been widely accepted among many of KKR's portfolio companies. Participation in the program is voluntary, but provides company management teams access to a community of practice around shared issues and challenges. Currently, more than thirty percent of KKR's private equity portfolio companies participate in the program.

Results

In December 2011, KKR and EDF announced program results from thirteen KKR portfolio companies. Collectively, through their efforts in key areas, these companies have achieved more than $365 million in financial impact and avoided 810, 000 metric tons of GHG emissions, 2.2 million tons of waste, and 300 million litres of water. More information on how the companies achieved these results are available at http://green.kkr.com. Information on KKR's ESG efforts is available at www.kkr.com/responsibility

"The example of The Hoxton Hotel demonstrates how visionary concepts and decisive financing can transform industries and areas alike. We have played a clear role in promoting the regeneration of Hoxton and Shoreditch, as well as providing tourists, businessmen and other visitors with low-cost, high-quality hotel space in the heart of London. We have also succeeded in delivering an excellent return to our investors, proving once again how financial return and social benefit go hand in hand."
Anne-Marie Harris, Partner, Sustainable Growth Funds, at Bridges Ventures

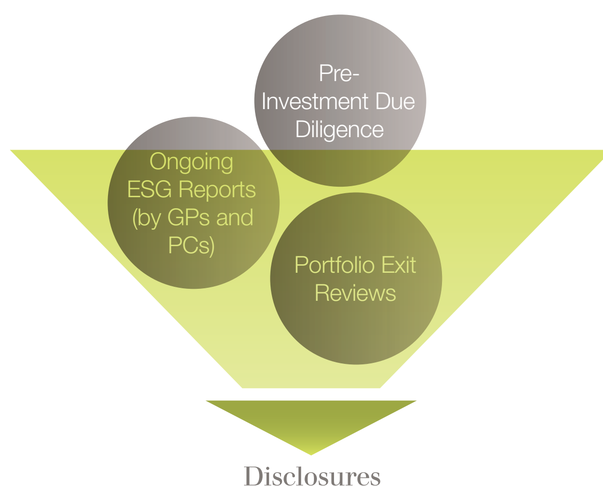
The Exit phase

Preparing for Exit

Planning for a successful exit should start prior to an investment being made as the GP may need to make early strategic decisions as to how to manage ESG matters during exit. The focus on ESG issues throughout the ownership phase may be influenced by the proposed exit strategy (e.g. IPO or secondary buyout). This in turn will influence the extent to which ESG risks need to be minimised and/or opportunities for value enhancement proactively managed from acquisition onwards. The portfolio company's own positioning on the ESG agenda will also play a vital role, as this will determine the nature and extent of the GP's involvement. This may range from supporting and enhancing existing initiatives to setting a completely new agenda. In addition, as each portfolio company's exposures are different, it will be necessary to review the exit strategy on a case by case basis.

Nearing the term of the investment, the GP should consider an early portfolio company review so that any material ESG concerns can be identified prior to divestment, giving sufficient time for action to be taken to correct or mitigate problems. Holistic preparatory work, irrespective of the specific exit strategy, may help to maximise portfolio value. This may be particularly valuable for investments that have been held for a long time and where initial acquisition due diligence may not have matched current best practice. In such circumstances, a detailed audit or review may be necessary. However, where adequate ongoing portfolio engagement and ESG reporting has been encouraged, this may merely require collation of up-to-date information in an appropriate format.

The original acquisition due diligence report can serve as a baseline against which improvements (or otherwise) in ESG performance and, therefore, overall business value can be effectively assessed. On exit, a high-level review may be pertinent to identify "lessons learnt", both positive and negative which can help to inform the GP's wider ESG strategy, policies and procedures. Regular ESG reports prepared during the lifespan of the investment (e.g. periodic reports to LPs or other stakeholders, as part of voluntary or mandatory reporting schemes, etc) may also be a source of valuable information during the exit process.



A GP should assess the benefit of including holistic ESG material in data rooms to provide additional information to potential bidders, and a holistic perspective on the business's ESG performance over the investment period. The GP should prepare for any "awkward" topics which may be raised in relation to ESG performance, and agree internally what responses will be made.

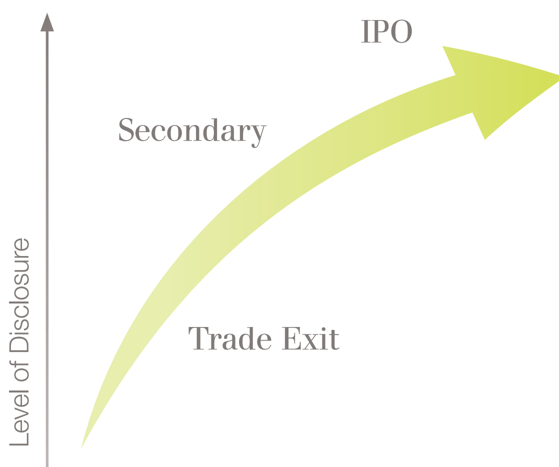
ESG Issues and Types of Exit

The strategy on disposal will be determined in part by the GP's chosen method of exit. For example, the level of data presented by the GP is likely to be more robust and detailed when selling through an IPO than via a secondary exit or trade exit.

i. IPO: IPOs come with associated listing requirements, public scrutiny and reporting, stakeholder pressure and increased need for transparency. Growing sustainable capital markets also present a platform for GPs to exit their portfolio companies to ESG conscientious investors, but this also comes with more demanding investors. As a result GPs should prepare more detailed disclosures when considering an IPO. Increasing regulation on mandatory reporting (most recently on greenhouse gas emissions) will require further transparency associated with portfolio companies' activities.

ii. Secondary exits: This type of exit has proliferated over the last few years. Inter private equity house trading may mean that the potential acquirer may not have the synergies with the industry to fully understand ESG implications for a particular sector. As a result, the GP may need to answer more detailed questions from technical advisors appointed by the acquiring GP, who will also scrutinise the disclosed information in detail.

iii. Trade sale: Trade buyers, motivated by synergies, are more likely to have increased awareness of the likely ESG issues impacting the business. Therefore the level of detail required in disclosures may be reduced or at the least more targeted to those identified issues. Familiarity with the industry sector may mean that (with the right information disclosed) the level of Q&A is also reduced, although the questions presented may be the most "challenging". In these cases, it is prudent for GPs to prepare their responses for those potential questions.



Enhanced Value

It has been widely recognised within the industry as a whole that implementing and maintaining ESG strategies during the investment and ownership periods can have a positive impact upon exit. Although the market is still young and firm quantified data on the financial impact of strong ESG performance is not widely available, it is believed that a positive GP and portfolio company attitude towards ESG issues, translated into improved ESG performance, can result in higher exit prices. The most significant contributing factor to this enhanced exit value from ESG issues is without a doubt good market reputation, both for the portfolio company and for the GP. This is a "win win" situation for GPs, who will see both an improved return on their investment and also additional opportunity at fundraising, as LPs are increasingly looking for evidence of sound ESG issue management in fundraising documentation.

Finally, there is the potential for long term value creation, which is often more difficult to generate within the ownership period for a GP. In the majority of cases, sustainability improvements may require longer periods of time to come to fruition than the expected ownership period, and therefore significant investment in this area may be difficult to justify in terms of short-term return. However, appropriate management of the longer-term sustainable business strategy may be critical to the ultimate performance of the business in a changing social, economic and physical environment. Often, it will be a case of the GP "doing the right thing" without the ability to justify their actions in short-term economic terms. However, there is also an increasing trend to scrutinise long term ESG initiatives set up, or proactively supported, by exiting GPs, even if these have yet to produce positive results at the time of divestment. Long term ESG strategies and the existence of a workable plan may be seen as offering the potential for value creation by interested parties.

It is therefore essential that the GP makes sure that ESG values are entrenched not only within their own investment managers, but also the portfolio company. This will ensure continuity of the projects beyond subsequent owners. Where social and environmental programmes are implemented as part of the ESG policy, liaison with stakeholders may also be necessary, and this should be driven by the GP with due regard to the risks and opportunities that this sort of engagement can create.

Summary of Key ESG Risks and Opportunities

Economic performance	Environmental performance
Direct value generated and distributed – how does the target contribute to the local or national economy? Implications of **climate change** – what could the longer term considerations be for the target in a carbon- constrained world? Does this potentially undermine the current business model? **Pensions** Defined benefit plan obligations – does the target have defined benefit plans for its employees? Are these in line with recognised best practice for the sector, and what percentage of the workforce is covered? **Government assistance** – does the target receive government incentives or similar? **Wages** relative to local norm –how well is the workforce remunerated relative to accepted (including legal) local standards? **Local spending** on supplies – how much of the target's supplies are sourced from the local market place? i.e. how much of the economic benefit generated by the target remains in the local community? **Local labour** supply – how much of the target's labour force comes from the local area and, therefore, what percentage of the local population benefits from the target's activities? This is also a social performance factor. **Infrastructure investment** & service provision for public benefit – how much financial benefit does the target recycle to the local community to improve welfare, services and infrastructure? This could include pro bono support.	**Material usage & recycling –** what is the indirect impact of raw material manufacture required for the target? How much of this material comes from recycled or sustainable sources? **Energy usage, energy savings and energy saving initiatives** – what is the direct contribution to carbon emissions from the target's activities? Will this represent a significant constraint in a carbon-constrained world? **Water usage and sources** – what is the direct impact on water resources of the target's activities? Will the business still be viable in a water-constrained world? **Biodiversity** – how does the target's activity impact on global and local flora and fauna? **Emissions, effluents and wastes from both normal and abnormal (e.g. accident) conditions –** what are the outputs of the target's activities, and how can these be mitigated or minimised? **Mitigation of product and services impacts** – does the target (need to) take action to minimise the total environmental impact of its product? Could stakeholder perception of these impacts reduce the target's viability in the longer term? **Compliance with environmental laws –** is the target in material compliance with relevant local, national and international environmental laws? Could non-compliance represent a significant risk of prosecution and/or business interruption? Impacts of **transportation of goods, raw materials and labour force** – what is the carbon footprint associated with logistics, business travel and commuting? **Environmental protection, expenditure and investment –** has the target allowed sufficient provisions within the business model for current and future required environmental expenditure? Are provisions associated with legal compliance or a move towards best practice?

Social performance

Workforce profile and turnover (by number, region, contract, benefits etc) – are statistics suggestive of a balanced work force with equal opportunities? Is employee retention supporting or hindering the business?

Collective bargaining agreements – percentage of workforce covered.

Notice periods for operational changes – are contractual and operational changes notifiable within reasonable periods?

Health and safety compliance and performance – is the target at risk of fines, penalties or regulatory intervention? Does the target take appropriate steps to protect the health and safety of its employees?

Training provided, including performance and development reviews – is employee development encouraged to ensure that human capital is directly contributing to the business with maximum impact? Does this effectively contribute to staff retention and motivation?

Diversity of staff and equal opportunities (pay relative to gender, age and ethnic origin) – is this in line with recognised best practice?

Human rights conformance and awareness – does the target ensure that human rights of its employees are considered and protected?

Non-discrimination – is there sufficient evidence that employees are treated fairly and equally? Is there any litigation underway or pending which could have a significant adverse impact on the target (financial or otherwise)?

Freedom of association and collective bargaining – does the target meet legal requirements or best practice?

Child labour rates, and measures to combat this. Forced and compulsory labour rates, and measures to combat this – does the target meet legal requirements or best practice in this area? Is there a risk of reputational damage or litigation which could impact the target?

Security practices – are personnel in high risk areas provided with sufficient security and protection? Are security personnel sufficiently trained in understanding human rights of employees or others?

Indigenous rights, based on number of violations and actions taken – is the target considerate of indigenous rights? Is there a risk of reputational damage associated with previous or current activities? Could there be significant market opportunities to improve this reputation?

Community programmes to manage business impacts on the local population – are mechanisms in place to minimise impacts on the local community or to create positive effects?

Corruption-related incidents, anti-corruption policies and actions taken – does the target take a firm stance on anti-corruption, and have there been any incidents which could result in penalties or negative publicity?

Public policy positions, e.g. lobbying and political donations – could any of these public positions result in positive or negative reputational impact?

Anti-competitive behaviour – is there a risk of penalties, legal intervention or reputational damage?

Overall business compliance with relevant laws and regulations – are there risks associated with fines or regulatory intervention? Has the target allowed sufficient contingency within the business model for reasonably foreseeable legal requirements?

Supply chain management / producer responsibility

Investments with **human rights** screening/clauses – have agreements been made to ensure legal liability through the supply chain is minimised in key areas?

Suppliers undergoing screening for environmental and social performance (see individual sections) – does the target take actions to encourage improved ESG performance, and does it monitor actual performance?

Customer health and safety across product lifecycles – are there issues associated with products and services which could impact the end user, and result in negative publicity?

Product and service **labelling** - does this conform with legal requirements or seek to meet best practice standards?

Marketing communications relative to laws, standards and voluntary codes of practice – do these meet relevant standards or have there been any breaches which could represent a material risk? Has marketing improved product image among stakeholders?

Complaints data regarding breaches of customer privacy – has there been any significant evidence of such breaches?

Bold – likely core considerations for any transaction.

Additional Sources of Information

Global Reporting Initiative (GRI)
(www.globalreporting.org)
An international, multi-stakeholder effort to create a common framework for voluntary reporting of a company's global economic, environmental, and social practices.

Institutional Investors Group on Climate Change (IIGCC); A Guide on Climate Change for Private Equity Investors
(http://www.iigcc.org/__data/assets/pdf_file/0017/269/IIGCCGuideonClimateChangeforPrivateEquityInvestors.pdf)

Organisation for Economic Co-operation and Development (OECD)

- OECD Guidelines for Multinational Enterprises (www.oecd.org/daf/investment/guidelines)
- OECD Anti-Bribery Convention (www.oecd.org/daf/nocorruption/convention)
- OECD Principles of Corporate Governance (www.oecd.org/daf/corporateaffairs/principles/text)

UN Global Compact (http://www.unglobalcompact.org/)
The UN Global Compact's ten principles in the areas of human rights, labour, the environment and anti-corruption are derived from:

- The Universal Declaration of Human Rights (http://www.un.org/Overview/rights.html)
- The International Labour Organization's Declaration on Fundamental Principles and Rights at Work (http://www.ilo.org/public/english/standards/decl/declaration/text/)
- The Rio Declaration on Environment and Development (http://www.un.org/esa/dsd/agenda21/res_agenda21_00.shtml)
- The United Nations Convention Against Corruption (http://www.unodc.org/unodc/en/treaties/CAC/index.html)

UN Principles of Responsible Investment:

- UNPRI; Responsible Investment in Private Equity; A Guide for Limited Partners (http://www.unpri.org/files/PE%20LP%20Guide%20FINAL.pdf)
- UNPRI; Responsible Investment in Private Equity; Case Studies (http://www.unpri.org/files/PrivateEquityCS151209H.pdf)

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