Company Law Unit (JUST .A.3)
Directorate-General for Justice and Consumers
European Commission
B-1049 Brussels
Belgium

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Re: Public Consultation on Long-Term and Sustainable Investment

To whom it may concern,

The **British Private Equity and Venture Capital Association ("BVCA")** is the industry body and public advocate for the private equity and venture capital industry in the UK. With a membership of over 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital houses, as well as their professional advisers. Our members have invested nearly £30 billion in around 2,600 European companies since 2012. In the UK specifically, companies backed by private equity and venture capital employ around 490,000 people, and 88 per cent of investments in 2014 were directed at small and medium-sized businesses.

The Role of Private Capital

Private equity and venture capital firms provide an essential source of funding for innovative businesses at key stages of their growth journey. Unlike other forms of finance, their investment provides more than a simple cash injection, with both also offering significant managerial advice and expertise to ensure that the recipient can make the most of their funding and develop into a healthy business with strong fundamentals and good growth prospects. At a time when bank finance remains restricted, private capital is of utmost importance if EU member states are to successfully harness their respective competitive advantages and create the next generation of global European brands in fields as diverse as technology, media, health and energy. The UK in particular maintains a strong equity culture, with overall investment by BVCA members increasing by more than 14 per cent in 2014, reaching £4.7bn compared to £4.1bn in 2013.[1] Furthermore, recent figures from the British Business Bank have shown a 43 per cent increase in overall equity finance in small businesses in the year to October 2015.[2]

We are reassured to see that the asset class has been recognised as a vital component of the nascent Capital Markets Union (CMU) project. Notably the CMU action plan, released last September, states that venture capital has a “key part to play in supporting growth” and suggests that such funding to growing SMEs could be boosted through the use of new tax incentives, allowing larger fund managers to set up funds under the EU Venture Capital Fund Management Regulation (EuVECA), or through the development of pan-European public-private venture capital funds-of-funds.[3] With this in mind, we believe that it is important for the European Commission to be fully aware of the role of private equity and venture capital, not only in supporting expanding businesses and creating jobs, but in pursuing growth in a way that recognises the importance of Environmental, Social and Governance (ESG) matters. We will set out below how our industry is proactively implementing structures to develop responsible investment through increased transparency and accountability, and how it contributes to the goals of the Commission set out in the consultation document to transition to a low carbon and climate resilient economy with environmentally and socially sustainable wealth creation at its core.

[1] BVCA, ‘Report on Investment Activity 2014’, p.3.
(http://www.bvca.co.uk/Portals/0/library/documents/IAR%20Autumn15.pdf)
[2] British Business Bank, ‘Small Business Finance Markets Report 2015/16’, 2 February 2016, p.28. (http://british-business-bank.co.uk/research/small-business-finance-markets-report-201516/)
[3] European Commission, ‘Action Plan on Building a Capital Markets Union’, September 2015, pp.8-9.
(http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf)

Responsible Investment in Private Equity

As an asset class private equity is particularly well suited to integrating and managing ESG matters, given its hands-on active stewardship of businesses and long-term ownership timeframe. Whilst private equity firms and their portfolio companies have long been aware of the need to account for their wider social impact, they have increasingly recognised the potential for value protection and creation through ESG issues management across the investment cycle, employing coherent and structured frameworks to reduce costs and minimise risks whilst securing opportunities such as promoting supply chain sustainability and improving employee engagement.

Simultaneously, investors have pushed for private equity firms and managers to demonstrate their commitment to ESG issues through non-financial performance. Many have signed up to initiatives such as the UN Principles for Responsible Investment (PRI) to highlight their view that investor activity should be better aligned with broader objectives of society. Indeed, the PRI alone counts over 180 investors as signatories, alongside more than 240 private equity firms.[4] Furthermore, increased legislative obligations in the wake of the financial crisis have strengthened this requirement, with pension funds in particular mandated to consider ESG issues in their investments as part of their fiduciary duty.

Combined, these factors have ensured that the responsible investment agenda is now a key component of private equity industry practice. This has been evidenced in a recent survey of 42 private equity firms by the London Business School, which found that 38 of the group, or 90.5 per cent, had adopted ESG policies.[5] Indeed, the BVCA's own annual Responsible Investment Awards have shown time and again that private equity firms of all sizes are now implementing transformative ESG strategies across their portfolios swiftly and effectively.

Whilst there is a clear and positive direction of travel on this matter, it is important to recognise that individual members of the private equity and venture capital community find themselves at different stages of the responsible investment 'journey'. As mentioned above, ESG considerations are to an extent part of the industry's DNA, making clear business sense, but for firms starting out in this area there may be a lack of internal structure and consistency to ensure that less obvious ESG factors are recognised and managed appropriately. As such, the BVCA, and no doubt our sister organisations across the EU, will continue to bolster this important cause by highlighting best practice through case studies (a number of which are featured in this submission), publishing guides, developing training courses and through our ongoing awards programme.[6]

Responsible Investment at the Private Equity Firm - Strategy and Investor Relations

For a private equity or venture capital firm to factor ESG metrics into any investment it must first establish a strong responsible investment strategy at the level of the firm itself. This process includes a number of aspects. Firstly responsible investment values and principles must be defined, taking into account how these may align with key investor concerns, some of which may require investments in certain sectors to be excluded, such as those in alcohol, tobacco and the arms trade. With this broad scope in mind, the firm

[4] UN PRI, 'Private equity: About the work stream', (http://www.unpri.org/areas-of-work/implementation-support/private-equity/)
[5] Ioannis Ioannou, Francesca Cornelli, Thomas Zhang - The Coller Institute of Private Equity, London Business School, 'ESG: Moving Out of the Compliance Room and into the Heart of the Investment Process', 2015. (https://gls.london.edu/uploads/documents/Adveq_Applied_Research_Series.pdf)
[6] The case studies in this submission can be found in the BVCA publication 'Guide to Responsible Investment: Putting Principles into Practice', March 2015. (http://www.bvca.co.uk/Portals/0/library/documents/RI%20Guide%202015/BVCA%20Guide%20to%20Responsible%20Investment%202015.pdf)

can then move to develop a responsible investment policy or policies which communicate its principles and clarify its ESG commitments. Governance frameworks may then be formulated to define responsibilities for responsible investment management activities across the investment cycle within the firm, and will extend to include reporting arrangements from portfolio companies. As a minimum, private equity responsible investment policies will look to incorporate a commitment to compliance will all relevant legislation; a commitment to 'continuous improvement' in ESG performance; a list of excluded activities or sectors; and a set of ESG standards which the private equity firm will apply in judging potential investments. More developed responsible investment strategies will include frameworks for increasing value through product or service life-cycle management and brand differentiation. The most advanced firms will incorporate ESG matters in order to cement strategic advantages across their portfolio, enabling companies to pursue product and service innovation, attract better talent, enhance their brands and build market share. Whilst, as highlighted in the previous section, not all private equity firms yet have a policy in place, the sector is making positive progress and increasingly engaging with this structure.

Growing interest in responsible investment has met with substantial shifts towards increased transparency and accountability in the private equity sector in recent years. This has led to the development of several transparency-focussed schemes which specifically relate to ESG matters. The Environmental, Social and Corporate Governance Disclosure Framework - which the BVCA helped to develop alongside a number of investors and overseas sister organisations - was launched in 2013, and aims to provide guidance relating to the changing and diverse expectations of investors for the disclosure of ESG information from private equity firms and their portfolio companies. 2015 saw the launch of the UN PRI Limited Partner Responsible Investment Due Diligence Questionnaire, which builds on the aforementioned Disclosure Framework by providing a detailed list of questions which investors can ask private equity firms when they are looking to allocate funds.

These initiatives aim to improve dialogue between investors and private equity firms, and ensure that both have a firm foundation for developing a mutual understanding of expectations and abilities in terms of the integration of material ESG factors into investment practices. With a clearly defined responsible investment strategy and rigorous disclosure practices in place, private equity and venture capital firms are able to attract and build strong relationships with investors and ensure that funds are invested in a manner which consistently incorporates ESG-related decision making and therefore maximises opportunities to protect and increase value. Notably, this represents a positive-sum game which has acted as a prime driver of the responsible investment agenda in the asset class.

CASE STUDY: Scottish Equity Partners

Scottish Equity Partners (SEP) actively promotes responsible investment best practice, and will not invest in companies pursuing unethical business activities such as gambling, tobacco production or firearms manufacturing. All partners and employees are aware of the importance of responsible investment, which is enshrined in SEP's fund management processes and operational procedures. These are further realised through induction and on-job training. SEP keeps up to date with ESG issues through industry briefings, and regular updates from its legal and accountancy advisers. These measures are driven by the understanding that ESG issues can influence the firm's reputation and impact value creation within SEP's portfolios, in turn affecting fund performance and future fundraising potential.

Pre-Investment Phase

When considering target businesses, the pre-investment phase presents an opportunity for a private equity or venture capital firm to evaluate ESG risks and opportunities across the value chain. Central to this process is an assessment of the materiality of these factors in terms of the magnitude of their expected effect on the financial 'bottom-line', as well as on other stakeholders including society at large. These may range from environmental concerns (such as resource scarcity and air emissions), social issues (such as diversity and consumer protection), and governance matters (such as employee relations and corruption). Having established whether a target aligns with their values and principles and sector limitations as part of a top level screening, many private equity and venture capital firms will begin a process of 'business profiling', whilst more detailed due diligence investigations may be commissioned at the 'exclusivity' stage. Developing a system that allows adequate scoping of due diligence in relation to ESG matters is vital if a responsible investment strategy is to be worthwhile and successful. To achieve this, private equity houses will use a range of providers including consultants on an ad hoc basis, but often with a view to integrating this capability within the firm itself, allowing for consistency in approach across a portfolio of businesses.

The breadth of this process will vary substantially depending on the nature, location and activities of a business, but will always consider its current and reasonably foreseeable ESG issues, including legal compliance and non-regulatory matters. This could include the use of recognised reporting standards like the Global Reporting Initiative, sector-specific concerns (such as carbon foot-printing for the food sector or social capital for the service sector), and/or investment community agreements (including the aforementioned PRI). Opportunities will also be considered in due diligence and include evaluating the potential for new markets or income streams through ESG changes (for example developing clean tech products, responding to changing consumer tastes by producing sustainable products, or adopting labels such as Fair Trade); securing 'eco-efficiencies' (through using less energy or raw materials); and 'industrial ecology' whereby company waste products are provided to another as raw material. Vitally, ESG due diligence will also look to identify the steps necessary to improve ESG performance post-acquisition, allowing for the proper integration of ESG-focussed action plans into the target business.

CASE STUDY: 3i

Pre-investment is the first opportunity in the investment lifecycle for 3i to actively consider and action ESG components. An initial assessment of all new equity investment opportunities is carried out using an online proprietary ESG due diligence tool to check the company for high level ESG risk areas which may require more detailed due diligence. This allows all staff, regardless of location to carry out a consistent ESG assessment based on the IFC Performance Standards. If potential ESG risks are identified, 3i commissions 'deep dive' due diligence involving external experts. If the diligence identifies material ESG risks, 3i may require the company to commit to implementing appropriate measures to mitigate those risks. 3i will then support the company by developing action plans with appropriate targets, timetables and resources.

Ownership Phase

Whilst ESG issues are rarely so material that they prevent an investment progressing, immediately after a deal has been completed company management will often work closely with the private equity owner to develop action plans which take into account ESG value creation and protection opportunities arising from the aforementioned due diligence process. Active management of ESG factors will then take place throughout the holding period, with new issues potentially arising over the years, some of which will come to the fore due to the rigorous ESG framework and requirements for management, monitoring, measuring and reporting that the private equity firm will have put in place at the time of investment.

Notably, private equity firms are increasingly factoring long-term ESG issues such as climate change into this management process, rather than simply focussing on matters that can deliver a return during a standard holding period (from 5-7 years), like reducing staff turnover. This long-term approach to value generation during the ownership phase is also evident with the incipient integration of ESG reporting into financial matters through instruments including environmental profit and loss statements. This establishes a price for the external impact of a company along its entire value chain, embedding a responsible approach and ethos through traditional business metrics. It is important to emphasise once again that this ability to drive forwards progress on ESG issues within a business at a deep level is a key benefit of the private equity model, which may not be present amidst the diffused interests of multiple shareholders.

During the ownership phase, private equity firms will often collate ESG monitoring data and use this in reporting to investors and wider stakeholders as evidence of their responsible investment approach. This information will also form part of the constant line of communication between private equity firms and their investors, with the latter expecting to be informed on any significant developing ESG matters. The Guidelines for Disclosure and Transparency in Private Equity, published in 2007 and overseen by the Private Equity Reporting Group (PERG), have provided an important means to monitor and assess the take-up of the responsible investment agenda and ESG matters by the largest private equity firms and their portfolio companies. Recent changes to the Guidelines require in-scope organisations to provide enhanced disclosure of information relating to social and community issues and environmental matters in line with the public FTSE 350 companies, and it is hoped that this will act as an incentive for a stronger focus on ESG standards across the industry in coming years.

CASE STUDY: Terra Firma - The Garden Centre Group

In 2012 Terra Firma acquired The Garden Centre Group, now known as Wyevale Garden Centres, and since then has driven the business to take significant steps forward in its ESG strategy. On acquisition the business already had various Corporate Social Responsibility (CSR) activities in place, but Terra Firma encouraged the further development of a range of ESG initiatives including:

- Bringing in external expertise to work with the business in developing a new corporate responsibility strategy.
- Promoting sustainable gardening practices, such as encouraging customers to use water butts, to grow their own fruit and vegetables, and recycle plant pots.
- Approving investment projects which brought both environmental and financial benefits, such as real-time water meters, capillary matting and £3m on LED lighting and light sensors.
- Launching an Employee Assistance Programme, providing staff with access to anonymous financial and legal support.

Addressing these issues has led to significant financial benefits (changes to lighting reduced energy use by 60%, and improved water monitoring reduced waste management costs by 14%), whilst greater environmental awareness (of issues such as increasingly volatile weather, the impact of peat and timber use, or changing pests and diseases) has also allowed Wyevale to educate customers and adjust its product mix, making it easier for customers to buy the right products, thereby maximising sales.

Exit Phase

As private equity firms usually look to own a business for around 5-7 years, planning for exit will usually begin once an investment is initially finalised. This helps guarantee that interests between the private equity firm and company management are positively aligned, and ensures that the eventual exit process is as smooth as possible. A review of the business' ESG performance, and the level of progress towards pre-set targets will take place as the holding period draws to a close. This allows the firm to deal with any potentially ongoing material issues in an up-front manner, establishing key actions to minimise risks and maximise opportunities to build value. In addition the firm will look to reassess the likely ESG disclosure requirements of any potential buyer.

The actions required of a private equity firm in this regard may vary substantially depending on the type of exit being pursued. IPOs for example come with associated ESG listing requirements (including information on carbon emissions; social, community and human rights issues; and details on employee diversity), increased public scrutiny and reporting, and stakeholder pressure. As a result the firm will look to prepare more detailed disclosures and provide greater transparency. Secondary exits to fellow private equity firms may require answering complex questions from technical advisors appointed by the acquiring party, particularly if its ESG strategy is minimal or non-existent. Finally, trade buyers may be highly aware of ESG issues impacting a business, with their purchase likely motivated by a familiarity with the company's industrial sector. This may reduce the level of disclosure required, but lead to more challenging questioning by the acquiring firm.

Whilst rigorous quantified data on the financial impact of strong ESG performance is not yet widely available, it is believed that a positive firm and portfolio company attitude towards ESG issues, translated into improved ESG performance, can result in higher exit prices. Such an approach will also lead to good market reputation for the company being sold, and the private equity firm in question. As mentioned above, we once again see a positive-sum game whereby firms will, through their responsible strategy, see an improved return on their investment and additional opportunity at fundraising, as investors look for more evidence of sound ESG issue management.

CASE STUDY: Endless LLP - Crown Paints

Endless acquired Crown Paints in 2008. On acquisition, Crown Paints was a heavily loss making subsidiary of Akzo Nobel. There were a number of environmental issues to be addressed as well as a lack of strategic direction and investment. These included innovations in R&D to reduce the environmental impact of products and operations; development of a low carbon range of paints; and waste, water and carbon reduction strategies. Endless' strategy did not only address Crown Paints' environmental issues, also viewing strengthened corporate governance as vital to a successful turnaround and a prerequisite to a profitable exit. For Endless, failure to address the ESG issues it identified on acquisition would have been a serious impediment to a successful exit. The improvements made to the company led to its sale to Hempel A/S in 2011. Notably, no ESG concerns were raised during the sale process, with many improvements cited as assets and enhancing value.

Closing Remarks

With 97 per cent of investors expecting responsible investment to grow in importance over the next two years, it is sensible to assume that the number of private equity and venture capital firms engaging with this agenda will also continue to expand.[7] Demonstrating how this approach makes real business sense, generating value through the industry's existing efforts to combine strategic, financial and operational expertise to grow better companies, will continue to be a central mission for the BVCA. We recognise that a strong approach to ESG issues will become an increasingly key pillar of competitiveness for businesses and investors across the EU. Similarly, in the wider political debate on the role of business in society - and particularly the financial sector - it is important that each asset class makes clear its contribution to this effort. As we hope to have demonstrated above, the integration of ESG matters in private equity and venture capital demonstrates an industry embracing modern financial, environmental and social realities, working towards a more secure and sustainable future.

Please do not hesitate to contact us if you have further questions regarding the role of private equity and venture capital in long-term, sustainable and responsible investment.

Kind regards,

Jeremy Lytle

Chair, BVCA Responsible Investment Advisory Group

[7] PwC, 'Bridging the gap: Aligning the Responsible Investment interests of Limited Partners and General Partners', 2015, p1. (http://www.pwc.com/gx/en/sustainability/publications/assets/putting-a-price-on-value_pwc-private-equity-survey.pdf)