Responsible Investment Forum Europe 2019

PEI Alternative Insight
PRIVATE EQUITY INTERNATIONAL

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PRI Principles for Responsible Investment

GOING MAINSTREAM

10 years of ESG

The past decade has seen the private equity industry take huge strides toward advancing a responsible investment agenda, writes Victoria Robson

Time flies. Over the last 10 years, the private equity industry has transformed its approach to environmental, social and governance issues. What began as a high-level, niche concern focused on core principles espoused by a few industry participants has evolved into an increasingly mainstream, hands-on preoccupation.

Looking back, 2009 marked a watershed year when the global financial crisis precipitated sharper regulator and public scrutiny of the financial services industry and a heightened awareness of risk management. The American Investment Council (then the Private Equity Growth Capital Council) issued its first guidelines for responsible investment. KKR signed up to the UN-supported Principles for Responsible Investment (PRI) launched at the New York Stock Exchange three years earlier. And Invest Europe (then the European Private Equity and Venture Capital Association) introduced ESG language into its handbook for the first time.

"Ten years ago when we were having conversations with GPs on ESG issues, we were told that we were one of few investors raising these points," says David Russell, head of responsible investment at USS Investment Management, which was among the first LPs to sign up to the PRI. "There were also very few in-house ESG professionals, even among the very largest private equity managers."

Fast forward to today and the industry is much more familiar with the language, topics and issues relating to ESG. The number of ESG specialists has rocketed and responsibility for ESG matters has begun to spread across firms.

This year, PRI and *Private Equity International* will host their 10th responsible investment forum. Since the debut event in 2010, these gatherings have grown in scale, number and geographies, and the »

TIMELINE

How ESG went mainstream

2009

KKR signs the Principles for Responsible Investment

The AIC develops responsible investing guidelines

2010

First PEI-PRI Responsible Investment Forum held in London

2011

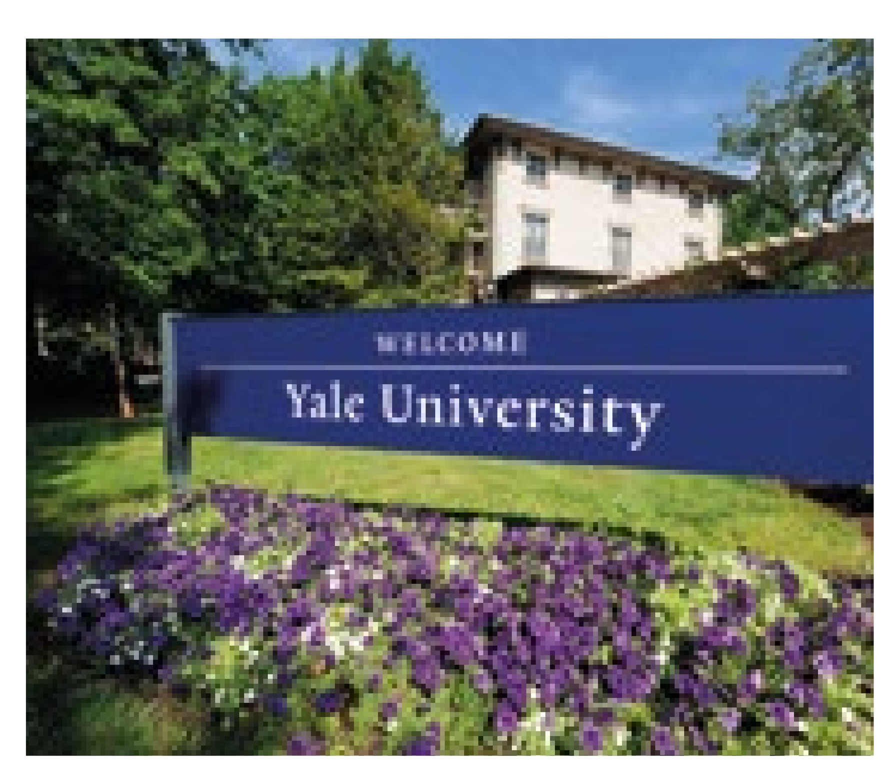
2012

2013

Invest Europe publishes ESG Disclosure Framework for Private Equity

2014

Yale Endowment CIO David Swenson calls on money managers to consider climate change in their investments



THE STANDARD BEARER

Canvas any industry professional and they will agree that since its launch in 2006 with 100 signatories, the Principles for Responsible Investment has been instrumental in galvanising ESG best practice within private equity.

A meeting in New York in 2008 convened by PRI of large GPs and LPs, as well as other representative organisations, was pivotal moment, says USS's David Russell. "This meeting really initiated discussions on ESG among large private equity firms and their key investors, and was the first time that ESG was discussed as an important issue amongst such a group," he says.

Jump to 2019, from a handful of signatories holding private equity assets, PRI now has more than 700. While some GPs remain beyond the fold, The Carlyle Group is a notable outsider, PRI membership is increasingly seen as a badge of commitment that LPs expect managers to obtain.

"LPs want to know what they could expect from GPs in terms of ESG, what's realistic," says Natasha Buckley, senior manager private equity at PRI, who sees the organisation as a platform for LP/GP engagement. "GPs view PRI as a framework to explain what they are doing."

While Buckley notes that GPs have met and exceeded the bar set by LPs, the organisation's work is not done. In the US, where ESG has become a divisive topic, some LPs still refute the argument that investing responsibly is their fiduciary duty. "If a GP is not fundraising in Europe then they may not even be exposed to ESG agenda or understand that it is concerned with investment value. The US is where we want to get a stronger foothold," she says.

TIMELINE

2015

World leaders pledge at COP21 in Paris to keep global temperature rise this century below 2C

UN adopts 17 Sustainable Development Goals

PRI launches the LP Responsible Investment DDQ at the PEI Responsible Investment Forum

French private equity firms launch Initative Climat 2020

2016

The Financial Stability Board convenes Task Force on Climate-related Financial Disclosures

The G20 launches Sustainable Finance Study Group

2017

PEI launches an annual New York series of the Responsible Investment Forum

TPG launches and closes $2 billion RISE Fund

2018

The European Commission releases action plan for financing sustainable growth

BlackRock's Larry Fink focuses annual letter to CEOs on sustainable long-term value creation

An IPCC report urges world leaders to restrict global temperature rise to 1.5C

SASB publishes industry-specific sustainability accounting standards

» delegate list has become more diverse. The topic focus has also shifted. "There's less evangelism and more detailed exploration of how to enhance returns through good ESG deployment: a focus on how, not why, you should do it," says Nicholas Lockley, director events EMEA at *PEI*.

FUNDRAISING

Demonstrating a commitment to ESG has become integral to fundraising, says Graeme Ardus, head of ESG at Triton, which closed its latest fund, Triton V, at the end of last year on €5 billion. "The nature of expectations and level of diligence conducted by LPs related to ESG is different from five years ago," he says, noting that a more diverse set of LPs in terms of scale and location asked specific questions, requested calls and submitted separate ESG questionnaires during marketing for Fund V. "LPs themselves are more engaged. The appetite for information is increasing and there is more follow-on monitoring," he says.

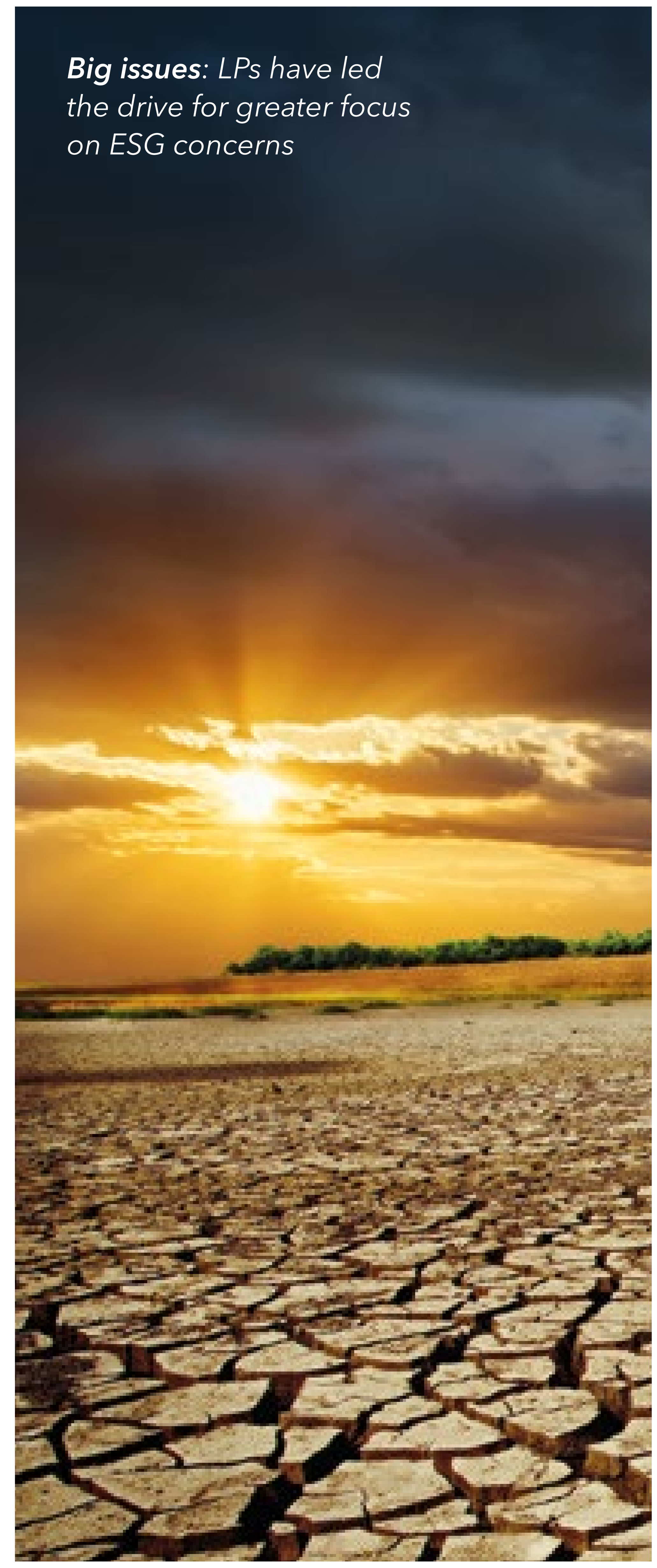
The launch in 2015 of the PRI's LP due diligence questionnaire (DDQ) and the inclusion of ESG-related data in fund documentation have been key developments, says Russell. "Even 18 months ago we would have typically had to ask for this, but it is now provided proactively by the majority of GPs as they are raising new funds," he says.

POLICY MATTERS

In addition to LP pressure, industry bodies, like Invest Europe which launched its ESG DDQ for portfolio companies in 2016, are pushing the agenda. The rapidly evolving regulatory environment is also forcing investors to consider their ESG obligations. More than half of responsible investment policy dates from 2013, according to PRI. Among the most recent touching on a growing ESG issue is the EU's General Data Protection Regulation that came into force last year and has put the spotlight on cybersecurity and data privacy.

The Financial Stability Board's Task Force on Climate-related Financial Disclosures is also viewed as a game-changer. The TCFD issued its first status report at the end of last year, which reviewed around 1,800 companies' current disclosure practices relative to its recommendations. It follows the Paris Agreement on climate change reached in 2016 and the launch of the UN Sustainable Development Goals (SDGs) a year earlier in spurring GPs to address climate-change related costs and risks. The influence of the Sustainability Accounting Standards Board founded in 2011 has also upped the stakes of not paying attention to topics that matter to investors.

At the same time, technology and social media are enabling increased public scrutiny, exemplified by the #MeToo campaign



***Big issues**: LPs have led the drive for greater focus on ESG concerns*

against sexual harassment. This has positioned workplace diversity and inclusion front of mind. "Diversity and, in particular, gender were talked about at every event in 2018," says Shami Nissan, head of responsible investment at Actis. "Private equity firms have a significant opportunity to promote gender equality through their portfolio companies. In our portfolio, for example, we employ 160,000 people. There's real power to drive change there." Gender and inclusion, she adds "has become a gating issue for some LPs."

RISK TO OPPORTUNITY

Today, there are still some GPs that approach ESG as simply a compliance function. But increasing numbers sitting at the other end of the spectrum recognise that investing responsibly, concentrating efforts on topics with material impact, and integrating a robust programme throughout the investment cycle, present a huge opportunity to create value.

ESG engagement has become a differentiator. "With competition being so fierce and record levels of dry powder, particularly at the larger end of the market, it's about finding every value creation and functional lever you can to differentiate yourself," says Alan Gauld, investment director at Aberdeen Standard Investments. "That's part of the reason why people are focussing more on ESG during due diligence rather than approaching it as a reporting requirement post event. ESG is being seen more and more as a value creation lever rather than just risk mitigation."

Private equity was late to the conversation about investing sustainably. For those managers who continue to shrug off its importance, the reputational and operational risks will only increase and they will miss an opportunity to create additional returns. For those seeking to catch up, the benefit of private ownership is they can get there – very quickly. ■

WHAT'S NEXT?

Progress has been made but the path to responsible investment is long

Market participants note that the diversity of LP, GP and consultant approaches to ESG and the variety of reporting methods is an obstacle to benchmarking firms. On the other hand, case studies and metrics proving the case for value creation are scarce.

"I'd like to see ESG spoken about in terms of the financial benefits, its contribution to the business and ultimately to the exit process," says Adam Black, head of ESG and sustainability at Coller Capital, who believes bottom-up ESG engagement involving the investment team is typically more impactful than top-down initiatives alone. "SDGs are interesting to map across a portfolio but GPs need to focus on where they can make a material difference," he says.

At the same time, some GPs are adopting a bolder and more ambitious take on what it means to invest responsibly. "As an industry and as a firm we have moved from articulating principles at a policy level to a deeper connection to our role in society and impact beyond financial returns," says EQT head of sustainability Therése Lennehag. This requires moving from a "risk focused compliance approach and process orientation to caring about outcomes and impact and thinking about the investment opportunities".

Impact investing – with its focus on the societal and environmental implications of a portfolio company's product and service offering – has arrived. For sustainable investment veterans, it is an inevitable destination. "The better firms are looking at operations and supply chains as well as outputs," says Black. "We should view this as ESG with impact."