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# Responsible Investment 2020

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#### Contact Us

For programme information:

**Niann Lai**

✉ [niann.l@peimedia.com](mailto:niann.l@peimedia.com)

For sponsorship opportunities:

**Sponsorship Team**

✉ [asiasponsorship@peimedia.com](mailto:asiasponsorship@peimedia.com)

For registration queries:

**Customer Services**

✉ [asiaevents@peimedia.com](mailto:asiaevents@peimedia.com)

## How to contact us

Senior Editor, Private Equity

**Toby Mitchenall**

toby.m@peimedia.com, +44 20 7566 5447

Senior Editor, Private Equity, Americas

**Isobel Markham**

isobel.m@peimedia.com, +1 646 380 6194

Senior Special Projects Editor

**Graeme Kerr**

graeme.k@peimedia.com, +44 20 3862 7491

News Editor

**Adam Le**

adam.l@peimedia.com, +44 20 7566 5437

Senior Reporters

**Carmela Mendoza**

carmela.m@peimedia.com, +44 203 640 7512

**Rod James**

rod.j@peimedia.com, +44 20 7566 5453

Asia Reporter

**Alex Lynn**

alex.l@peimedia.com, +852 2153 3148

Contributors

**Amy Carroll, Claire Coe-Smith, Simon Meads,**

**Vicky Meek, Ben Payton, Victoria Robson**

Managing Editor, Production: **Mike Simlett**

Head of Production: **Greg Russell**

Production Editors: **Daniel Blackburn,**

**Adam Koppeser, Karl Shmavonian**

Copy Editors: **Eric Fish, Nicholas Manderson**

Art Director: **Mike Scorer**

Head of Design: **Miriam Vysna**

Senior Designer: **Lee Southey**

Designer: **Denise Berjak**

Head of Marketing Solutions,

Private Equity Group:

**Alistair Robinson**

alistair.r@peimedia.com, +44 20 7566 5454

Subscriptions and reprints

subscriptions@peimedia.com

Customer Service

customerservices@peimedia.com

Editorial Director: **Philip Borel**

Director, Digital Product Development:

**Amanda Janis**

Director of Research and Analytics: **Dan Gunner**

Managing Director, Americas: **Colm Gilmore**

Managing Director, Asia: **Chris Petersen**

Chief Commercial Officer: **Paul McLean**

Chief Executive: **Tim McLoughlin**

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# Insight

## Hot topic LP scrutiny of approaches to ESG is intensifying, with climate change a key concern. Here are seven takeaways from this year's Responsible Investment report



### Climate change is a growing focus

"The biggest challenge is how to address the risk and the opportunity," says Sean Collins, service manager (pensions) at Oxfordshire County Council, which runs the £2.5 billion (\$3.3 billion; €2.9 billion) Oxfordshire Pension Fund. The fund, with a 7.2 percent allocation to private equity, is currently developing its first climate change policy.

Environmental activism has played its part. The Oxfordshire Pension Fund came under pressure from activists Fossil Free Oxfordshire (FFO) to divest from all its fossil fuel holdings. But other factors are at play, too. There's a clear sense that with climate change becoming more visible - most strikingly with the Australian bushfires

- investors need to open their eyes to this global crisis. "We're not only doing this because we've been shouted at, but the protesters have helped our thinking. There's been a recognition that we need to do more and be more transparent and work with others including FFO to develop a policy," says Collins.



### LPs want to be seen to lead by example

With C\$327 billion (\$245 billion; €221 billion) of net assets, of which C\$43 billion is invested in private equity (through funds and direct investments), Canadian pension fund Caisse de Dépôt et Placement du Québec believes it can influence GPs and their response to climate-related issues. "We try to sensitise them to the importance of it, and educate those that don't realise the importance," says chief stewardship investing officer Bertrand Millot. "We lead by example and increasingly



### Risk management is key

Directors have a duty to take ESG into account, says Simon Witney, special counsel at Debevoise & Plimpton. "Any issue that affects a firm's risk profile can fall within the ESG category," he says.

"In my view, a lot of this is about governance - it doesn't really matter if you classify an issue as being part of ESG; what matters is ensuring good corporate governance and proper risk management."

Data protection is paramount. "Cybersecurity and data privacy are becoming more of an issue for private equity, because of the GDPR but also because society at large is focusing more on these issues. And of course, anti-corruption is a perennial concern," says Witney.

we are going to take a more demanding approach.

At the UN in December, we announced we're going to be net-zero carbon by 2050. In that context it's inevitable that at some point all the money we manage will have to be strictly climate-compliant. And that will apply to external managers. For GPs that don't

do anything on climate, I'm not sure we'll be investing with them in the future."





### A sense of understanding is required

The £2.5 billion Church of England Pensions Board describes itself as being on a “fairly early stage of our private equity journey” and has just started working with Cambridge Associates to increase its holdings to a target allocation of 7 percent. On climate change, it describes its approach as “nuanced” as it tries to contribute to a move towards a more carbon-free economy. “We require all our managers to have the capacity to analyse, understand and act on ESG criteria,” Stephen Barrie, deputy director of ethics and engagement at the CEPB, tells *Private Equity International*. “We want to be at the forefront of driving the transition.”

Private equity is in a powerful position to drive change, says Barrie: “We think that GPs have got the opportunity for greater influence on the portfolio companies. There are opportunities for excellent responsible investment practices in private equity - the model is corporate governance-based.”

### GP behaviour is changing

Swedish pension funds, which have been among the most vocal in demanding action on ESG issues, say the private equity industry is responding to their demands, especially on climate change.

“In our 2019 ESG assessment we aggregated our portfolio climate change data for the first time,” says Anna Follér, sustainability manager at the Sixth Swedish National Pension Fund (AP6). “It revealed that a number of GPs carry out climate-related risk assessments based on forward



“For GPs that don’t do anything on climate, I’m not sure we’ll be investing with them in the future”

Bertrand Millot  
CDPO



looking scenarios. We haven’t seen this before.”

There’s also been a shift in emphasis from the fund manager itself to the companies it invests in.

“We also realised carbon emissions and the impact on the climate was not the only issue,” says Follér. “The other side is how climate change impacts portfolio companies. Over time, that’s been a big change in how we look at climate impact and diligence it.”

### Diversity is rarely a deal breaker

LPs are becoming more diversity-conscious, but a lack of gender balance in investment teams is rarely a reason to pull an investment.

Data compiled by Private Equity Recruitment, an executive search firm, suggests only 13 percent of partners in private equity firms are women. This figure falls to just 9 percent among senior partners and only 3 percent among operating partners.

Yet our latest *LP Perspectives Survey* reveals that although a significant proportion of LPs - 35 percent - say they are actively encouraging fund managers to promote gender diversity, just 14 percent of respondents report they have refused an opportunity due to a lack of diversity at the fund manager level.

### Blended finance offers impact

The rise of the impact investment movement has seen the growth of blended finance, where typically development finance institutions or other donor bodies provide the initial first-loss capital on below-market terms, allowing private sector investors in the fund to benefit from higher rates of return. The fund is normally managed by a GP that specialises in impact investments.

Katrina Ngo, a senior manager at the Global Impact Investing Network, says these structures can work well in the private equity sphere. “We’re hoping that private equity investors can see blended finance as a tool that allows them to invest in sectors or regions or themes that they might not have explored due to the risk profile of the investment.” ■



## Editor's letter

# It's time to talk about climate change



**Graeme Kerr**

graeme.k@peimedia.com

The Australian bushfires are a striking warning of the destructive powers wrought by climate change. Many institutional investors, especially the big European and Canadian pension funds, are entitled to view the horrific scenes with an air of “we told you so”. Pension funds such as USS, the Sixth Swedish National Pension Fund (AP6) and Caisse de Dépôt et Placement du Québec have been pushing GPs for more disclosure on climate change. The response has been patchy. The vast majority of GPs simply don't collect the data, says David Russell, head of responsible investment at USS, one of the UK's largest occupational pension schemes.

Yet there is a sense something is definitely changing. The conversation has shifted to one of risk – and whether the underlying portfolio could be under threat from the kind of climate-driven calamity seen in Australia. LPs report progress on this point among GPs. AP6's 2019 ESG assessment revealed that a number of GPs carry out climate-related risk assessments based on

**“ The conversation has shifted to one of risk - and whether the underlying portfolio could be under threat ”**

forward-looking scenarios, something it said it had never seen before.

Investors are also shifting tack. In compiling this report, we talked to several LPs formulating their first climate change policies for private equity. UK local government fund Oxfordshire Pension Fund developed its policy after coming under pressure from activists to divest from all its fossil fuel holdings, conceding the protesters may have helped them become more transparent. And the Church of England Pensions Board has honed a “nuanced approach” designed to encourage “good responsible investment behaviours among GPs”.

A climate change dialogue is emerging between LPs and GPs. As Adam Heltzer, Partners Group head of ESG and sustainability, puts it: “They are not prescriptive in suggesting what we should do, but they want us to have an approach.”

And that perhaps is the biggest sign of progress of all. No one expects fund managers to have all the answers about the myriad of matters relating to ESG but investors and fund managers are at last beginning to engage on the issues. It is good to talk.

Graeme Kerr



**New York**

130 West 42nd Street  
Suite 450  
New York  
NY 10036  
T: +1 212 633 1919

**London**

100 Wood Street  
London  
EC2V 7AN  
T: +44 20 7566 5444

**Hong Kong**

19F On Hing Building  
1 On Hing Terrace Central  
Hong Kong  
T: +852 2153 3240

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## KEYNOTE INTERVIEW

# Integrating ESG into value creation is essential



*A sustainable approach to investing goes hand-in-hand with higher returns, say CVC managing partner Jean-Rémy Roussel and ESG director Chloë Sanders*

CVC Capital Partners has more than \$80 billion under management across private equity and credit, and fully integrates ESG considerations into its approach to creating value across its investments. Here, Jean-Rémy Roussel, managing partner and head of private equity operations, and Chloë Sanders, ESG director, explain CVC's approach to ESG across its investments.

**Q How does CVC integrate ESG into its value creation plan, and why?**

**Jean-Rémy Roussel:** When we invest in a company and set out to grow value, we don't just look at the more obvious factors such as cashflow, sales and profitability, we also look at more fundamental value drivers, such as: how to gain market share through sustainable and responsible value creation. ESG plays a critical role in this.

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We sit down with a company's management team and look at how we can really improve the 'value fundamentals', as well as considering costs. You can grow market share simply through your customers being satisfied, and therefore being more likely to recommend you and give you repeat business.

We see five levers that feed into this: workplace, community, marketplace, environment and governance. Some of these levers will not necessarily improve short-term profitability, but they will make a difference in the medium and long term. You are unlikely to achieve a higher price when the time comes to sell the business if you have just cut costs; you have to improve the value fundamentals of the company.

**Q What are the first steps in improving the value fundamentals?**

**JRR:** When we work with management teams, the first thing we do is to focus on the customer – we collect data on customer satisfaction and look at where we are falling short against the competition. If you go into a company with negative customer feedback and five years later that feedback is positive, then most likely you will have grown market share and created value.

We then survey employees and look at how we can retain talent and improve the engagement and satisfaction of the workforce – finding ways to understand and build on employee values and motivation is essential. For example, we will look at a company's engagement with the community and environment and encourage the company to engage on environmental initiatives,

community projects, training and education. You get higher employee engagement if you hit on the core values that you want to be known for.

On climate change and environmental considerations, it is possible to source very sophisticated data on the current consumption of natural resources and the carbon footprint of a business. This forms the basis for agreeing with the business on what they are going to improve and how. If you can do that while making long-term costs savings and also improving the quality of the product or service, then you are able to significantly impact customer satisfaction and have an environmental impact.

Broadly speaking, governance means focusing on the rules of engagement and making sure your business conduct and ethics and compliance are all in good order. All of this is common sense because it is absolutely the right thing to do. And if you get it right, it leads to lower risks for the company and better financial results. It's as simple as that.

### **Q How do you balance the long-term nature of ESG strategies with the shorter, four- to five-year hold periods of most private equity investments?**

**JRR:** That is a question that is often asked by management. If you think about the long term, even the medium term, then there is no trade off in having better products, more engaged employees and a more positive impact on the environment. If people tell me that they cannot make changes because of the short-term financials, I ask them to think again, because there will be benefits down the line. Sometimes you have to take a short-

*“I’ve been engaging with investors on ESG for nearly 10 years and more recently I’ve observed a significant increase in interest and depth of understanding of ESG topics”*

**CHLOË SANDERS**

term hit in order to genuinely address an issue like customer satisfaction, but we are happy to support that, even if it's a five to 10-year payback horizon. So we are laying the foundations for long-term, sustainable growth and value creation that will endure long after our period of ownership comes to an end.

And if you explain clearly your long-term strategy to employees and customers and they understand and see you are doing the right thing, you will also begin to gain their trust and loyalty. Setting the right tone from the top is critical.

### **Q Can you give an example of a portfolio company where ESG has been at the heart of the value creation strategy?**

**Chloë Sanders:** A good example is Continental Foods, one of Europe's leading food companies, which was acquired by CVC Fund V in 2013 and sold last year to GB-Foods. During the time of CVC's investment, the company made significant strides in growing its market share. At the heart of this was creating better, healthier recipes across Continental's portfolio of European food brands, and focusing on improving the efficiency and sustainability of operations and customer experience.

This quote from the CEO of Continental Foods, Thomas Bittinger, sets out his perspective on ESG: “The business strategy should always encompass ESG, as the levers you need to work on to improve a business are the same as those required for an increased focus on ESG,” he says. “To compete strongly in the market, a company needs to produce great products within an agile and efficient organisation. To achieve this, a full range of ESG issues, from employee engagement through to energy efficiency, can, and should be, considered.”

### **Q How do you adapt your ESG approach to different types of businesses and industry sectors?**

**JRR:** The principles are broadly the same whether you are selling to consumers or other businesses, and whether you are selling goods or services. The biggest adaptations are on the operations side, looking at the end-to-end supply chain and ensuring a focus on those topics that are most material to the business.

The approach to employee culture is something that you might adapt for a particular location or country, where diversity can mean different things in different places. It is the same with the environment and community engagement, where employees and customers will have different ideas, but the fundamentals are the same. In terms of reporting and measuring progress you adapt the ratings and what you measure, but the key is to measure key fundamental factors for the business such as employee engagement or environmental impact so that you know your starting point, and can then set targets to improve on. If you measure and monitor ESG factors, you can manage them.

### **Q What mechanisms do you have in place to monitor ESG dimensions in your portfolio businesses?**

**JRR:** There are three ways. First, the operations team are working on the investments with the deal teams, talking with management, giving them three to six months to develop their new corporate strategy with new financial objectives and a complete value creation plan that includes sustainable and responsible growth. At subsequent board meetings we review progress against these objectives on an ongoing basis.

Second, we have non-financial metrics to measure, using external programmes to track progress on topics such as customer satisfaction and employee engagement, environmental impact, community initiatives, anti-bribery and corruption policies, and so on. For customers, we will look at net promoter scores, which measure the willingness of customers to recommend a company's product or service to others. For employees, we use questionnaires that can be very effective at measuring progress. For example, if you buy a company and 70 percent of the workforce say they would not recommend it to their friends as a place to work. But you turn that around so that when you come to sell several years





**Q You put customer satisfaction at the heart of your ESG strategy. Can you give an example of how this works?**

**CS:** A good example is CVC's investment in Sunrise Communications, the Swiss telecoms provider. When we made that investment in the complex and challenging European telecoms market in 2010, its customers weren't very happy, particularly about the pricing structure in place at the time.

CVC helped to turn the customer experience around by investing in a quality improvement plan and pioneering flat-rate tariffs and differentiated price plans. By improving the overall customer journey, we were able to achieve much higher satisfaction levels and significantly improve the company's reputation and brand positioning. At the same time, to ensure that the needs of employees were also being met, we implemented a comprehensive employee engagement programme and added customer satisfaction and employee engagement targets to the senior management teams bonus conditions. These improvements culminated in Sunrise winning industry awards for best telephony network and best customer service and attracting world champion tennis player Roger Federer as a brand ambassador. Ultimately, CVC was able to generate considerable value on the back of that ahead of a listing on the Zurich stock exchange in 2015.

later and 70 percent say they love working for the company and feel they are properly paid and rewarded, then that is a better company.

When it comes to additional topics such as sustainable procurement, environment and ethics, there are ratings available from well-respected providers that help track the progress companies are making. Finally, we have our own assessment process, where we collect reports from companies and ask our external auditors to conduct periodic reviews to validate the answers given.

**Chloë Sanders:** On the internal assessment process, we are engaging with lots of different companies across a broad range of industries. There are certain questions that apply to all companies and others that are more bespoke. It is not a cookie-cutter approach.

**Q What drives you to make this a priority? Are you under pressure from LPs to increase your ESG focus?**

**CS:** I've been engaging with investors on ESG for nearly 10 years and more recently I've observed a significant increase in interest and depth of understanding of ESG topics. Those investors interfacing with us on ESG are sophisticated and are asking for far more detailed information about portfolio companies, wanting to understand more

about our overall approach to the big global challenges. A lot of that comes from obligations in respect of their own ESG commitments. As long-term signatories to the PRI and more recently as a member of the PRI Private Equity Advisory Committee, we are actively involved in the finance industry's

dialogue on these topics. And, of course, it isn't just our investors: our portfolio companies, management teams, partners and employees demand it of us precisely because it is the right thing to do.

**JRR:** Investors have become much more attuned and expert at asking questions, and more determined to invest in investment managers that make this a priority. They have responsibilities of their own and we encourage them to ask questions and get engaged, private equity has a huge reach and the industry can have a significant impact. I fundamentally believe there is no trade-off between returns and ESG; they go together in creating value. Of course you want to improve the financials, but by focusing on all the inputs you know that you are going to leave the company in a better shape than you found it, which means you have a strong investment and of course you get better financial results. I would also add that ESG itself is a growing, attractive industry. Just as we want to measure how our portfolio companies are performing on key ESG credentials, so many other companies across the global economy increasingly need to track their own metrics. That's why we recently invested in environmental ratings group EcoVadis to tap into this growing demand. ■

*"I fundamentally believe there is no trade-off between returns and ESG; they go together in creating value for our investors"*

**JEAN-RÉMY ROUSSEL**

I would say we're in a climate crisis, just like a financial crisis, where action needs to be taken," governor of the Bank of England, Mark Carney, told the BBC at the end of December. "A question for every company, every financial institution, is: what's your plan?"

As former chairman of the UK's Financial Stability Board that backs the Task Force on Climate-related Financial Disclosures, Carney's is a powerful voice urging the asset management industry to move faster to address rising global temperatures. Increasing numbers of LPs, pushed by a diverse set of stakeholders, already are. For them, the threat to future portfolio returns is clear.

"Even if you have a fluorescent green portfolio, you will still incur climate risk," says Bertrand Millot, chief stewardship investing officer at Caisse de Dépôt et Placement du Québec. The C\$327 billion (\$245 billion; €221 billion) pension fund is a founding member of the UN-convened Net-Zero Asset Owner Alliance. The group of institutional investors, which includes the California Public Employees' Retirement System, is committed to reducing their portfolio carbon footprint to net-zero greenhouse gas emissions by 2050.

"Climate risk applies to all companies," says Millot. "The power that we have as large asset owners is to push companies and governments to do the right thing to decarbonise the economy so we can stay invested and continue to honour our fiduciary obligations vis-a-vis our retirees in a way that is prudent and diversified."

Funds across the spectrum have recognised the danger. Anna Follér, sustainability manager at the Sixth Swedish National Pension Fund (AP6), which manages SKr35 billion (\$3.7 billion; €3.3 billion) targeted at unlisted assets, reiterates the concern. "For us, sustainable development is fundamental to the well-being of future generations, and for generating an economic return for future pensioners," she says. "Climate change will affect our ability to generate that high-level long-term return. It's an important question that spans the portfolio."

"There is growing awareness that climate change is the key risk to investment performance and long-term financial success," says Sean Collins, service manager

# LPs take a stand on climate change



## Cover story

*Echoing the increasingly urgent public discussion around global warming and its impact, more investors are voicing their climate concerns, and goals, to their GPs.*

*By Victoria Robson*

(pensions) at Oxfordshire County Council, which runs the £2.5 billion (\$3.3 billion; €2.9 billion) Oxfordshire Pension Fund. The fund, with a 7.2 percent allocation to private equity, is currently developing its first climate change policy. “The biggest challenge is how to address the risk and the opportunity,” Collins adds.

In turn, LP scrutiny of their GPs’ approach to the issue is intensifying. “With climate change in particular, we have seen a significant ramp up of client queries in the last six to nine months,” says Alex Scott, partner at Pantheon and co-head of the firm’s ESG committee. As a fund of funds and co-investor with \$47 billion of private markets assets under management, the firm has a bird’s-eye view over both sides of the LP-GP fence. Scott adds: “Stakeholders are lobbying pension funds and government entities and they need to be seen to be doing something. The first thing institutional investors ask is, ‘What’s going on in our portfolio?’”

### Question time

Going forward, managers can expect to be asked more climate-related questions in ESG fund due diligence and monitoring. “Our investors take their responsibility to address the topic very seriously,” says Adam Heltzer, Partners Group head of ESG and sustainability.

“They want managers to have an intelligent understanding of how climate impacts the portfolio, where the greatest risks are and how to mitigate them on behalf of their clients. They are not prescriptive in suggesting what we should do, but they want us to have an approach. It’s, ‘Please don’t say you are investing in renewables and that’s the extent of your responsibility. Show us you’re doing something substantive.’”

LP/GP discussions of climate change are getting more sophisticated. “In very basic terms, the conversation has shifted from, ‘Do you know what climate change is?’ to, ‘How are you assessing and managing this risk (or opportunity) for your assets?’” says David Russell, head of responsible investment at USS, one of the UK’s largest occupational pension schemes with £64 billion (\$83 billion; €74 billion) of assets under management.

The physical risk climate change poses to underlying investments is evident. As a GP, Heltzer notes that extreme weather is a key one, pointing to a restaurant chain in







'There was a surprising degree of consensus'

### The Oxfordshire Pension Fund is developing its first climate change policy.

Under pressure from activists Fossil Free Oxfordshire to divest from all its fossil fuel holdings, the Oxfordshire Pension Fund is formulating a new climate change policy. In November, the £2.5 billion fund with a 7.2 percent allocation to private equity invited a diverse group of activists, climate experts, fund managers, students and representatives from Brunel Pension Partnership, a £30 billion local government pension pool of which OPF is a member, to participate in a climate workshop. Brunel plans to release its own climate policy early this year.

"There was a surprising degree of consensus," says Sean Collins, service manager (pensions) at Oxfordshire County Council, who expects continued focus on the issue in the year ahead. "We're not only doing this because we've been shouted at, but the protesters have helped our thinking. There's been a recognition we need to do more and be more transparent and work with others including FFO to develop a policy."

However, he maintains that divesting from fossil fuels entirely means the fund hands over its influence to less responsible owners. "The issue goes way beyond public market [fossil fuel investments]," he adds. "You can't have a policy to divest and say, 'We've done our bit.' We have to invest in industries that are going to help sustainability."

Key takeaways from the meeting noted a pension fund committee report including recognition that "the risks posed to our investments by climate change are real, and that the financial system can and should do more to address these risks"; the aim to "contribute to a low-carbon world, consistent with a maximum 2 degree [global warming] scenario"; and the need for collaboration, timescales, accountability, better metrics and clear targets, as well as improved stakeholder communication.

The working group established to draft the new policy is due to deliver it ready for review in March, ahead of its formal adoption in June.

its portfolio that had to close one of its outlets in California for a few days due to wildfires. Inevitably, the business lost revenue. The Australian bushfires have prompted firms like Sydney-based Adamantem to consider climate change a key investment risk.

LPs are also concerned about the regulatory risk inherent in any future government climate-related initiatives. Echoing the Principles for Responsible Investment's work on the Inevitable Policy Response, which argues that governments will be forced to act more decisively on climate change than the market currently expects, Collins notes: "There will be inevitable political consequences, like the introduction of a carbon tax. If you don't buy in you will make losses."

And LPs want to know if their GPs are capturing the opportunity present in transition to a low-carbon economy through the creation of new markets, infrastructure, technologies and products and consumer demands, as well as the operational upside from factors such as improved energy efficiency. "If we don't act on this and take it seriously, we will lose the faith, confidence and trust of our clients, employees, colleagues and government counterparts and regulators," acknowledges Heltzer.

### The questions LPs are asking

So what information are LPs asking for? Five years ago, when AP6 began to incorporate climate change into its ESG questionnaire, it focused on carbon emissions, a typical starting point despite the fact that it is far from an exact science.

"We'd like to see more transparency around carbon emissions in privately held companies," says Follér. However, she adds that while carbon emissions data are "tangible and quantifiable" and more GPs are collecting it, "it's also one piece of the puzzle". Over time, the fund's approach has undergone a significant shift, she notes, expanding its focus from simply emissions to how climate change impacts the portfolio. Overall, both the fund and its GPs have become more forward-looking, she adds.

For USS, at "a high level, our priorities will be on gathering more data on climate exposure and the management of it from our GPs," says Russell. "The exact ask will vary depending on the industry or sector being invested in – what is relevant for real estate will be different to oil and gas. In the former we'll be interested, for example, in how they are improving energy efficiency, reducing water usage and managing flood risk, whereas in

the latter we'd be asking about such issues as measuring and reducing emissions from production facilities or leakage from pipelines and the impact of carbon pricing on demand and how they are responding to climate-related policy risk."

However, there are limitations on what information LPs can expect to receive. "The investor universe knows it needs to be doing something, but it's still learning about what information it can gather," says Scott. "The challenge is working out what you can do in a private equity context," he says, noting that in public markets the information flow is faster and more consistent and often includes statutory reporting on emissions.

"A pension fund invests across multiple asset classes and they are grappling with what to ask [their diverse set of fund managers]. At the moment it's largely confined to broadly worded questionnaires," he adds.

Another break on collecting climate-related information is lack of availability. "The vast majority of GPs simply don't collect this data," says Russell. "But we are beginning to see a change – leading GPs have, or are now beginning to collect, appropriate carbon footprint data. However, footprinting is just one aspect of managing climate risk – it tells you where you have been, not where you are going."

To help grow a culture of transparency, Follér cautions LPs not to apply a one-size-fits-all approach to GPs. "You need to be balanced in requirements and be aware that there is a huge spread of maturity among [portfolio] companies," she says. "They may be in sectors that are not so carbon intense or at an early stage and have other priorities. Here dialogue [with our GPs] is important. If they have a good rationale for not requiring emissions reporting [from their investee companies], we can understand that."

LPs also need to take into account that for GPs, it is easier to obtain relevant data from businesses based in certain markets. "[For] European assets in jurisdictions where there is greater sense of regulatory action or impending action, it's an easier conversation," says Heltzer. "In the US it's more difficult."

In the US, investor focus remains on economic returns, notes David Fann, chief executive at fund advisor TorreyCove Capital Partners. "Clearly, given the challenges the Californians have faced with the wildfires, it has become top of mind for some of my Californian [LP] clients. It's happening in their backyard. But the challenge is nobody has created a good framework for mapping climate change from a private equity perspective."

This divergence between European and Canadian LPs on one side and their US counterparts on the other is perhaps not surprising given the absence of US government engagement with the topic. "The US stand on climate change is less than participatory of late," says Fann, pointing to its withdrawal from the Paris climate accord.

With GPs that do not yet realise the significance of climate issues, "we try to educate them", says Millot, noting that promoting the fund's climate objectives is easier in new relationships where the terms of engagement are not yet set.

"We lead by example and increasingly we are going to take a more demanding approach," he notes. Given the pension fund's 2050 net-zero carbon ambitions, "for GPs and external funds that don't do anything on climate, I'm not sure we'll be investing with them in the future".

Prodded by LP scrutiny and regulators, GPs need to act. There are positive indicators that this is happening. "We are now seeing leading GPs undertaking carbon footprints for their portfolios, and even committing to complete TCFD reporting," says Russell. "So while private equity as a whole has some way to go, we are beginning to see moves in the right direction." ■

## Crucial questions

**These are the climate concerns that Swedish pension fund AP6 raises during ESG due diligence and monitoring**

**1** Have you identified any climate change-related risks or opportunities that could potentially have a significant impact on the return of any of your funds or of individual holdings?

**2** Do you ask portfolio companies for climate change risks and opportunities mapping, climate change scenario analysis or a specific climate change strategy or policy?

**3** Do you ask portfolio companies to report their greenhouse gas emissions?

## Taking GPs to task

**The Financial Stability Board's Task Force on Climate-related Financial Disclosures is forcing the private equity industry to rethink its approach to global warming.**

For many LPs (and GPs) grappling with the wide-ranging complexities of climate change impacts, the UK Financial Stability Board's Task Force on Climate-related Financial Disclosures has offered some welcome structure.

Backed by Bank of England governor Mark Carney and its chairman, US businessman Michael Bloomberg, the company financial disclosure framework that covers governance, strategy, risk management and metrics and targets, has credibility.

"It's had a big impact," says Scott. "In ESG you see a lot of initiatives, but the TCFD is one that people are getting behind. It has scale and momentum."

The recommendations have reach and clout. "The TCFD requires all UK-listed companies and large asset owners such as USS to report on their climate-related financial risks and, as it applies to all assets classes, data-gathering will be a top priority going forward," says Russell.

However, it is not totally fit for private equity purposes. Focused as it is on listed entities there is an "insufficient push in regards to private companies", says Millot. "TCFD reporting should be applied to all companies public and private, big and small. They should all be doing it in the same way they should all fill in tax forms," he says.



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# KEYNOTE INTERVIEW

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## A new investment climate



*Partners Group head of ESG and sustainability  
Adam Heltzer talks us through the firm's approach to dealing  
with the impact of climate change on its portfolio – the risks and the opportunities*

**Q Within your environmental, social and governance agenda, where does climate change sit?**

At Partners Group, climate change stands out as one of our high priorities due to the scale of the risk, the impact and the urgency, and that's escalated over the past six months. It's very important to us, as well as our stakeholders, which are not just our clients and shareholders, but also our colleagues and our portfolio companies. Our task is to translate this huge and complex topic to the portfolio companies we invest in on behalf of our clients.

**Q What climate impacts are you most concerned about?**

From a risk perspective there are many different concerns, but extreme weather events

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have proven to be a key climate risk, which is evident from the devastation that has happened with wildfires in Australia and flooding in Indonesia. Clearly, this raises major social concerns for our investors, which we continue to monitor from all angles.

From a portfolio perspective, these events can have a direct financial impact, too. For example, in our current portfolio we have a restaurant chain with branches in California, which lost revenue due to the wildfires last year. We've also had investments shut down due to flooding. Over the past year, we considered an investment in the rail space, but the documentation

for the asset highlighted river flooding as a risk. We've also looked at a possible investment in the agriculture space, where climate change has many impacts, including global shifts in areas of production, which is a threat to our core markets. The flip side is the creation of new markets, for instance as the US breadbasket moves north to Canada – that is part risk, part opportunity – but you can see how the issues are prolific.

**Q How do you identify and deal with climate risk in your investments?**

Our annual ESG Key Performance Indicator survey collects carbon footprint data and fuel and energy consumption numbers to pinpoint areas for action, as well as information on climate risk. For instance, has

the business suffered any adverse financial impacts from climate-related incidents? In the example of the restaurant chain, we also asked how many of their other restaurants were in locations vulnerable to similar physical and financial impacts.

However, it's not always easy to get information. Only a minority of companies will have a robust carbon dioxide emissions number ready to give to us. Gathering that data for assets in European jurisdictions where there is greater regulatory pressure is an easier conversation than in the US, but we do this for our entire portfolio.

Active ownership is critical. We could hire an outside firm to triangulate a footprint number based on very crude industry averages that generate a working estimate. That is not as reliable as sitting down with a portfolio company and explaining how to measure necessary factors and helping them to understand the definitions and validating the data. That takes a lot of time and education to get right.

We also conduct what we call a "sweep" to assess a number of ESG topics that cut across our portfolio, for example health and safety, cybersecurity, fraud risk and climate change. It's a way to capture data on a single topic across several companies at once and prioritise risks and opportunities, including in energy and fuel management for which we have developed a standardised toolkit.

### Q What do you do with all this information?

We use this information to improve our portfolio companies' climate-related efforts, our investment process, and of course share it with our investors. The emissions data is published in our annual corporate sustainability report and included in our ESG dashboard. This also addresses those companies where we have not been able to gather enough data.

There has to be transparency and forthrightness around what's not good enough and how we're working to improve it. This is critically important and lacking in the broader ESG world. As owners, our role is to continuously professionalise the way the data is collected so we can have an ever-more reliable emissions figure that we can defend. This is a multi-year effort, but we are on that journey.

### Q Before you invest, how do you assess risks and opportunities?



### Q Does your approach to climate-related risks and opportunities differ across asset classes?

It does. We have the most impact on our private equity portfolio because we have more control and climate change is well integrated into our investment process. Our due diligence includes climate change topics and we are engaging with our portfolio companies directly. Our established system for scoping and implementing ESG initiatives, tracking and reporting on them has been running very well for several years.

Real estate is a bit different as the topics are much narrower. Globally, buildings contribute to a huge base load of emissions. Here, we are focused on energy management. During due diligence on an asset, we ask the operator about its current energy efficiency efforts, what initiatives they have undertaken to reduce consumption and its sustainability certifications, which will include climate-related topics. We can also benchmark buildings against their peers: similarly sized buildings in similar locations. Then we act during ownership to reduce emissions over time.

Private debt is the asset class that differs the most because we have less control. In this case our approach is somewhat more focused on risk mitigation. We take a similar overall approach to risk in private debt as we do to private equity, but in debt we work with the sponsor, which can have varying processes around ESG. However, we have had a number of sponsors say they want to take action on climate issues but don't know how. They have asked us for a steer on what to look for and how to tackle these risks given Partners Group's expertise in the area.

Our standard ESG due diligence questionnaire addresses climate change topics, including carbon emissions, but we build on that with input from an external expert who delves deeper into key areas.

For example, we now use a climate risk and opportunity matrix that ensures that when we approach the management team we have a fully baked climate change thesis about that company, what we can do to mitigate any risks and to capture upside opportunity.

### Q Given the breadth of climate-related issues, how do you pinpoint what to focus on at the portfolio company level?

It's not so different from other ESG topics in that sense. The first question is, what's within our span of control, and then, where is our responsibility, where can we be most impactful and where are our returns most threatened? We are active owners and are extremely focused on strong board governance. Our initial emphasis is on emissions,

prioritising which assets are the biggest emitters, and introducing initiatives to reduce them, and then ensuring the key risks are fully integrated into our enterprise risk management process overseen by the board. Our ESG team is part of Partners Group's industry value creation team, our in-house operating team, that works hand-in-hand with our investment team. This means we are closer to our assets than many others.

### **Q How are climate-related risks and opportunities integrated into the value creation plan?**

ESG footholds are embedded into every portfolio company's value creation plan. Within our ESG engagement, climate change as a topic is considered alongside other ESG priorities.

In due diligence, we select the topics that are the most critical and prioritise according to their materiality to the business or social and environmental impact, then start with the most urgent. We own assets for four, five, six years and take a long-term perspective so we are able to square away the most pressing issue then move to the next.

### **Q When you talk to management teams, how receptive are they to your climate change input?**

We are invested in companies in multiple industries and geographies. As you would expect, we see the full spectrum of responses from people asking for help with thinking about the risks and opportunities to others for whom it's not the first thing on their minds. In both cases our approach is the same: we identify specific topics relevant to the business and see how they speak to risks and opportunities and, of course, the ethical imperative.

### **Q What are the main challenges?**

The major one is translating the broader concept of climate change into an organisational set up. The Task Force on Climate-related Financial Disclosures provides a framework and has added some structure to this large and complex topic. But even then you have to tailor the framework to your specific strategy, platform and culture.

The second challenge is to galvanise senior management to take action to authorise and drive improvements. I'd argue that compared to other ESG topics, with climate change, you have to do more

*“There has to be transparency and forthrightness around what's not good enough and how we're working to improve it. This is critically important and lacking in the broader ESG world”*

change management and education within the firm and at portfolio companies, and in some cases even with clients. As a team we have to work out how to translate our key climate-related messages to all our stakeholder groups.

The complexity is a challenge. So, we focus on the largest and clearest impacts. There isn't much argument against reducing energy consumption through low-cost/no-cost behaviour changes at our portfolio companies. We focus on areas where there is unlikely to be a net negative impact, for instance building renewable energy infrastructure in Australia, which has one of the largest coal-fired power generating bases in the world.

### **Q Where do you see the opportunities?**

We actively target assets and companies that back the transition to a low carbon economy, such as wind and solar energy and supporting industries like battery storage. We are looking at an investment now that manufactures electric vehicle recharging stations.

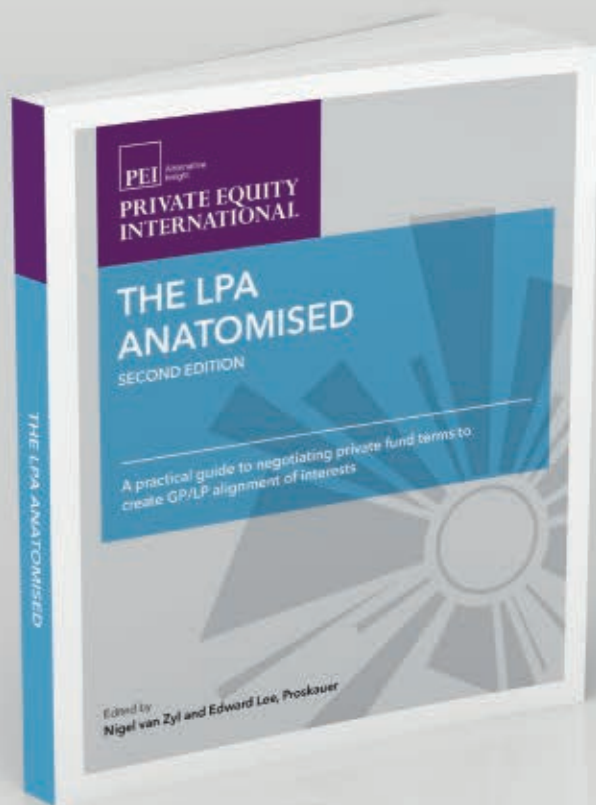
We have also invested on behalf of our clients in a European energy efficiency business that, prompted by European energy directives, retrofits meters that charge apartment residents for their energy use rather than billing them based on the size of their apartment. This can reduce consumption by 10-20 percent.

There is no question that we will see the impact of climate change on our portfolio companies. Governments will have to take action, as spelled out in the UN Principles for Responsible Investment's 'Inevitable Policy Response'. We think about how that will impact companies and the opportunities that will flow from that. We adapt for the leading edge regulators to stay ahead of our peers.

### **Q What's the cost of doing nothing?**

If we did not act, we would be overlooking risks with material impacts on the investments we make on behalf of our clients, and failing to capture the opportunities to cut fuel and energy costs, and to create value. If we didn't take climate change seriously, we would also lose the faith, confidence and trust of our clients, shareholders, employees and business partners, as well as government counterparts and regulators. ■

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# Q&A

## *Caisse de dépôt et placement du Québec vice-president and chief stewardship investing officer Bertrand Millot talks climate-related priorities*

With C\$327 billion (\$245 billion; €221 billion) of net assets, of which C\$43 billion is invested in private equity (through funds and direct investments), the voice of Caisse de dépôt et placement du Québec speaks loudly within the industry. We asked Bertrand Millot about the pension fund's climate-related priorities and how it communicates them to external private equity managers.

### **Q As a multi-asset manager, what's your response to climate change?**

Climate risk is real. Even if you have a fluorescent green portfolio you will still incur climate risk. We have a four-pillar policy. First, we take climate into consideration in all investment decisions. Second, our objective is to increase our green investments by 80 percent by 2020; we started in 2017.

Third is to reduce the carbon intensity of our portfolio by 25 percent by 2025. The fourth pillar is to engage with companies, our peers and the industry generally about climate change. These objectives apply to all asset classes across the organisation, whether they are internally or externally managed, and bonuses are linked to them.

### **Q How do you communicate these priorities to GPs?**

We talk about them in initial discussions. For new relationships, we rate GPs on operational risk using a point system and a large share of that overall mark is based on environmental, social and governance topics and their implementation. Climate is referred to in a number of questions: whether GPs take climate into consideration; whether they carbon footprint their portfolio; what kind of engagement they undertake with companies; how they appraise climate risk.

In new relationships, we would like – although it's not always possible for funds to



*“We recently told a GP we're not going to invest unless you give us carbon numbers the way we want them”*

give us – emissions data in the format we use internally. That makes our life easier. In some cases we've imposed it. GPs that could potentially invest in high emissions sectors would have an impact on the team's internal carbon budget.

With existing funds it's a little bit more difficult as the terms of engagement are agreed. Some are on their own climate journey, which is good. Some, not so much; which is not good. We try to engage and push them. Part of that is education.

### **Q Does each investment team have an emissions quota?**

Yes. The objectives are split across investment teams and private equity has a carbon budget that they must not exceed. As a result they have a vested interest in making sure external managers don't blow up that budget. Steel, cement, power, oil and gas – we are very, very careful if that's within the GPs remit. We have a very detailed conversation with the GP about the business model and what the GP can do about it.

### **Q What influence can you have over GPs and their approach to climate-related issues?**

We try to sensitise them to the importance of it, and educate those that don't realise the importance. We lead by example and increasingly we are going to take a more demanding approach. At the UN COP25 in December, we announced we're going to be net-zero carbon by 2050. In that context it's inevitable that at some point all the money we manage will have to be strictly climate-compliant. And that will apply to external managers. For GPs that don't do anything on climate, I'm not sure we'll be investing with them in the future.

### **Q Have you ever not invested with a GP due to climate-related concerns?**

We recently told a GP we're not going to invest unless you give us carbon numbers the way we want them. Period.

The GP was surprised at first and then said, “Great, explain it to us because you're the first ones to ask but you won't be the last and it's an opportunity for us to learn and put that to our competitive advantage.” We thought, bingo. We spent quite a bit of time explaining how our methodology works and how we look at the world in this respect, and they got the money. ■



# Q&A

*David Russell, head of responsible investment at USS, discusses how the private equity industry's understanding of climate-related issues is evolving*

**Q USS has been assessing climate-related risks and opportunities for almost 20 years, how has your interaction with GPs changed?**

In very basic terms the conversation has shifted from, “Do you know what climate change is?” to, “How are you assessing and managing this risk (or opportunity) for your assets?”

GPs are now well-aware of what climate change is – you can't fail to see it in global media – and are increasingly assessing what it means for their assets.

There is clearly variation in how material the issue is for GPs, depending on the market segment, underlying sector exposure and regional policy differences. However, awareness is now significantly higher than even a few years ago.

**Q Across the breadth of environmental, social and governance topics, where do you rank climate change in importance?**

Although GPs and their underlying assets will be exposed to a range of ESG issues, climate change and the policy response will impact a range of sectors and how companies are managed. As a result, climate change usually ranks quite high as an issue we focus on in our private equity investments.

Around 70 percent of our private markets investments are done directly. Here we hold ourselves to the same high standards.

**Q Given climate change is such a complex topic, what are your priorities for GPs?**

They are GP and asset specific. However, at a high level, our priorities will be gathering more data on climate exposure and the management of it, from our GPs.

This is because by 2022, large UK asset owners must be reporting in line with the recommendations of the Task Force on



*“The vast majority of GPs simply don't collect this data, but we are beginning to see a change”*

Climate-related Financial Disclosures. The TCFD requires all UK listed companies and large asset owners, such as USS, to report on their climate-related financial risks and, as it applies to all asset classes, data gathering will be a top priority going forward. That also includes any of our direct investments.

**Q How do you communicate these priorities to external managers?**

Where it's relevant, we ask GPs about

climate-related risks during our fund due diligence. We also ask them how they manage these risks during face-to-face monitoring meetings, where we also spend time highlighting the requirements of TCFD reporting.

**Q What detail, facts or other information do you ask prospective and existing GPs to report on climate-related issues or opportunities?**

We are interested in how GPs are identifying climate- and other ESG-related risks and opportunities in both their pre-investment due diligence and their post-investment monitoring and management.

Exactly what we ask will vary depending on the industry or sector being invested in. What is relevant for real estate will be different to an oil and gas company.

In the former we'll be interested, for example, in how the company is improving energy efficiency, reducing water usage and managing flood risk.

In the latter we'd be asking about issues such as: measuring and reducing emissions from production facilities or leakage from pipelines; the impact of carbon pricing on demand; and how they are responding to climate-related policy risk.

**Q How easy is it to get carbon footprint data from GPs?**

It is quite difficult. The vast majority of GPs simply do not collect this data, but we are beginning to see a change in this. Leading GPs have, or are now beginning, to collect appropriate carbon footprint data.

However, footprinting is just one aspect of managing climate risk – it tells you where you have been, not where you are going. We encourage our managers to think more broadly in their assessment and management of this issue. ■

# KEYNOTE INTERVIEW

## Investing in the future



*Peter Wirtz, co-head of 3i's private equity business, and Anna Dellis, partner in its infrastructure business, discuss how the sustainability agenda is changing and how it can bring opportunity*

### **Q** What do you see as private equity's role in sustainability?

**Peter Wirtz:** Private equity investors are in a privileged position. We have a wide scope of influence which extends beyond our own organisations to a large number of portfolio companies, their management teams, employees, customers and suppliers. In addition, decisions can be made quickly, so we have a lot of impact. Our goal is to bring the sustainability agenda to our portfolio companies through introducing best practice and applying what we've learned in other investments. It's not just about environmental factors; we have a role as responsible investors in influencing good social and governance practices too.

### **Q** Why is sustainability important? And what does it mean to you as a firm?

**Anna Dellis:** We want to understand the

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impact we are having, through our own organisation and our portfolio companies, on the environment and the communities in which we operate. We want to ensure that our portfolio companies are responsibly managed. This matters to us as individuals within 3i, to the individuals managing and working within our portfolio companies, and to their customers, who increasingly want to understand the values of the companies they are buying from. It's also important to the regulatory authorities, who are focusing more and more on sustainability. As investors, we depend on all of these stakeholders for our investments to be successful. We believe investors who do not engage in a serious way around sustainability will be left behind.

### **Q** What does this mean for how you operate as an investor?

**PW:** Sustainability has always been a key criteria for us as investors, but over the past 10 years, our approach has evolved, in particular as the available tools and the opportunities created by the sustainability agenda have developed. Ten years ago, we assessed each investment according to a limited number of ESG criteria. However, we now look at how our portfolio companies impact society in a wider sense and how their businesses fit with sustainability objectives. We also conduct annual assessments where we look at each portfolio company to monitor where improvements can be made and where there are new opportunities for the business.

**AD:** Our ESG assessment has become much more detailed over the past two years. It is no longer a checklist or risk manage-

ment tool, but rather a document that we use to support a proper discussion around ESG between 3i and portfolio company senior management.

While our historical focus in infrastructure was on areas such as regulatory compliance, we now look more broadly at sustainability, as well as set and monitor targets. For example, we are starting to link management incentives to these targets, which we are finding incredibly effective in bringing about change.

**Q Peter, you mentioned opportunities stemming from sustainability. Can you give me an example?**

**PW:** We have a business in our portfolio called Weener Plastics. With the word plastic in its name, it would be easy to draw the conclusion that it is not a sustainable business, yet there is significant opportunity to create value here through sustainable practices. We are working with the company's customers – mainly large FMCG groups – to develop more sustainable packaging through the use of recycled materials. The aim is to reduce waste and input materials and move away from using virgin materials. By working proactively on these areas, the business becomes more valuable as a supplier as it helps customers reduce their footprint.

*“We believe investors who do not engage in a serious way around sustainability will be left behind”*

ANNA DELLIS

**AD:** As we've developed our sustainability processes, some companies that might have not been evident previously are now on our radar in infrastructure. One of these is Joulz, a Dutch company we invested in during 2019. It leases equipment, such as transformers, for electricity. It captures the trend in the Netherlands away from gas as an energy source towards electrification using renewable sources.

**Q What are the challenges associated with sustainability as an investor and how do you manage them?**

**PW:** The biggest challenge is the amount of time it takes to get pay-back – you often have to think over the longer term. It can be difficult to prioritise this when day-to-day business issues also need to be managed and when there are opportunities that can provide a more immediate pay-back. As an investor, we need to support the long-term view and not expect results tomorrow.

**Q What do you see as the key future trends in sustainability?**

**PW:** There will be more regulation. Already we see this in Germany where OEMs supplying the automotive industry are having to adapt to EU regulations. Yet this does create opportunities – for example, these OEMs and other companies facing increased regulation need help to adapt, and that's where private equity can help either directly in these businesses or by backing companies that can assist.

**AD:** There will definitely be more scrutiny around sustainability from all stakeholders and I think that, as an industry, we need to devote more resources to better communicate what we're doing. It also means that there will be more pressure on future CEOs. Ten years ago, they were focused on profits; now there is a whole range of challenges they have to manage, including sustainability. ■



Sea change: 3i transformed Scandlines to a best-in-class operator

**Q What trends are you seeing in terms of how buyers look at sustainability when it comes to exit?**

**PW:** We're clearly not the only investors looking at businesses from a sustainable perspective which means that we have to work hard on improving the sustainability of the businesses that we invest in. As an example, at Scandlines, a ferry operator between Denmark and Germany, we introduced hybrid ferries and battery packs to reduce the consumption of fuel, among other measures. As a result, we've reduced CO2 emissions by 15 percent and sulphur emissions by 90 percent.

**AD:** With ESVAGT, a Danish company that provides emergency rescue vessels to offshore oil rigs, we've helped reposition the business so that its activities increasingly support vessels for the offshore wind sector.

# How ESG will become a CFO issue



*Sustainability is turning into a numbers game and moving into the finance chief's wheelhouse, write Toby Mitchenall, Brian Bonilla, Philippa Kent and Connor Hussey*

Every year a team from LGT Capital Partners, a global fund investor, collates qualitative data from more than 300 of its general partners and converts it into a quantitative scoring system. Managers emerge from the process with a grade of between one and four, which tells them – and LGT – how they rate with regards to environmental, social and governance issues.

To achieve a score of one (the best), a manager must demonstrate “genuine” commitment to ESG and have institutional processes in place, applying ESG criteria to investment decision-making,

ownership and reporting. Managers who demonstrate little or no commitment to ESG – scoring four – are “encouraged to improve over time”, according to the firm’s annual write-up of the results.

Another global fund investor, Pantheon, applies a green-amber-red ESG risk rating to its managers. Ratings are arrived at through an operational due diligence questionnaire – around eight or nine “relatively open-ended questions” – and then further conversation with the GP’s investment team, says Alex Scott, a partner in the investment team and member of the five-person ESG steering committee.

That these two fund investors are

Europe-headquartered – LGT on the edge of Lake Zurich in Switzerland and Pantheon in the City of London – is significant. Europe has been the epicentre of ESG.

“We have seen the greatest capabilities in being able to report ESG-related data out to investors among European GPs, because European LPs have been asking for it,” says Andrea Auerbach, head of private investments at consultant Cambridge Associates. “It has now spread to North America and is going viral.”

This was certainly true for Genstar Capital, a San Francisco-based firm with \$17 billion in assets under management and a history stretching back to 1988.



“We probably thought about ESG more in response to our European investors being thoughtful about it,” Genstar managing director and chief financial officer Melissa Dickerson explains. “Europe has done a good job of leading the way here.”

### Joining the club

Genstar became a signatory of the United Nations’ Principles for Responsible Investment in 2015.

Being a UN PRI signatory requires a firm to formally apply and pay an annual membership fee. It also has to report on its responsible investment activity within the first 24 months of signing up. This has become an important indicator for many prospective LPs of a manager’s commitment to ESG; it is alluded to, for example, in both Pantheon’s and LGT’s assessments.

There are now nearly 2,400 organisations (both asset owners and managers) signed up to the UN PRI. This proliferation – ostensibly a good thing as it shows widespread engagement with ESG – is also making it less of a useful indicator and more of a “tick the box exercise”, said Maria Sanz Garcia, managing partner of Munich, Germany-based fund investor Yielco Investments, at an event in October. “Everyone has an ESG policy and is a signatory. Everyone does that in Europe.”

Sanz Garcia contrasted her dealings with European and US GPs: “We invest a lot in the US in smaller managers, and when you ask them about ESG, they often ask, ‘What does ESG mean?’ If you go to the southern part of the States, it is worse.”

Sanz Garcia’s dismissive take on US GPs’ ESG engagement is reflected in the data that LGT publishes on its managers. In the firm’s 2019 report, 79 percent of European managers scored either one or two (the top grades), while only 49 percent of US managers achieved that grade. To put it another way, 25 percent of the US managers LGT works with demonstrate “little or no commitment to ESG”. A further 26 percent showed some commitment but lack institutionalised processes.

One reason that the adoption of ESG policies and procedures has been slow to

## Is the SEC interested in ESG?

### One of the great things that our colleagues at sister title *Regulatory Compliance Watch* do is share with subscribers recent document request letters (redacted) from the SEC’s Office of Compliance, Inspections and Examinations.

In a recent batch was a letter digging deep into one advisor’s approach to socially responsible investing, or ESG-related investing.

One item requested by examiners from the SEC’s Los Angeles regional office was details of any proprietary scoring system or third-party scoring system.

“I would suspect the SEC would focus on three fundamental questions relating to scoring systems,” says Ken Berman, partner at Debevoise & Plimpton. “Do you have a scoring system? Have you represented that you will have a scoring system, and if so, did you follow it consistently?”

Another focus of the letter had to do with whether the advisor “adheres to the UN Principles for Responsible Investment”, and if so, provide documentation of the use of these principles when making investments and managing portfolios. The wording for this inquiry is key, says Berman. “I don’t think this is a tacit endorsement by the SEC of those principles. I think they’re focusing on a set of principles that they may sense are either being widely used or that people are suggesting that they’ll follow. If you use the principles as guide but don’t exactly follow them, the SEC will likely want that explained.”

Other aspects of the letter included questions on the advisor’s definitions of the terms ESG and SRI, their policies and procedures for deciding whether an investment fits these criteria; a list of clients with ESG/SRI investments; research and due diligence files from the advisor’s three best and three worst ESG/SRI trades; and any ESG-related marketing materials or industry award wins.

In this letter the SEC is clearly focused on transparency and disclosure but is that enough to prove the agency is now focusing on ESG matters? Sister publication *Private Funds CFO* requested clarification from the commission, but it did not respond.

“I don’t have the sense that this is a high priority at the SEC right now, or that it’s at the top of their regulatory priorities,” says Isabel Dische, a partner at Ropes & Gray, who has received similar questions from clients that were issued a similar letter directly or came across them indirectly. “I think to a degree the questions of investment strategy, marketing materials and policies and procedures are questions that the SEC has raised independent of ESG.”

*“It has now spread to North America and is going viral”*

**ANDREA AUERBACH**  
Cambridge Associates

take hold in the US is that systematic data-driven scrutiny by LPs of it is still in its infancy, even among some of the most sophisticated private markets investors.

### No policy? No problem

At the Alaska Permanent Fund Corporation, Marcus Frampton, chief investment officer of the \$65.3 billion state sovereign wealth fund, says evaluating ESG is “qualitative as opposed to formulaic”.

“At some point, we may look at formalising some sort of an ESG policy,” says Frampton. “But today, it’s simply that we review managers’ approach to ESG on their prior investments, just as we’d evaluate



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their responsible use of leverage, the reasonableness of the valuation decisions they make, etc.”

“The short answer is no” to whether the \$139.6 billion Washington State Investment Board looks at ESG ratings when evaluating a firm, according to Chris Phillips, a spokesman for WSIB.

“Our asset class teams individually are responsible for evaluating all material risk factors as part of their due diligence,” Phillips adds. “The WSIB has not adopted a single position or practice regarding various ESG ratings or metrics systems.”

But the direction of travel is only in one direction. WSIB is reviewing its ESG-related mapping and measurement frameworks ahead of a planned hiring of a sustainability officer next year, adds Phillips. The Rhode Island State Treasury in October hired consultancy Wilshire to advise it on how to incorporate ESG into its private markets investment processes. Like Auerbach says, it’s going viral.

So what does it mean for a GP to integrate ESG reporting? The short answer is: different things to different firms.

Genstar works with consultant Malk Sustainability Partners. “With their help, we worked with lots of investors to develop checklists and templates that are specific to different industries,” says Dickerson.

This means that while an industrial business might be required to measure outputs relating to carbon or waste, a services business might be assessed on a different set of metrics. “It’s going to be different for different industries and it’s evolved to include lots of things like data privacy, diversity and inclusion, etc.”

Genstar engages Malk whenever the firm is conducting due diligence. “They’ll talk to the management teams and look at the data rooms and give us an assessment,” says Dickerson, “which we’ll then incorporate into our investment committee process. If there are already red flags, we’ll know about them before we buy a company. But it gives us a good baseline, because if you do end up buying the company, this is where you start.”

Finally, there is an annual monitoring piece – again undertaken by Malk. Says Dickerson: “We’ll also engage them upon exit so that we have a picture of the round trip during our hold period. This shows the kind of impact we might have had on the ESG paradigm from start to finish.”

Dickerson includes summaries of the ESG updates in the firm’s annual report.

### Oil-y adopter

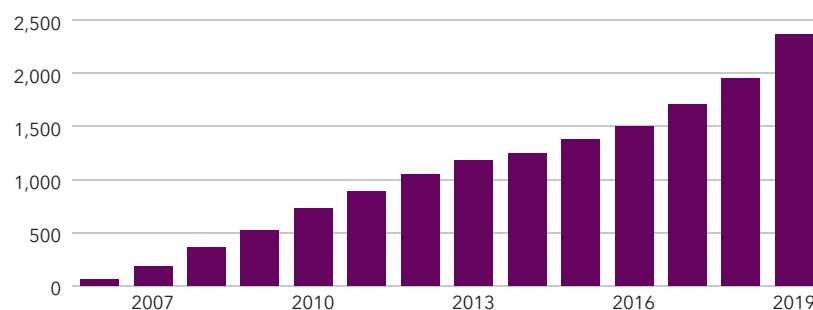
Houston-headquartered EnCap Investments is one of the largest private equity firms in the world. The energy specialist closed its 11th flagship fund on \$7 billion in 2017 and then raised a further \$3.25 billion for its fourth midstream fund. The firm first instituted a responsible investment policy in 2008 and then created a standalone ESG policy in 2012. The firm is now working on standardising ESG reporting from its portfolio companies so that it can aggregate the data and report fund-level ESG performance.

“For example, there is a standard

*“There was a desire to do things as an industry rather than to be rogue and out doing things on our own”*

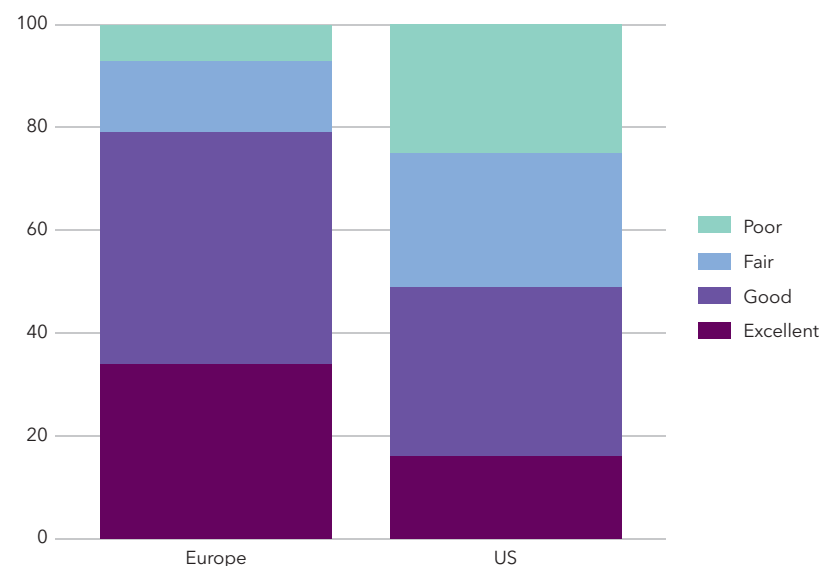
**CRAIG FRIOU**  
EnCap Investments

The number of signatories to the UN PRI is rocketing



Source: UN PRI

ESG ratings by region in 2019 (%)



Source: LGT Capital Partners

template for diversity that portfolio companies can fill out,” Craig Friou, EnCap’s deputy CFO, says. “By conforming to a standardised template we can add it up across all our funds – or by individual funds – to provide meaningful reporting to our investors.”

This year will be the first of reporting “and that will be the baseline data”, says Friou. “Just having that information is the first step to making good decisions.”

Adds the firm’s CFO, Bobby Haier: “What it does is really focus on constant improvement of the ESG process in all areas and give us a base in order to measure that improvement and be able to determine that in fact goals are being met.”

The templates – which are 20 questions long – were based initially on the due

diligence questions that some investors were asking for during fundraises. “If they were asking for information in a certain way, that was probably a good indication of how we should be collecting and reporting it,” says Friou. “In terms of examples, we are an energy manager, so the two top topics are greenhouse gas emissions and use of water.”

Friou road-tested the templates with portfolio companies and they fed into the design, highlighted where questions would be hard to answer or perhaps would not yield the right information. “I just took all the feedback and after going back and forth for a couple months, finally landed on the final version. I imagine it will always be updated and refined and improved every year,” he says.

The ESG data are gathered through OneSource, a Thomson Reuters-owned disclosure management software.

As of October, EnCap has joined the swelling ranks of PRI signatories. “I think there was a desire to do things as an industry rather than to be rogue and out doing things on our own,” says Friou. “When we looked at all of the different groups that were doing similar things, I would say PRI stood out as the most prominent one with the greatest amount of participation. They offer a lot of resources, a lot of networking opportunities. When we looked at the reporting, we thought it was balanced as far as having granular and meaningful information but not being too burdensome.”

Cloverlay, a mid-market private equity firm that invests in “adjacent private markets,” has had an ESG policy since 2017. “The reasons were two-fold,” says principal and CFO Omar Hassan. “We wanted to think about it critically and have an answer for our stakeholders. To us it just makes sense to have one, regardless of where you are in the spectrum of ESG, mainly for transparency. It is something we want to codify as part of our process.”

It was not something that LPs had specifically asked for, adds Hassan.

In terms of designing the policy, Hassan, the firm’s legal counsel and the senior investment professionals sat down and said: “Okay, what are we actually doing when assessing an energy deal or a transportation deal or something that can potentially run into some of these issues?”

“We worked with our compliance consultant [Adherence] and our legal counsel to see what is acceptable from a regulatory

perspective and we relied heavily on them to help us think through the actual language.

“We took the stance that we’re going to leave it high level. The policy doesn’t go into scenarios or specifics, but it lists out certain procedures where we could evaluate certain factors. We try to gather qualitative and quantitative information.”

ESG policy and implementation does not always fall into the CFO’s remit. Three of the firm’s sister title *Private Funds CFO* spoke to say it is the domain of someone whose background is in external relations, marketing or IR. One such firm is Central and Eastern Europe-focused Abris Capital. Partner and CFO Steve Richmond is responsible for investor reporting, while IR and comms head Monika Nachyla has spearheaded the creation and rollout of the firm’s ESG policy over the last two years.

Richmond says that while he is not too involved, this could change if the firm gets to the point where it is doing “more frequent, more detailed” reporting to the investors.

That “more frequent, more detailed” reporting of ESG data is coming. The industry is at a stage now where “table stakes” for raising capital from sustainability-minded institutions is an ESG policy and willingness to engage. This will not be the case for ever.

According to EnCap’s CFO Haier, the future is “providing more quantitative data where you can show measurable improvement across the portfolio by fund. That’s what LPs want to see. They want to see an improvement quarter to quarter, year to year.”

“What will probably end up happening is standardised metrics will start being more regular,” adds Cloverlay’s Hassan.

### Cherry-picking

The current state of affairs allows flexibility for GPs to choose how much to report and how often to do it, which leaves the door open for managers to cherry-pick examples of favourable outcomes, while burying unfavourable ones.

While pressure from investors is forcing some firms to acknowledge the need for a framework around ESG considerations, it is unlikely that this pressure alone – patchy as it is – will move the needle. Less than a quarter of investors surveyed as part of *Private Equity International’s LP Perspectives* survey described evidence of ESG consideration as being a “major” part of due diligence. Most

# 2,400

Organisations (both asset owners and managers) signed up to the UN PRI

# 250

Employee threshold where UK companies are required to publish data on gender pay balance

# 20

Questions on EnCap’s ESG reporting template

(55 percent) said it forms a minor part, while 22 percent said the matter was not covered in due diligence at all.

So what will convert ESG into a data-centric exercise? Regulation will likely play a large part.

At a high level there is evidence that the Securities and Exchange Commission is taking an interest in how managers describe and adhere to ESG policies. Elsewhere, it is likely that individual elements of ESG will be the subject of issue-specific law. Take for

example the law in the UK that now requires companies with more than 250 employees to publish the data on gender pay balance. How long will it be before mandatory reporting requirements are brought in relating to energy or water usage?

“Discussion of ESG reminds me of the early days on the internet, when it was talked about like an amorphous unified cloud-like entity,” says Cambridge Associates’ Auerbach. The needs for accurate and timely data will coalesce around individual topics, rather than ESG as a uniform concept.

The concept of integrated reporting of financial and extra-financial data is discussed frequently among ESG specialists, says Keimpe Keuning, an executive director at LGT heavily involved in its ESG efforts: “We are a long way from global standards, but it is getting a lot of attention. This should be the ultimate goal.”

There is also the prospect of financial rewards – beyond the benefits of good risk management – linked directly to sustainability performance. In October, Dutch bank ING launched what it described as the first capital call facility with an interest rate pegged to ESG performance targets for the fund portfolio companies. In Spain, the private equity association, ASCRI, is currently working with local governments to see if there is a way of linking tax incentives to sustainability.

Further into the future, the influence of impact funds will start to be felt. Mainstream private equity investing could include a direct link between the attainment of sustainability goals and the amount of carried interest a GP is entitled to. This is already the case with some impact funds, said Yielco’s Sanz Garcia.

“We would like to see funds having measurable goals in the way that impact funds do. They have impact goals that are measured, and they are linked to their compensation,” she says, adding that goals could relate to any ESG measure, such as energy usage or diversity. “As we move forward, this could be the next step of ESG.”

For now however, it is up to individual GPs how far up the ESG data curve they travel. As one CFO put it: “We are implementing a new portfolio management tool at the moment, and at the back of our mind is that at some point we will have to collect that [ESG] data ... but it isn’t something we need to do immediately.” ■

## How an impact-focused firm does it

**Ambienta is a private equity firm and certified B Corporation that invests in businesses related to resource efficiency and pollution control. We asked Daniel Gatti, the CFO, how it reports ESG.**

### How does Ambienta report on ESG to LPs?

At Ambienta we separate environmental impact from ESG, because the first refers to our investment strategy while the second is a management best practice, and we report to LPs on both. We developed Environmental Impact Analysis, a proprietary methodology which we use to measure the environmental impact of our portfolio on 11 environmental metrics. For ESG management, we developed the ESG in Action programme to create value and manage risks in our daily operations and at portfolio level. Both methodologies have become industry references and are recognised by industry participants.

We report environmental impact to LPs once a year, company by company, and we report ESG progress to LPs on both a quarterly and annual basis. As part of the quarterly reporting process, we describe achievements in the sustainability and ESG space at GP and at portfolio level. As part of the Q4 quarterly report, we include a detailed company-by-company section called “ESG achievements”, and we describe our sustainability and ESG-related matters in an annual “ESG & Environmental Impact Report”. We also use LP-developed templates in instances where there is one they require us to use in inbound enquiries.

### What data are used to measure ESG performance in portfolio companies?

We monitor specific portfolio company KPIs as part of our ESG in Action programme. This provides us with an understanding of our effectiveness in delegating to management teams the integration of ESG guidelines in their operating practices. Portfolio company KPIs are selected following pre-investment ESG due diligence and materiality analysis, which provide the foundation to identify the most material risks for each company.

Where possible, we define a KPI for each ESG issue identified, which will be used by the management team and ESG team to monitor progress and report achievements. The final list of KPIs is included in the ESG Action Plan, a document that enables us to engage management in ESG conscious practices and delegate accountability to support processes and practices in line with our framework.

Both cross-portfolio and portfolio company KPIs are monitored and reported to the board on a monthly basis and shared with LPs on a quarterly as well as annual basis, as previously described.

In addition to specific KPIs, we encourage companies to select a mix of preventative (voluntary and mandatory certifications) or remedial (ad hoc) actions for each material risk identified as part of the materiality analysis, which we require each company to perform as part of the ESG in Action programme. Since 2019, we’ve also required Ambienta III portfolio companies to run a third-party carbon footprint analysis to evaluate the greenhouse gas emissions caused by the operations of each portfolio company and create a baseline to benchmark future performance.

## KEYNOTE INTERVIEW

# Effective ESG strategies need to start from the top



*Gone are the days when lip service to ESG is enough to assuage investors, says StepStone's global head of responsible investing **Suzanne Tavill***

After years of talk, the private investment world is taking action on ESG and responsible investment. The key to successful strategies, says Suzanne Tavill, is for GPs to ensure ESG efforts are investment-led with clear lines of accountability. Meanwhile, she says LPs must continue advocating for greater emphasis on measurement and reporting, particularly in the application of the United Nation's Sustainable Development Goals, or SDGs. The concern is that without impactful measurement and reporting, SDGs could prove to be a "check-the-box" activity, rather than effective indicators of progress.

## **Q** What is the essence of StepStone's approach to responsible investing?

At its core is our belief that ESG is an investment strategy. What I mean is, ESG consid-

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erations need to be deeply embedded in investment due diligence so that it influences how an asset is priced. We believe strongly that if these factors are not comprehensively considered, then assets will be mispriced. We acknowledge that many ESG issues are externalities which need to be internalised in asset pricing. GPs that fail to actively embrace these issues are not effectively performing their fiduciary responsibilities.

When we look at the market, we are seeing greater divergence between those investors who are considering these issues in due diligence and those who are not. This is creating an ESG arbitrage in the pricing of assets. Our approach is to position our clients to be on the right side of this arbitrage.

## **Q** Can you give some examples where ESG arbitrage is possible today?

An obvious example is that better-managed businesses with respect to ESG can access lower-cost debt. So, the ability to measure and report on key metrics for debt providers is delivering real value. Another example is the increasing divergence in the pricing of property portfolios that are thoughtfully curated with respect to location (high versus low-lying flood zone prone areas) versus those portfolios that are not. We believe that the pricing spread will continue to grow, and that some investors are underestimating the risk of their assets becoming stranded. This underestimation is tied to the belief that ESG issues will only be relevant in the future and fuelled by a lack of foresight for inevitable policy responses. It is our belief that these policy responses will be material and



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are in the forecast period for investments.

### **Q In your experience, how are GPs approaching ESG today and what approaches are effective?**

I think GPs fall into two broad categories: Those that recognise that ESG is an investment function with a clear line of accountability to senior investment principals, and those that do not see ESG as relevant to their investment business. We recognise that within this first group, GPs will be at varied points in their journey of integration. We want to support and engage heavily with such GPs by suggesting approaches, tools and specialist consultants.

Often, with the second group there's confusion between ESG and philanthropy. They will give examples of their philanthropy efforts, but that is not ESG as we're speaking about it, which is something that is integral to the investment process. Within this second group are also GPs that view ESG solely through a risk lens. Often this is reflected in reporting lines that only include compliance or operations departments, and not the investment team.

Along geographic lines, Europe continues to lead. The US relatively has been a laggard, but in 2019, we started to see more GPs raising their game. I think 2020 is going to be a critical year for that jurisdiction.

### **Q And from the LP side? How are LPs driving the progress when it comes to responsible investing?**

LPs are critical in driving change at GPs. Their advocacy on these issues raises the priority level of ESG considerations for GPs. Particularly as GPs come back to market for new fundraising, we are seeing LPs becoming more vocal in terms of restrictions, exclusions and reporting requirements. On the latter point of reporting, I believe this is an area where LPs should continue to push hard; if GPs have to report on something, then hopefully this means that they will be taking action in their underlying portfolio assets. This should also drive GPs to implement more comprehensive measurement systems for their portfolio companies that blend financial and ESG related metrics.

These efforts are going to become even more critical as LPs begin to further integrate SDGs into their portfolios. But for LPs to be able to invest, measure and report on SDGs effectively, they will need the GPs

to invest in better systems to enable these efforts.

### **Q So, LPs are pushing and GPs are responding. But how effective are restrictions and exclusions as a strategy for achieving sustainable development and responsible investing goals?**

In our view the risks and merits of each investment must be carefully considered. Any investment decision comes with complexity and trade-offs, and consequently we are cautious around applying absolute screens or restrictions and exclusions. We are also cognisant that when you exclude capital to an asset or sector, you are removing the opportunity to engage and advocate for change.

With respect to our due diligence process, there are some opportunities that fail to progress through our process. For example, we looked at a co-investment into a company that produced firearms for hunting and another that provided specific

services to inmates in prison, and ultimately decided that there were a number of ESG concerns that we were unable to mitigate.

On the other hand, we have been able to progress investments into certain industrial businesses that on first look presented a range of ESG concerns. The difference was these investments presented opportunities to reposition businesses and drive value through active ESG management (the ESG arbitrage we were discussing earlier).

### **Q Which responsible investment and SDG goals matter the most to LPs?**

With 17 UN SDG goals to choose from, there's something for everyone. We see two groups emerging: LPs with a more social orientation tend to focus on education, gender equity, health and wellbeing goals; and LPs that are oriented around sustainability and environment, tend towards clean water, sanitation and circular economy goals.

There are two goals that I would say resonate across most LPs. The first is climate



### Q Can you give an example of how StepStone's approach to responsible investing has created value for its clients?

StepStone allocates capital to and invests alongside GPs, so our key mechanism for value creation is in our due diligence and continued active engagement with GPs. We recently vetted a co-investment in the heavy industrials sector. This space is replete with ESG issues: challenging working conditions involving hot metals, extensive toxic chemical usage, noise and dust pollution, groundwater contamination risks, etc. It would be easy to walk away from industrial investments, but our approach involves considering the risks and merits of each investment.

We engaged heavily with the lead GP during our due diligence, raising the set of ESG risks and opportunities we identified. The GP was able to produce solid responses across many of the issues but was also receptive to extending environmental due diligence and ensuring that there were relevant executive and board level appointees dedicated to these issues. At the end of the collaborative process, the deal structure was improved and the risk-adjusted return enhanced.

One could say, great, you've gone through all this trouble to do an investment in an old industrial metal business. The thing is this company manufactures critical components for aircraft that materially enhance fuel efficiency. The investment in this company directly contributes to lowered greenhouse gas emissions. The reason I highlight this example is that often when people think about making responsible investments, there's a tendency to concentrate on the obvious green sectors, such as renewables. But I feel very strongly that if the global economy is to effectively decarbonise, it is important to recognise that capital will need to go into all sectors, including spaces like mining and industrials. Having said that, selectivity at the asset level will be critical, as not all businesses will manage to transition and unfortunately some may not even embark on the journey.



action and the second is gender equality. Arguably, climate action has become the first among equals as climate is relevant across E, S and G dimensions. With the partnership between UN Principles for Responsible Investment and the Financial Stability Board's Task Force on Climate-related Financial Disclosures, climate is becoming central in terms of what LPs are expecting GPs to consider, and how they report.

### Q Within the investment world, how has the conversation around gender equality, and diversity more broadly, evolved in the face of modern social movements including #MeToo?

I think #MeToo raised awareness of sexual harassment, but critically it was remarkable in giving a modern voice to women. As you've rightly noted, the issue of diversity is broader than sexual harassment and gender; but #MeToo has helped drive all these discussions into the open – and we need to work hard to maintain the momentum.

*“For LPs to be able to invest, measure and report on [Sustainable Development Goals] effectively, they will need the GPs to invest in better systems to enable these efforts”*

Within the finance community there are several very rational-sounding arguments about why there's not more diversity within financial and investment organisations. But we know that the people managing these organisations are can-do people. They build businesses and provide solutions for their clients, and I think those minds need to be applied with ever more urgency to driving diversity. I would hope that the equity argument is sufficient, but there's plenty of research supporting why diversity leads to more sustainable and arguably more successful organisations, so diversity efforts can be supported on pure financial grounds.

### Q When you talk about advocacy, what are some of the challenges for you in your role as the head of responsible investment at StepStone?

I've heard it said that there is often a cognitive disconnect between what people know to be true in their personal lives and their mandate at work. I think this is an important observation. I know that across our hundreds of employees in 13 countries, they are deeply concerned about building a sustainable future for themselves and their families.

My challenge is creating that link so that StepStone's employees understand they are empowered in their work. As a global private markets investment firm overseeing over \$280 billion of private markets allocations, including \$58 billion of assets under management, we can make a real difference. With our considered focus on responsible investing and a drive to support those GPs that effectively integrate ESG into their investments, we enable the decarbonising of our economy. Just like GPs and LPs, we are on a journey. There is urgency in this journey. We all must do more and do it better.

I often hear colleagues in finance speak of the difficulty of explaining to their kids what they do. Responsible investing allows us to shift from speaking about numbers to real world outcomes. When my kids enquire about what I do, I speak about the companies and projects we have funded that are actively contributing to decarbonising our world and making it more sustainable. They ask tough questions at home, and are disappointed with the rate of progress, particularly around climate change. I'm proud to know that they feel I'm contributing to changes necessary for their futures. ■

# Keeping faith with responsible investing

*The Church of England insists it can uphold its ethics by carefully selecting its GPs and staying closely engaged. Ben Payton talks to Stephen Barrie, deputy director of ethics at its pension board*

For an institution like the Church of England, ensuring investments are managed in keeping with its ethical principles could hardly be more important. Indeed, as the Church has found several times in the past, any investments in activities that are deemed unethical can bring serious reputational harm.

The Church of England Pensions Board invests funds of £2.5 billion (\$3.25 billion; €2.92 billion) on behalf of around 40,000 people who have worked for the Church. It foregoes investment in companies that have significant involvement in gambling, alcohol, tobacco, pornography, defence or high interest rate lending.

Naturally, avoiding these excluded categories – and other potentially problematic investments – is more complicated when it comes to private equity investing. However, the performance of the CEPB's public equities investments has been volatile in recent years; its FTSE 100 vehicle suffered an 8.7 percent loss in 2018. With private equity providing far stronger and more reliable returns, the CEPB is working with Cambridge Associates to increase its holdings to a target allocation of 7 percent. We spoke to Stephen Barrie, deputy director of ethics and engagement at the CEPB, about how an institutional investor can put its money in private equity but remain faithful to its values.

## How do you approach responsible investment?

We're a Christian institution – it's part of our ethos to think about our responsibili-



*“We require all our managers to have the capacity to analyse, understand and act on ESG criteria”*

STEPHEN BARRIE  
CEPB

ties in relation to the way we invest. And we think there's a case to be made on fiduciary grounds, in terms of risk-adjusted returns over the long term, for ESG and responsible investment to be incorporated into investment decisions. Our current priorities are climate change and the extractive industries. We also do a lot of work on corporate governance, mostly in public equities.

## Why not divest from fossil fuels?

We have a nuanced approach. We have a policy from 2015 that sets out disinvestments from thermal coal and tar sands, on the basis that they are the most carbon-intensive sectors. But there's a very big emphasis on the role we can play as a Church investor in contributing towards the move to a low carbon economy. We want to be at the forefront of driving the transition.

The Transition Pathway Initiative, which we co-founded back in 2017, is a key pillar of our intervention on climate change. It allows us to assess publicly listed companies in 12 sectors on their management quality and their performance in relation to transition. We have committed to using the TPI to guide further disinvestment decisions based on climate change, and we're also working with FTSE Russell on developing a passive index that incorporates TPI assessments so that we can have a TPI-aligned passive product.

**How can you ensure that your private equity investments respect the same ethical standards as your investments in public equities?**

## Dam tragedy spurs institutional investors to press for change

**For more than 40-years, an 86-metre-high dam had towered over a mine site near Brumadinho in south-eastern Brazil.**

Behind the dam wall lay millions of tonnes of waste, known as tailings – the detritus of decades of iron ore extraction carried out by Vale, one of the world’s largest mining companies.

Then, on 25 January, 2019, without any warning for those living and working nearby, the dam wall collapsed. Ninety seconds later, hundreds of mine workers were engulfed by a tsunami of toxic sludge that carved a trail of destruction through the surrounding farmland. An estimated 270 people lost their lives.

Stephen Barrie was not entirely surprised. The Church of England had been engaging with industry stakeholders on tailings dam safety for the previous two years. “We were not reassured that the investment community had a good handle on tailings dams,” he says. “There was no global public registry, reporting was pretty patchy and all around the world there were different regulatory regimes.”

As soon as the mourning period was over, Barrie began working with a new urgency to demand changes. “We issued a call for there to be a new global standard on tailings dams that incorporates a classification of dams based on the consequences of failure. We wanted a global, independent, accessible standard.”

The result was the Investor Mining and Tailings Safety Initiative, a project incorporating institutional investors in the extractive industries, asset owners and asset managers, and co-chaired by the CEPB.

Within weeks of the disaster at Brumadinho, Barrie’s team was pressuring mining companies for information on the state of their tailings facilities. “We wrote to all of the listed oil and gas and mining companies that we could find, 726 of them, to ask that they disclose all of their tailings dams.” By early November, 73 percent of the mining industry by market capitalisation had responded, with 55 percent providing full and public disclosure.

The CEPB is now working with its partners to collate the disclosures into a global tailings database. Barrie’s aim is to make this “accessible to community members, regulators and investors, so that there’s one place where you can go to find all the information on tailings dams”.

It’s one thing for an institutional investor to put pressure on



Source: Guilherme Venaglia

publicly listed companies, and another to influence a company that it indirectly invests in via a private equity fund. But Barrie is certainly in no mood to stop trying.

“Recently we’ve been working with one of our managers and their equity analysts who were going to meet a company that we were invested in but had not responded to our tailings disclosure request,” Barrie explains. “They were able to make that request directly, following up on the letters we had sent. We’ve now seen some movement and we’re expecting a report from that company.”

The key, says Barrie, is for a responsible investor to select GPs it can continue to engage with throughout the lifecycle of the fund. “We want to work closely with our asset managers and we brief them on the things we are working on, particularly our stewardship priority topics,” he says. “We challenge them if we see a portfolio company that has surprised us in terms of their ethical approach.”

We’re at a fairly early stage of our private equity journey.

We’re only a couple of months into a 10-year mandate with Cambridge Associates – we’re working with them on a discretionary basis. They told a very good story on how they’d be able to work with us to encourage good responsible investment behaviours among GPs in relation to the underlying companies.

We ask about GPs’ ability to avoid the

categories of investment that we’ve excluded. That’s a core part of the conversation. We require all our managers to have the capacity to analyse, understand and act on ESG criteria.

Partly because of the blind-pool risk, we’re investing quite a lot of trust as well as money in these managers. We have to be assured that they respect the excluded categories that we have.

All our investments in private equity so

far can be described as impact funds. We’ve not set a percentage threshold coverage, but it’s definitely part of the brief for Cambridge to find GPs that run positively impactful funds.

We think that GPs have got the opportunity for greater influence on the portfolio companies. There are opportunities for excellent responsible investment practices in private equity – the model is corporate governance based. ■



# KEYNOTE INTERVIEW

## Lessons from a decade of ESG



*Permira's head of ESG Adinah Shackleton discusses the firm's evolving approach to environmental, social and governance issues*

It is a decade since Permira launched its first environmental, social and governance framework. The firm's stated objective back then was to galvanise a more consistent approach to addressing ESG-related risks and opportunities during the investment process and to link this approach to value creation. We caught up with Adinah Shackleton, who joined the GP in 2015 as its first head of ESG, to ask how Permira's approach to responsible investing had evolved since then.

**Q Over the past decade, what's changed in how Permira addresses ESG?**

The ESG agenda has broadened in terms of topics, focus and LP, stakeholder and portfolio company expectations. Previously there was more focus on due diligence followed by the post-investment review of

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companies. Since 2010, deal teams have become increasingly thoughtful about the short-term and long-term ESG issues that could be material to a business.

One of the first things that I focused on is how we could monitor ESG more consistently across the portfolio and obtain data from companies around priority ESG areas. Monitoring and reporting get a lot more attention.

In terms of topics, 10 years ago the focus in due diligence was on environmental risks and liabilities, health and safety, and governance. Today, topics encompass areas like responsible marketing practices and human rights in the supply chain, which are really

front of mind for some companies.

Cybersecurity has risen up the ESG agenda and there's a recognition that this is a real risk to business. We've worked on how we ask deal teams to look at this during the investment process and engage with portfolio companies post-close.

Diversity and inclusion also cuts across the portfolio. It's something portfolio companies are very interested in: how diverse teams can make better decisions and be more successful financially. And there is significantly more focus on climate change. The level of public dialogue around this topic has really increased.

**Q What impact has this broadening agenda had on the due diligence process?**

Historically, ESG was more focused within

the boundary of the business. Now when teams conduct due diligence they take a wider perspective on the impacts, risks and opportunities that a company might be exposed to – whether that’s through the supply chain, products or services, for instance. That has been a key change.

There’s increasing awareness around the impact of poor practice on an investment in terms of reputation, customers and revenues. Deal teams see that companies that manage these issues well can be more successful over the longer term.

Teams are also more aware of how ESG plays into the exit story.

Buyers want to see that ESG issues have been addressed effectively – for example, that an apparel company has a well-managed supply chain that has a proactive approach to mitigating labour and working conditions risks.

### Q At exit, what kinds of ESG-related questions do buyers ask?

It varies depending on the sector and the nature of the buyer. A trade buyer making an add-on acquisition is often interested in the culture of a business and how well aligned it is with its own ESG compliance and business practices.

We saw this with Magento, an e-commerce platform we sold to Adobe.

Adobe was very focused on ESG during the due diligence, and people-related issues were important to it. It wanted to invest in a business that could slot in beside its existing business culture. Magento had spent a lot of time focusing on its diversity and inclusion strategy, including at a senior management level, as part of its focus on its values and culture.

### Q And what are LPs’ ESG priorities?

Today we receive investor questions on ESG from a much broader range of jurisdictions, not just LPs in Europe. Some LPs are shifting from a high-level questionnaire approach to showing increased interest in ESG performance at the underlying portfolio companies.

Increasingly, LPs have their own responsible investment teams, and go beyond asking whether there is an ESG policy at the GP level to asking whether our monitoring teams really understand how ESG matters are managed on the ground. That’s a trend.



### Q How do you keep up with a fast-evolving ESG agenda?

As investors, it’s important to be aware of how the conversation around ESG is changing and to ensure we’re reflecting on our processes and whether our approach remains fit for purpose.

The same applies to portfolio companies. They can’t stand still. New issues and different perspectives on ESG are going to continue to emerge, and companies will have to keep track of these changes.

One way we’ve done this over the last couple of years is by integrating ESG topics into our portfolio company conferences. We hold conferences for different roles in portfolio companies. At the last leadership conference, for CEOs and chairmen, three portfolio company CEOs talked about their experiences of ESG and how they integrate best practice into their overall business strategies.

These included the CEOs of German chemical manufacturer CABB, where process safety and health and safety are really front of mind; UK footwear business Dr Martens, which has integrated sustainability in its overall business strategy; and Duff & Phelps, a US-based valuation and business services provider.

We also used these sessions to address crisis management on topics such as #MeToo and cyberattack scenarios. These meetings are an opportunity for us to talk about our expectations and for portfolio companies to share and learn from one another.

*“We receive investor questions on ESG from a much broader range of jurisdictions, not just LPs in Europe”*

### Q In terms of monitoring, how do you handle the volume and variety of ESG information that companies generate across different sectors?

It’s a challenge. There are a huge number of different and relevant factors that you could monitor. We have taken a two-tiered approach and integrate ESG into the monitoring platform that we use for portfolio company financial data.

At the portfolio level, we use a set of core KPIs that we believe are relevant across all businesses regardless of sector. We also ask companies to agree and report tailored indicators specific to the company. For a food

and drinks business, a key topic might be food safety; for another, it might be energy efficiency. Ultimately, we want companies to report these indicators to their boards for action, so the reporting to us is almost secondary.

### **Q How do you evaluate ESG performance?**

It's very much integrated into how we evaluate portfolio companies' performance overall.

We hold six-monthly portfolio review committees, which include evaluation of ESG progress. It's a chance for us and our companies to reflect on ESG improvement areas included in their value-creation plans. We also highlight and discuss what more needs to be done to ensure management teams progress areas in which improvement has been slow.

For some companies – for example, one with a higher ESG risk or opportunity exposure – we also do visits to sites or operations during the hold period to see how ESG is managed on the ground.

### **Q Are there specific ways that businesses demonstrate the link between good ESG practices and value creation?**

Definitely. For each company it's going to be different. For instance, one of our portfolio companies benefits from significant tax rebates for meeting agreed energy efficiency targets. That directly impacts the business, which has invested in energy managers and energy efficiency measures to help achieve those savings over time.

One portfolio company, a data centre business in South Africa, started off small in terms of generating solar energy through installations on its roof. That has increased over time and it's now looking to reduce its demand on the grid.

We're also working with a business to put a value on health and safety initiatives. Reducing incidents and accidents over time leads to operational improvements and better employee safety, but also reduces compensation claims.

With some other areas – around supply chain improvements, for example – it's harder to put a number against it. Although it's harder to value in financial terms, it is clear that companies that focus on this can avoid crisis situations and reputational risk. It can also add to brand value.

*“There’s increasing awareness around the impact of poor practice on an investment in terms of reputation, customers and revenues”*

### **Q What kinds of challenges do you encounter implementing ESG best practice at the company level?**

Initially, the team can be one of the biggest. At due diligence, a company might not have the right people or structure in place to manage ESG effectively. This is particularly the case with businesses in emerging markets.

Often as part of the value creation plan we set targets around building the team, whether that's putting someone in place around health and safety, environment and quality control, or getting the chief operating officer to be really involved in the ESG agenda and topics. When the right team

is on board, you can really start to see improvements in practices and performance.

For a company new to ESG, another priority is to ensure the business is legally compliant. Once you have a strong baseline in place, you can move the discussion on to ESG opportunities. It can take some time to truly embed ESG in a business.

Historically, buy-in for the business case might have been an issue. I feel like that's becoming less of a challenge, and when we speak to companies around ESG and sustainability there is much more awareness and receptiveness to the value that this can bring. Management teams want to make sure they are not left behind as other businesses and customers are increasingly focused on these areas.

Management teams do recognise the connection between ESG topics, supply chain, products, reputation and crisis management and the impact that this can have on a company, its stakeholders, talent retention, customers and revenue.

### **Q Global warming is an increasingly urgent issue. How are you responding?**

Public dialogue on climate change has really increased. Within management teams, we see a mixed level of understanding about the short-, medium- and longer-term impacts of climate change. We have been raising awareness through webinars and have engaged with portfolio companies to better understand the risk and understand which companies are more likely to be exposed. We also ask portfolio companies to report their carbon footprint and focus on energy efficiency measures, particularly for high energy consumers.

In terms of investment, we are seeing more opportunities for companies that help with adaptation and the transition from fossil fuels.

One of our teams looked at an electric batteries manufacturing company. This tied into the transition away from diesel- and petrol-based transport. Aside from this opportunity there were other issues to consider for the sector, including emissions from the production of new cars and human rights considerations in the supply chain linked to the use of cobalt in batteries. It's never one-dimensional.

We recognise that more needs to be done to develop our approach to climate change and this is one of our key focus areas. ■



# Slow progress for women in private equity

The private equity industry has long endured a reputation as an old boys' club. But despite some dilution of the macho culture in recent years, along with a plethora of initiatives to promote diversity, the traditional view remains uncomfortably close to the truth in at least one respect. Women are still grossly under-represented – especially at senior levels.

Data compiled by Private Equity Recruitment, an executive search firm, suggests that at least some progress is being made in encouraging women to enter the profession in the UK. At the analyst level (the most junior included in the data), 29 percent of staff are female.

But women become rarer and rarer with each step up the career ladder, and they are still an endangered species in the boardroom. Only 13 percent of partners in private equity firms are women. This figure falls to just 9 percent among senior partners and a

*LPs are becoming more diversity-conscious, but a lack of gender balance in investment teams is rarely a deal-breaker, writes Ben Payton*

woeful 3 percent among operating partners.

Meanwhile, the Investment Association, which represents the UK asset management sector, found a 31 percent median pay gap between men and women in the industry. This is far above the average gender pay gap of 18 percent across all sectors of the economy. The IA says the pay gap is explained in large part by the fact that women are under-represented in senior positions.

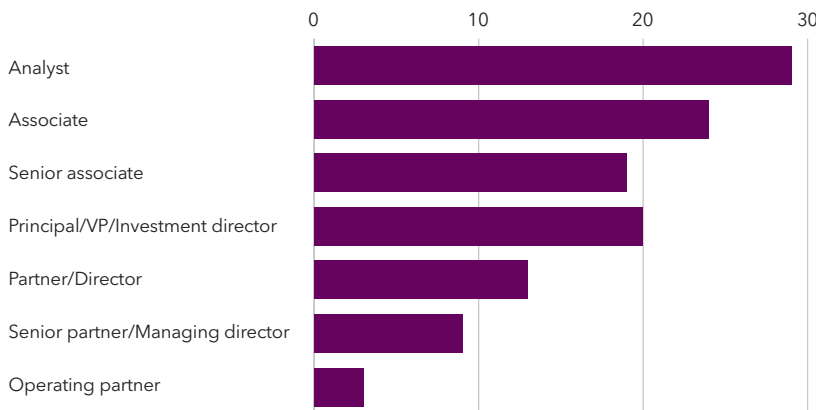
Pam Jackson, chief executive of Level 20, a non-profit organisation promoting greater gender diversity in private equity, says the lack of women in senior roles reflects the historical structure of the industry. “It isn’t an industry where it is easy to make lateral hires; people tend to work their way up from the bottom,” she told *Private Equity International*. Entry-level hires are typically recruited from investment banks, which themselves are not very diverse. “Firms are fishing in a very small and non-diverse pool.”

Jackson argues that firms need to change their hiring culture and “widen their search



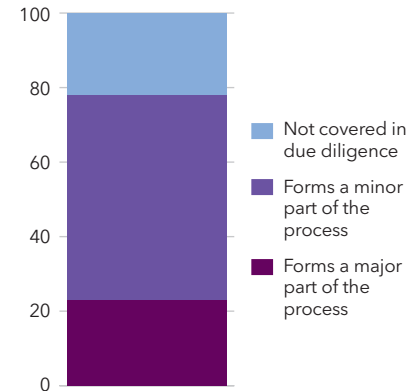
# Analysis

Female representation in private equity investment teams (%)



Source: PER, 2019 UK Investment Professionals Compensation Report

Diversity and inclusion is only a secondary factor in due diligence (%)



Source: PEI LP Perspectives Survey 2020

net” to see progress in gender diversity. “Managing partners need to ask, ‘What are the skills we need in an individual?’ – not ‘What have we traditionally always gone out and got?’”

Even with more women joining private equity firms, Jackson acknowledges that it will take time to reverse the legacy of men monopolising top positions. A woman entering the industry today will need to work for at least 10 years before she is ready to take on a senior role. And vacancies at partner level don’t open up often, with (overwhelmingly male) incumbents loath to give up their carried interest until retirement.

### LPs patient on diversity - but for how long?

It is easy to see why LPs should be concerned by a lack of diversity among fund managers. Research on private equity in emerging markets published by the International Finance Corporation in March 2019 found that gender-balanced investment teams achieved rates of return 20 percent above average.

Yet our latest *LP Perspectives Survey* reveals that while many institutional investors make some attempt to encourage diversity, only a relatively small minority are identifying diversity as a central concern when deciding on investment opportunities.

Just 23 percent of LPs claimed that diversity and inclusion formed a major part of their due diligence process. Slightly more than half of respondents said diversity is only a minor part of the process, while 22

percent admitted they did not consider diversity at all.

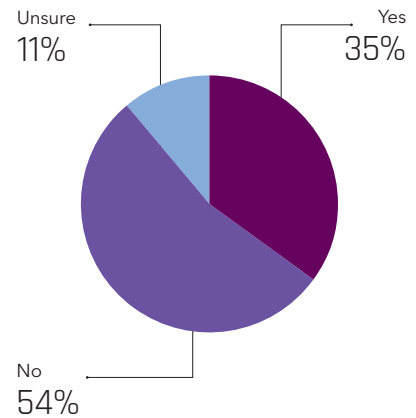
Nevertheless, a significant proportion of LPs – 35 percent – say they are actively encouraging fund managers to promote gender diversity. This figure barely differs between investors based in different regions, showing how the movement to promote gender balance has become truly global.

But while many LPs are pushing their fund managers to become more diverse, a much smaller minority are prepared to walk away from GPs that do not reflect their values. Just 14 percent of respondents report they have refused an opportunity due to a lack of diversity at the fund manager level.

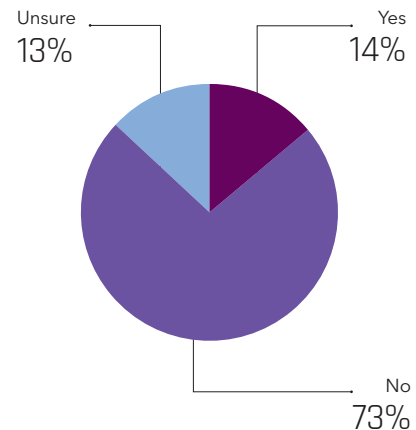
At PEI Media’s Women in Private Equity Forum, held in London in early November, delegates largely agreed that LPs will ask questions about diversity but are generally reluctant to pull the trigger on withholding an investment based on diversity factors. Brunel Pension Partnership, for example, considers diversity when grading managers on sustainability. But Gillian de Candole, an investment principal at the pension, told the forum that while a lack of diversity can leave a fund manager with a lower overall score, it wouldn’t automatically stop a commitment.

And Anamica Broetz, head of business development and strategy at DWS Private Equity, says LPs are not doing enough to use their influence to push investment teams to become more inclusive. “The pain point is at capital. If LPs start to say ‘no’ to teams that are not diverse enough, I think we’re going to start to see a lot of change very quickly.” ■

Do you actively engage your fund managers to promote gender diversity and inclusion?



Has your institution ever refused an opportunity based on a lack of diversity and inclusion at the fund manager level?



Source: PEI LP Perspectives Survey 2020

## KEYNOTE INTERVIEW

## How ESG can drive returns



*Delivering what today's ethically minded consumers want is opening up opportunities for private equity to find and build businesses with ESG at their core, explains Dennis Ever of L Catterton*

As a global consumer-focused private equity firm, L Catterton has invested in more than 200 businesses and brands around the world over the past three decades. With many customers increasingly concerned about the quality and provenance of the products they are buying, the firm is uncovering a growing number of companies and brands around the world driven by responsible and sustainable ideas.

Dennis Ever, partner and head of global investor relations at L Catterton, explains how private equity can identify investments and add real value to businesses by using ESG criteria and processes.

**Q Before joining L Catterton, you were at AlInvest when responsible investing started to become a hot industry topic. How have you seen ESG develop and evolve?**

Early in the 2000s there was a push among

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limited partners to spend time on the core backbone for ESG – environment, social issues and corporate responsibility. It was a big initiative at AlInvest and its backers, APG and PGGM. I strongly believed that these elements were important and that they would become even more important over time. In the mid-2000s, the movement started to pick up steam. More LPs came on board and you had the creation and growth of ILPA and the UN-backed Principles for Responsible Investment.

The process was initially one of education and building awareness among general partners, focusing on engagement post-investment – best practice at companies, implementing standards, identifying and managing any ESG issues. Then the debate moved to due diligence at the front end and

how to use ESG to create value at portfolio companies. LPs always had in mind that ESG factors would be important for value creation and driving returns.

For their part, GPs routinely considered these ideas – “are we working with companies and people in an ethical and responsible way?” But they increasingly embedded this thinking into their processes. A lot of GPs were open to LPs’ ideas and were engaged in the process. They started working with companies on responsible investment topics and they spent time actively trying to figure out how to bring ESG into investment processes.

**Q How have you embedded ESG processes at L Catterton?**

Our ESG policy starts at the top. L Catterton’s leadership team is very focused on ESG, and we make firm-wide decisions with an ESG mindset. Our global headquarters in Greenwich, Connecticut, was built to

LEED Platinum standard and across our 17 offices we have a commitment to reduce our environmental impact. Our real estate business has achieved LEED Gold or the equivalent for its development projects. It is very important for us as a firm, both internally and externally, to demonstrate our commitment to the highest sustainability standards. We are also very focused on diversity – roughly half of new hires are female, and we have a representative body for women at the firm internally.

At an investor level, where we can partner with LPs on initiatives important to them, we do. For example, we are a signatory to the UN PRI and we have pursued best

*“The global consumer industry presents a lot of ESG opportunities”*

practices on ESG reporting, including those established by the ILPA guidelines.

From an investment perspective, we have also made a lot of progress. We bring in third-party ESG experts to help us conduct our due diligence around the globe. Founders/entrepreneurs and management teams are focused on the importance and impact of ESG and we partner with them on strategies that enhance ESG and drive value.

We have a global ESG committee that includes professionals from each strategy and business unit and have adopted an annual ESG questionnaire for each portfolio company to report on metrics like job creation, diversity, environmental management and CSR policies.



Espaçolaser: spends about \$250,000 a year on childcare to help retain staff

## Social responsibility in value creation

### Q How are social considerations driving investment decisions in emerging markets?

Espaçolaser sits at the centre of a number of trends we have been following: wellness and beauty; shifting gender norms; and ‘by women for women’. The company is the largest laser hair removal group in the world and has a key focus on bringing women into the workforce and management roles. Some 96 percent of employees are women and 400 women hold leadership roles, including senior management. The company has trained about 3,000 women from across Brazil, including those from minority groups, and spends about \$250,000 a year on childcare to help retain staff.

### Q What do these kinds of initiatives mean to consumers?

Consumers in emerging markets respond really well to brands that have a social message. FabIndia is one of India’s most iconic artisanal brands. Its products are sourced from villages across the country and give work to 40,000 craftspeople, again many of whom are women in rural communities, and help keep traditional weaving and dyeing techniques alive. We introduced a number of initiatives to drive sales – for instance, the creation of a new sub-brand to reach a younger, more fashion-conscious consumer, and we made a strategic investment in Organic India, a leading producer of organic food and supplements. The result was that FabIndia was able to more than double revenues during our four-year investment and was recognised by the Bill & Melinda Gates Foundation for its impact.

### Q You talk about the role of ESG in value creation. How has that influenced the way you think about investments in the consumer sphere?

One of the biggest things for us has been putting ESG at the core of our investment themes. As we research high-growth consumer categories, ESG is an increasing source of value creation and a significant part of our investment thesis that we are factoring in and seeing driving trends. We are considering ESG criteria during due diligence, and we are looking at ways of creating value using ESG initiatives.

The global consumer industry presents a lot of ESG opportunities. As a category investor first and foremost, we have seen a lot of changes in consumer behaviour and attitudes. Millennials and Gen Z really care about what they buy, where it comes from, how it’s made, and what impact it is having. There are a growing number of important themes that we have pursued, such as By Women for Women, Clean Beauty, Better for Baby, Sustainability and Authentic Heritage.

ESG is also important for people we bring into the firm and the companies we invest in. New hires want to join a firm that truly focuses on responsible investing.

### Q What’s the practical impact on investment decision-making and strategic planning?

During due diligence, we have walked away from companies that may have had great return profiles but where we couldn’t get comfortable with issues like the supply chain. And when we do invest, the right ESG actions help to deliver value. At Honest Co – a



Ganni: the Danish fashion group signed up to the Sustainable Apparel Coalition

## Exceeding rising consumer expectations

### Q What kinds of responsible issues are consumers focusing on in developed markets?

Plastics and packaging are a very big issue for consumers. The growth in ecommerce means that fashion retailers are generating and sending a lot of packaging. Last year, Danish fashion group Ganni signed up to the Sustainable Apparel Coalition and started a collaboration with Finnish sustainable packing firm RePack. Customers can choose to have their purchases delivered in RePack's reusable packaging, which can be used again for 20 times or more. The company also has a programme to recycle used clothes and has been experimenting with clothing rental to make customers think about how they consume fashion.

### Q What other ideas are important?

Provenance is a critical consideration when it comes to quality. Last year we invested in Boll & Branch, a direct-to-consumer maker of luxury bed linens and home products. The company's mission is to be better for people, the planet and the consumer. Core to this mission is a supply chain where farmers and factory workers earn a real living wage, where there is no forced or child labour, and which requires equal treatment of women. The raw ingredients are made without chemicals, pesticides and GMOs, and are all done with sustainable waste and water treatment.

digitally native, clean beauty company – the aim is to deliver safe, natural products for the family. It's a fast-growing segment and ESG helps us make sure we are plussing up the benefits of the better-for-you positioning.

We've always had an active, operationally intensive investment model, which allows us to work in partnership with the founders/entrepreneurs and management teams on the important value drivers including ESG initiatives. Our dedicated operating team includes professionals with deep functional expertise in areas that matter most to these fast-growing consumer brands. They work with our companies on everything from digital marketing to supply chain.

### Q How does ESG play into value creation at the exit?

We work hard to make sure companies are well positioned for the buyer – in our case the majority of our exits are to strategics or to the public markets. If ESG is important to our investors, and important to us, then it's also important to the next buyer. So, it

becomes a critical piece of maximising value.

For all the areas where we can tangibly measure ESG impact, we do. We know it's creating value and driving better returns in many ways and we have KPIs we can use to show the impact of ESG. As an industry, there is increasing alignment on the importance of ESG on investment returns and we are moving towards ways of analysing and measuring ESG.

### Q How do you see consumer attention on topics such as sustainability and ethical practices?

ESG issues are already extremely important to the consumer and we think they will only become more important over time. Big businesses need to embrace ESG topics if they are to succeed. At the same time, brands and companies in niches can get to scale very quickly by meeting the demands of environmentally and ethically minded consumers.

In today's environment, investors care about what they are investing in, entrepreneurs care about what they create, and con-

sumers care a lot about what they purchase. We want to ensure we are building brands that meet customer expectations and drive loyalty, while also having a positive social impact.

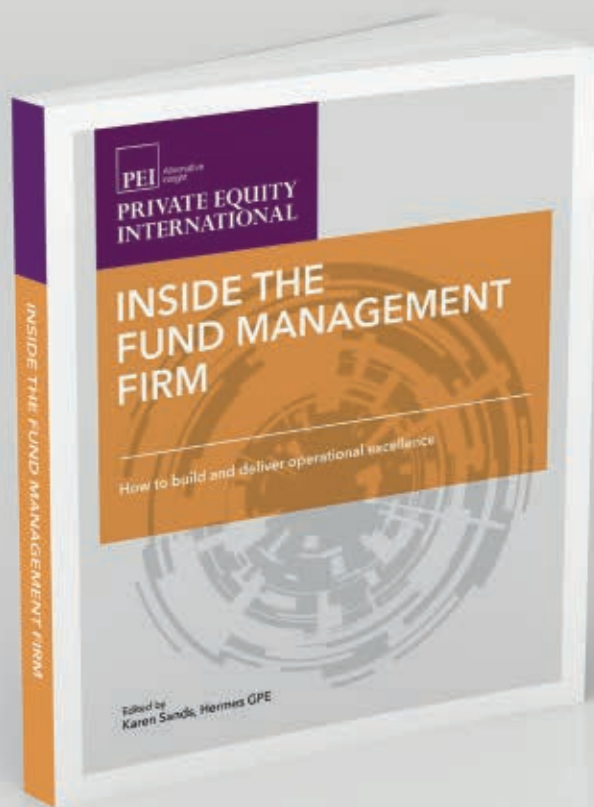
This is a global phenomenon. We see it across all the geographies we invest in – in emerging markets as well as developed markets. For example, FabIndia has had a lot of recognition for its work in local Indian communities, and Espaçolaser's by-women-for-women story is resonating strongly in Brazil.

### Q Where do you think the future will be for ESG?

I think in 10 or 15 years, ESG will be so engrained in what we do at private equity firms and in portfolio companies that the actual terminology will start to disappear. ESG is becoming embedded in everything we do – the investment processes, company management and reporting – and in the future everyone will be doing it. The fundamental ideas of ESG will be so central to value creation, that it will simply be value creation. ■



# Inside the Fund Management Firm



## *How to build and deliver operational excellence*

Edited by Karen Sands of Hermes GPE, this compelling title from PEI offers thought leadership on the key issues facing private fund firms, and usable best practice on how to navigate through them to deliver operational excellence.

### **Content highlights:**

- Integrating ESG issues into the firm and investment processes
- Blue Wolf Capital Partners recounts its operational growth story
- How to get the best operational staff onboard
- Navigating the new data regulation minefield
- Practical guidance on building cyber awareness
- Outsourcing intelligently – when to do it and how to manage the relationship with third parties
- LPs want evidence of operational best practice – discover the processes, information and documents they'll be analysing

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# Q&A

## *Anna Follér, sustainability manager at the Sixth Swedish National Pension Fund, talks us through the fund's response to climate change*

### **Q Why is climate change an increasingly prevalent investment issue?**

Climate effects are becoming visible to companies and investors across asset classes. Companies are losing revenue because of climate impact. However, with the transition to a low carbon economy there are opportunities and a market for new products and clients because consumer preferences are changing. People are generally worried about it. It would be strange if it wasn't in focus.

### **Q And for AP6 specifically?**

Climate change is an important question that spans the portfolio. AP6 and our owner, the Swedish state, see this as a priority area. For us, sustainable development is fundamental to the well-being of future generations, and to our ability to generate a long-term economic return for future pensioners.

At our most recent structured stakeholder engagement, which included our owner, portfolio companies, GPs, students and others, climate change stood out as an important issue. It is very much on the agenda in Sweden, and not just due to Greta Thunberg. It's important to us to promote the focus on climate change within the industry.

### **Q How do you address it within your portfolio?**

We invest through funds and directly in companies as a minority investor. In all investments, climate change is integrated into both the due diligence of new investments and how we monitor and follow up.

Since 2015, we've been calculating the carbon footprint of our private equity portfolio annually, using a combination of reported and estimated carbon data. Over the years, we've noticed that GP responses have shifted.

Initially many GPs said they didn't collect carbon data because it didn't make sense for the assets in their fund. We suggested it



*“Carbon emission data is tangible and quantifiable but it's also just one piece of the puzzle”*

was good to monitor at the company level and to compare with peers and benchmark within the sector. We've continued to ask for emissions numbers and see GPs increasingly collecting that data, although we'd like more transparency at private companies.

We also realised carbon emissions and the impact on the climate was not the only issue. The other side is how climate change impacts portfolio companies. That's been a big change in how we look at climate impact and diligence it.

### **Q How do you measure impact; what do you take into account?**

It's really difficult. We ask GPs in due dil-

igence and our annual ESG monitoring: if they have seen any impact in their portfolio; if they conduct a forward-looking analysis on possible impacts; how this is based in policy and risk assessments; and how integrated climate change is into their due diligence and monitoring of investments. We also ask if they ask their portfolio companies for carbon emissions reporting.

At the same time, we're aware that there is a huge spread of maturity among companies and understand the need to be flexible regarding the specificities of different sectors. Carbon emission data is tangible and quantifiable but it's also just one piece of the puzzle.

### **Q Has GP behaviour changed since you became more active on climate change?**

In our 2019 ESG assessment, we aggregated our portfolio climate change data for the first time. It revealed that a number of GPs carry out climate-related risk assessments based on forward looking scenarios. We haven't seen this before.

They are talking to their portfolio companies about it to understand the physical risk and the effects of the transition to a low carbon economy, looking at both regulatory risk and changes in consumer behaviour. Overall, the focus has become more forward looking, less about historic emissions data.

### **Q Would you ever decide not to invest in a GP due to climate-related issues?**

That could definitely happen. When we conduct due diligence, the GP needs to score sufficiently high on all parameters for us to commit capital. In the past, we have declined to invest based on ESG more broadly. We have also declined an investment that had a fossil fuel exposure we couldn't get comfortable with. ■

# KEYNOTE INTERVIEW

## Questioning the commitment to ESG



*Pantheon partners Helen Steers and Alex Scott outline the firm's evolving approach to environmental, social and governance best practice*

In the years since Pantheon signed up in 2007 to the UN-backed Principles for Responsible Investment, the private equity industry has undergone a transformation in the way it thinks about environmental, social and governance. We caught up with Helen Steers, head of European investment, and Alex Scott, ESG committee co-head, for an update on where the firm, its clients and managers are today.

### **Q How do you ensure your ESG priorities are implemented?**

**Alex Scott:** It's a big question and not something that is ever in a steady state. We invest in primary funds and secondaries where we have more visibility on underlying companies but not complete

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control over choice of manager, as well as co-investment.

That's a complex mix and there's always a tension between ESG and investment objectives. We've addressed that through a two-pronged framework. We assess the manager when assessing primary fund investments and in conjunction conduct a company assessment when buying secondaries and co-investing. This focuses on the risks in the business itself and the sectors in which it is operating. In co-investment, by deciding to pledge additional capital to a single company you are making a statement and we have more responsibility.

### **Q What does the manager assessment entail?**

**AS:** It is done in conjunction with our risk team, which assesses all operational risk factors that exist when we commit to a manager – such as cybersecurity, the valuation process, GP governance and business continuity. ESG is a special item within that and it makes practical sense to have it alongside for information gathering purposes and consistency of implementation.

The ESG assessment is semi-independent and rigorous. We ask the manager to complete a detailed questionnaire, which, through carefully targeted questions, seeks to get as much information as possible about how a GP operates. It's a template with open-ended questions that provides the manager with the opportunity

to submit supporting documentation that we can test.

As a global firm, the challenge is that we could be dealing with a high profile, multi-country, sophisticated institutionalised manager that may have a dedicated ESG professional, or we could be investing in a smaller, regional VC firm with a team of only seven or eight people. You can't expect them to have the same level of focus or policy and process.

**Helen Steers:** The questionnaire provides for a uniform assessment across the globe and that's really important. A decade ago, most managers wouldn't be well prepared to answer those questions. Nowadays, the bigger managers are very well prepared, but even smaller managers have got much more up to speed and it's easier to get the information. We rarely encounter any resistance to this at all.

### Q What do you do with the information from GPs?

**AS:** We have a template that sits against the questionnaire responses with three bands of ESG risk rating, ABC, or green, amber, red. We compare answers and build up a picture of where a manager rates on individual areas of ESG, for instance, its internal governance or approach to climate change. That builds into an overall ESG score that sits alongside other areas of operational due diligence that have been compiled in a similar way. It provides for an at-a-glance guide to the sophistication of a manager's operational process, including ESG, that the risk committee inserts into the investment team's investment recommendation. This immediately draws the committee's attention to areas that they might want to probe further.

### Q For those GPs that land in the red space, what happens?

**AS:** For us to be conducting operational due diligence or delivering documentation to the investment committee, GPs will have already met certain quality thresholds. There is correlation between ESG and organisational factors. Managers that are weak on ESG as well as other factors would have fallen by the wayside before they have even entered formal due diligence. Those marked red tend to be a subset of managers that offer something powerful in terms of investment thesis but come up short on ESG. That's not usually going to be a deal-killer. An example



### Q Overall have standards of ESG improved across the industry?

**AS:** Yes, more managers are meeting our green rating on ESG. One of the things we want to do over the next 12 months is get more granular and recalibrate. As more PRI members are obtaining high ratings, PRI is itself looking at this over the next two years. We also need to be able to further differentiate through refining our scoring on ESG metrics.

The key themes that have risen in importance to clients are climate change and diversity and inclusion. We introduced climate change questions into our manager assessment 18-months ago. We have subsequently seen a significant ramping up in client queries on this topic in the past six-to-nine months. Internally, we've also done a lot of work on this, from the ink we use in our printers and paper recycling, to hosting a sustainability-oriented investor annual meeting last year. We've always been ahead of the private equity industry in workforce diversity, but it's become increasingly important to incorporate gender and diversity disclosures and initiatives in a way that works globally. That's not as simple as it sounds.

might be a best-in-class fund in the venture space where substitution is hard.

**HS:** GPs could score red because they don't have a formal ESG policy. That never happens with a big GP, but with some smaller ones it can. It then gives us an opportunity to engage, talk and share best practice, and to bring them along on the journey. We sit in the middle between LPs and GPs and have a part to play in promoting ESG. A decade ago we ran workshops on ESG for managers and investors in Europe. We try to lead by example and share our knowledge. This work goes on today but mainly in Asia where there is a generally lower knowledge of ESG affairs but a real willingness to learn. Our colleague Jie Gong has worked actively with PRI and the Hong Kong Venture



Capital Association to promote ESG in the region.

### Q How do you assess ESG risk at portfolio companies?

HS: We use a business intelligence service, RepRisk, to monitor our 7,000 portfolio companies. It scours global news media in every language for mentions for all companies that are on our watch list, right through to their subsidiaries and brings any issues to our attention. For instance, it flagged a governance issue at one of our portfolio company's African subsidiaries. The US or UK press would never have picked this up. We learnt about it very early on. I called the GP. Happily, they were aware of the issue, were on top of it and taking action.

### Q How do GPs receive that kind of a call?

HS: We have longstanding relationships with most of our GPs and we engage with them on lots of issues, not just ESG. About 30-35 of these ESG situations arise each year and then we have a conversation. We never tell them what to do. It's the same as if we had discovered a financial issue with a company; we'd want to talk about that, too. In some ways it's helpful as the more dialogue you have with your GPs the better. It all helps to strengthen that relationship. It is also an opportunity to exercise some soft influence and raise awareness of ESG.

AS: GPs are often impressed we've found out about an issue and welcome our engagement. Indirectly it really supports ESG standards in the industry because our query will often result in a deal team being asked to respond. It is a helpful reminder that ESG is important to stakeholders and remains at the forefront of minds.

### Q As investors, how are you responding to climate change?

AS: We are working with a third-party consultant on our infrastructure programme to improve how we incorporate climate risk, which is multi-variable and complex. Assets in vulnerable locations are exposed to physical risk, while investments subject to changes in regulations and carbon pricing face transitional risk. There are increasing regulatory reporting requirements and we definitely want to be ahead of those.

We have focused on prioritising three objectives. The first is to identify tools to

*“GPs are often impressed we've found out about an issue and welcome our engagement”*

ALEX SCOTT  
Pantheon

help us evaluate climate change risk in assets we're buying.

Second, to collate information on climate change risk in specific sectors and the opportunity set over different time horizons. We can then subsequently develop a climate change heat map overlay on our programmes that we can report to clients. This will allow us to, for example, say by 2025, 10 percent of our portfolio will be at high regulatory threat, but 40 percent might benefit from changes to regulations. Building up this picture shows our clients that we know what's going on and that their portfolios are hopefully in a decent position.

The third objective is the measurement of greenhouse gas emissions across the portfolio. This is a backward-looking static metric but can complement a more sophisticated risk based approach to evaluating portfolios

At a high level all this sounds straight-forward, but integrating these into processes and reporting systems is a challenge. We're expecting to learn a lot by applying this to infrastructure, which is the sensible place to start from a risk perspective. Then we can think about private equity thereafter which is an even bigger challenge.

### Q And to promote diversity and inclusion?

HS: Pantheon itself is incredibly diverse in terms of gender, ethnicity, religion, race, social background, and that's not a recent thing. It's grown up organically from our formation. It works for us as a business and we need to translate it to our GPs and their portfolio companies by incorporating questions into our risk questionnaire. We believe more diverse groups make better decisions and better investments. As part of our charitable outreach, we also partner with Sponsors for Educational Opportunity and Best Buddies, which are both US-based organisations that promote social mobility.

### Q What are you asking GPs in your risk questionnaire?

HS: How diverse they are in terms of gender and ethnicity. If you don't measure it, things won't change. Many larger GPs are self-reporting and it makes quite painful reading for them. Most are not very diverse at all. GPs are making a lot of effort in recruitment, not just around gender but hiring from a wider spectrum of backgrounds. In some senses that is the easy thing to do.

The harder thing is the retention and promotion of women, ethnic minorities and individuals from a variety of social backgrounds. GPs understand that to recruit the best talent they have to change. The best people in the millennial generation will not want to work for a monotone organisation. GPs also see that in a very competitive transactional environment. They need to sell themselves to top performing companies that have a choice about where they get capital. Management teams tend to preference interacting with a GP that mirrors their own diversity.

### Q At the more senior levels, what will push greater diversity?

HS: There are organisations like Level 20, which I and 11 other senior women in private equity co-founded in 2015, promoting greater gender parity. Early traction has been heartening with 2,500 members and 56 GP sponsors signed up to Level 20. Within a firm, it is essential that whoever champions diversity and inclusion must have a seat at the top table otherwise it won't work. You need senior buy-in. Ideally the managing partner or very senior partners need to fundamentally believe in it and have their remuneration linked to the promotion of these values. ■



# Are ESG scores ready for prime time?

*Ratings and evaluations are being used to help managers raise money and land favourable loan terms. But, as [Jordan Stutts](#) and [Zak Bentley](#) find, the systems used to measure ESG have failings that cannot be ignored*

UK utility Southern Water was fined a record £126 million (\$158.9 million; €139.9 million) by regulator Ofwat in June for failing to prevent sewage spillages over seven years and manipulating figures about such incidents to avoid penalties. The fine was in addition to sanctions for similar leakages over that period.

Despite these offences and Ofwat's investigation into the company being in the public domain, marketing materials produced by UBS Asset Management – one of Southern Water's owners alongside JPMorgan Asset Management, Hermes

Infrastructure and Whitehelm Capital – showed the utility had received a five-star rating from GRESB, an ESG benchmarking organisation, in its 2018 results.

In other UBS marketing documents for investors produced by the manager after the fine and dated 13 September, 2019 – shortly before the 2019 GRESB results were released – this rating was still being presented. The 2019 overall GRESB ranking for Archmore International Infrastructure Fund I, which holds Southern Water, was four out of five, though at the time of going to press, it was not known if the score had been revised.

An asset slapped with a record fine for

serious environmental breaches received a clean bill of health from an ESG benchmarking organisation. That means investors unfamiliar with the Southern Water controversy are being led to believe there is little wrong with the asset when it comes to its ESG practices.

In a world where managers and investments are increasingly judged not just by their returns but by how much good they do, this raises two questions: what's the best way to tell if managers and investments are living up to ESG standards? And are the third-party benchmarking systems being developed to assess these managers and assets ready for prime time?

### Tricky task of defining ESG

For the best part of a decade, institutional investors and fund managers have been grappling with what it means for their portfolios to be ESG-compliant. Accordingly, due diligence has expanded to cover everything from pollution to transparency and workplace equality.

These metrics are far more nuanced than standard financial ones. To convey that their strategies uphold ESG values, infrastructure managers are turning to ratings from organisations such as GRESB, the UN and S&P Global Ratings. But trying to standardise measurements that are hard to explain is “exceptionally difficult”, says Chris Newton, executive director for responsible investment at IFM Investors, a firm that manages A\$152.4 billion (\$105.1 billion; €95.2 billion) on behalf of Australian pensions. Stewart adds that reporting on ESG should be more about being transparent with regard to an asset or company: “It’s not so much about the score. The ratings have got to serve a purpose, ultimately.”

Paul Shantic, who directs the \$246 billion California Teachers’ Retirement System’s inflation-sensitive portfolio, says “it’s not a simple ‘yes’ or ‘no’” when it comes to measuring ESG, and that “no one thing will drive the overall review process”.

“The more important thing in my mind is for managers to incorporate it into normal due diligence on any infrastructure asset under consideration, and then communicating those ESG efforts consistently and diligently to their investors throughout the year,” Shantic says.

However, Bill Watson, chief executive of the A\$3.1 billion First Super, an Australian superannuation fund, argues that this consistency is not always provided by managers. “We look for a documented, rigorous process to evaluate ESG,” he says. “With a lot of managers, it seems like it’s slide 45 in the pitch deck. I get reports from managers where they’ve got little vignettes each month about what they’re doing on ESG. That is a substitute for having a thorough analytical process.

“Essentially, we’re after a repeatable process, rather than just talking to infrastructure operators or owners of underlying assets. The repeatable process is the

*“It took over 500 years to develop accountancy standards and now on the sustainability side we’re expected to develop reporting standards in 10 or 20 years. There’s still a lot of room to improve”*

**FRANK SIBLESZ**  
DIF Capital Partners



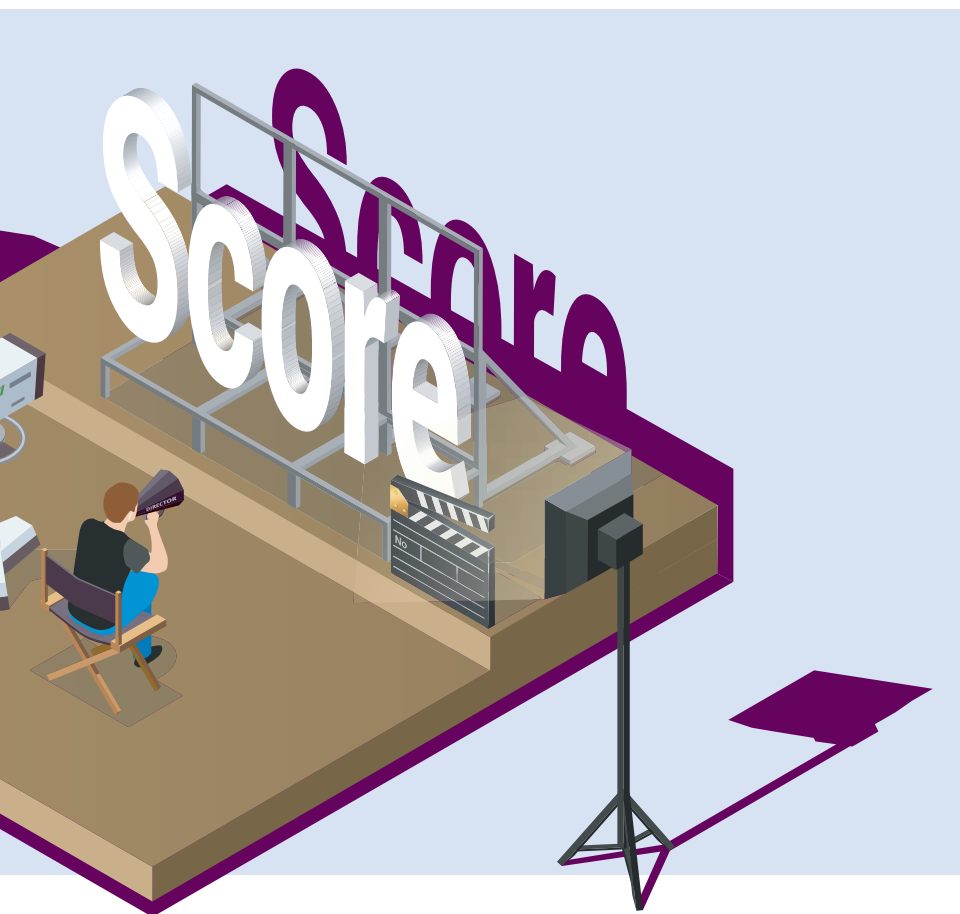
issue, rather than just talking about it.”

On the surface, what goes into an ESG rating or measurement probably isn’t that surprising. Agencies that compile ratings look for firms and the companies they manage to self-report their performance in areas like greenhouse gas emissions, workforce diversity and oversight procedures.

But that self-reporting – and the differing ways in which managers and assets are rated – present complications.

The UN-backed Principles for Responsible Investment, one of the first organisations to start awarding infrastructure ratings in 2014, is more focused on managers and their working cultures. GRESB Infrastructure – an extension of GRESB’s real estate benchmarking practice, established in 2016 – scores its signatories and their portfolio assets. The ESG evaluation launched by S&P Global Ratings this year requires an entity to request an evaluation.

One example of those different standards is the fact that GRESB may not rate all the assets in a given fund. For managers



that have submitted details of 25 percent or more of their assets, its scores are weighted 70 percent towards asset assessments and 30 percent towards fund assessments.

Rick Walters, director of infrastructure at GRESB, admits the voluntary nature of ratings means “it comes down to [the firm’s] own decision about which assets they are comfortable with, which assets they feel they can report to GRESB”.

He says GRESB offers managers “allowable exclusions” from its ratings, covering recent investments and assets under construction. Otherwise, unreported assets count as a zero on a fund’s overall score.

“We don’t see cherry-picking too much,” Walters explains. “Investors want to see all of their funds reporting all of their assets.”

GRESB’s 2019 results involved the participation of 107 infrastructure funds, of which 64 submitted 25 percent of their assets or more. The overall asset score fell from 48 out of 100 in 2018 to 46, though Walters says that was due in part to new

*“We look for a documented, rigorous process to evaluate ESG. With a lot of managers, it seems like it’s slide 45 in the pitch deck”*

**BILL WATSON**  
First Super

participants submitting only part of their portfolios. He calls the results “mixed”.

“You like to see people improving and some have and some haven’t,” he says. “It would be great to see a bit more progress given the challenges infrastructure and the world faces.”

### Trust and kind of verify

So how does information from these managers get validated? At GRESB, Walters says, there’s a three-tiered process that was designed in conjunction with PwC.

The first tier involves checking “a number of aspects across all indicators”, Walters explains, “but only [the] basic answers [submitted through the form]. We don’t open all the evidence documents which are attached [to submissions].” He adds that GRESB is reviewing this process.

The next step, which he calls “validation-plus”, sees “an indicator each year – selected on a risk basis – chosen to go through more thoroughly. We check the evidence in one section and check it matches the claims made, and then make a decision based on that”.

“The final layer is that we pick random entities or funds and check all of those [indicators],” Walters says.

S&P Global Ratings includes a preparedness opinion, which goes a step further in evaluating ESG standards, according to Mike Wilkins, the agency’s head of sustainable finance, corporate and infrastructure ratings. He says that after the first stage of self-reporting, analysts will conduct “interactive meetings” with the participating company’s senior management. This is similar to how it conducts its credit ratings, and helps identify long-term risks and actions that can be taken to reduce them.

“This gives us insight and allows us to use our analytical judgment to come up with a preparedness opinion,” Wilkins explains. “It’s based on us asking questions and gaining insight, especially at the board level, about whether the company is able to deal with future disruptive risks.”

However, the S&P model is at an early stage. Wilkins says three evaluations have been completed since it began, and a dozen are close to completion. It has also received several hundred expressions of interest.



The PRI is also at an early stage when it comes to verification. The agency has collected 2,500 signatories since launching in 2006 and has offered ratings specifically for infrastructure for four years.

“It’s become a bit like a badge of honour,” says Simon Whistler, a senior specialist at PRI. “An A-plus rating sends a signal that you’re among the more advanced investors when it comes to responsible investing.”

He describes “process-driven” questions all signatories must answer about governance, organisational structure, hiring practices and investment due diligence. PRI has developed modules that then detail specific questions for each asset class. “When it comes to infrastructure, it’s whether you have an ESG policy specifically for infrastructure investments,” he says. “How do you integrate ESG into your due diligence process? What types of issues do you monitor when operating infrastructure?”

Whistler says that, as the rating matures, efforts are underway to hold firms to greater account than simply what they report. PRI is undergoing a review to include best practices that will “address the accountability of being a PRI signatory. We need to make investors more accountable for what they are saying and what they are doing on responsible investments”.

### More art than science

The lack of clarity around ESG ratings and measurements is leading some LPs to be cautious when a firm promotes them during due diligence.

“Benchmarks aren’t sufficiently developed yet for people to be incorporating them into their investment policy,” says Anish Butani, director of infrastructure at bfinance, which advises institutional investors. “One investor we’ve been working with has a big sensitivity to offshore tax havens for fund structures. That’s a ‘no’ for them. It wouldn’t be most people’s idea of ESG, but for them that was on reputational grounds.”

Shantic says evaluating ESG is “more of an art than a science” and that there is more than one way to measure how good a firm or asset is doing. To start, he says, CalSTRS requires managers to know



*“We’re very much by industry for industry. We will try to keep working with everyone in the industry and will try to standardise if we can”*

**RICK WALTERS**  
**GRESB**

and understand the pension’s ESG risk factors. Managers also have to certify and report on those factors to CalSTRS on an annual basis.

“We also encourage managers to subscribe to ESG principles, as we do believe it demonstrates that a manager realises the importance of ESG in the formation and management of a portfolio,” he says.

Marcus Frampton, chief investment officer of the Alaska Permanent Fund Corporation, says evaluating ESG is “qualitative as opposed to formulaic” for the \$65.8 billion state sovereign wealth fund.

“At some point, we may look at formalising some sort of an ESG policy,” he says. “But today, it’s simply that we review managers’ approach to ESG on their prior investments, just as we’d evaluate their responsible use of leverage or the reasonableness of the valuation decisions they make.”

“The short answer is no,” says Chris Phillips, a spokesman for the Washington State Investment Board, when asked whether the \$139.6 billion pension fund manager looks at ESG ratings when evaluating a firm. “Our asset class teams individually are responsible for evaluating all material risk factors as part of their due diligence. The WSIB has not adopted a single position or practice regarding various ESG ratings or metrics systems.”

He adds that the WSIB is reviewing its ESG-related mapping and measurement frameworks ahead of the planned appointment of a sustainability officer next year.

### Need for standards

First Super undertakes its own research, particularly into the kinds of actions taken against Southern Water. “We look at how thoroughly [managers] investigate prosecutions and other enforcement actions taken by regulatory agencies,” Watson explains. “It’s things like looking at that, rather than, ‘We’ve talked to management, done a walk around and everyone seemed happy and cheery.’ That kind of royal tour is pretty easy to manipulate.

“We’ve got a low level of confidence [in ratings] because there’s not the degree of maturity, particularly when it comes to the social factors. However, this is a continuum

and there's now more focus on these social factors being placed than there was 12 to 24 months [ago]."

As the Southern Water debacle showed, not every manager or benchmarker gets their ESG practices right. In a statement to sister title *Infrastructure Investor*, Southern Water shareholder Hermes Infrastructure said "the company has undertaken several fundamental improvements which were recognised in the Ofwat report [published at the same time the fine was issued]. We will continue to work with other investors, the holding and operating company boards and senior management at Southern Water to deliver a resilient water future for the south-east [of England]".

Southern Water's other shareholders – UBS Asset Management, JPMorgan Asset Management and Whitehelm Capital – did not wish to comment or could not be reached.

GRESB does not comment on individual assets or funds, but Walters did say the benchmarker is "building indicators around 'controversies and incidents' that would go into the annual assessment". He added: "[Investors] haven't seen the need for having information any quicker than once a year at this point – something we consider [there is the] potential for and is in the medium-term plan."

As well as using benchmarking scores to secure fund commitments, asset owners are increasingly using them to secure credit. In December 2018, Thames Water, another UK utility that is a regular recipient of Ofwat penalties, agreed a £1.4 billion revolving credit facility with the interest rate over five years linked to its GRESB score. Neither the score nor the rate was disclosed by BNP Paribas, which arranged the deal.

A similar deal has already been agreed on the back of an S&P evaluation, despite its short time in operation. Spanish telecoms group Masmóvil received a 67 out of 100 rating and agreed its €150 million credit facility in July tied to this score. "We've seen a number of loans from banks based on ESG scores or their own sustainability metrics as a way of differentiating the margin they pay on the loan," says Wilkins.

Yet not everyone is convinced this is the

**What affects an ESG evaluation?  
The 12 factors that S&P assesses for a company's ESG profile**

Factor	
E	Greenhouse gas emissions
E	Waste and pollution
E	Water use
E	Land use
S	Workforce and diversity
S	Safety management
S	Customer engagement
S	Communities
G	Structure and oversight
G	Code and values
G	Transparency and reporting
G	Cyber-risk and systems

Source: S&P Global Ratings

**GRESB assesses assets using seven core aspects across a range of sectors**

Core aspects	Sectors
Management	Data infrastructure
Policy and disclosure	Energy and water
Risks and opportunities	Environmental services
Monitoring and EMS	Network utilities
Stakeholder engagement	Power generation (excl. renewables)
Performance indicators	Renewable power
Certifications and awards	Transport

Source: GRESB

**Signatories to the PRI agree to uphold six ESG principles**

Principles	
1	Incorporate ESG into investment analysis and decision-making processes
2	Be active owners and incorporate ESG into ownership policies and practices
3	Seek appropriate disclosure on ESG by the entities in which you invest
4	Promote acceptance and implementation of these principles within the investment industry
5	Work together to enhance the group's effectiveness in implementing the principles
6	Report on your activities and progress towards implementing the principles

Source: PRI

best way to ensure good practice. "ESG is part and parcel of everything we do," says Darryl Murphy, head of infrastructure debt at UK-based Aviva Investors. "It's a very dangerous world if you start to have ESG financing separately. What's the rest of it then?"

There's also the question of standardisation – or rather, the lack of it. "I'd like to see more standardisation," says Murphy. "It would help issuers more. There are varying degrees of information asked of the borrower. It can end up in data-rich, information-poor."

This is not an idea dismissed by Walters either. "We're very much by industry for industry," he says. "We will try to keep working with everyone in the industry and will try to standardise if we can."

This would certainly help overcome the significant barriers that benchmarking systems currently face, though there also has to be a meaningful desire for this to happen. In the meantime, DIF Capital Partners' head of ESG, Frank Siblesz, calls for patience and sounds a note of caution. "We really believe it's a combination of qualitative and quantitative information and engagement," he says. "You can ask a company if they have a health and safety policy, you can answer 'yes' or 'no', but for us the real value sits in understanding who it applies to and how it transposes to how you run your project, so it doesn't just become a paper exercise.

"It took over 500 years to develop accountancy standards and now on the sustainability side we're expected to develop reporting standards in 10 or 20 years. There's still a lot of room to improve. But maybe we should not have the objective that we can display all sustainability efforts in a single currency."

Siblesz may be right. But when everything from loans to fundraising is being done on the back of still-developing measurement systems, a much more concerted effort from benchmarkers, managers, investors, lenders and regulators is arguably called for.

If the industry is to really meet the "challenges infrastructure and the world faces", as Walters puts it, it will require a step change in mentality: from being seen to be doing good to simply doing good. ■

# KEYNOTE INTERVIEW

## Private equity embraces impact



*Managers are increasingly raising funds designed to marry financial returns with positive societal outcomes, says Tania Carnegie, leader of the Impact Ventures practice at KPMG*

**Q Impact investment seems to have ramped up over the past 12 months. How would you describe that escalation?**

I would describe the growth we have seen in impact investment in three ways. First, it is very much in line with a broader movement, calling for the evolution of capitalism. The latest evidence of that is the Davos Manifesto, promoting a shift to stakeholder capitalism.

Second, I would describe it in the context of a general maturation. In 2019, in particular, we really started to see some common practices emerging. A number of initiatives, such as the Operating Principles for Impact Management, released by the IFC, are supporting that, bringing clarity around best practice, as well as additional understanding around what impact really means.

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Finally, the impact universe is expanding. Impact has historically been associated with value-based investors such as high-net-worth individuals, or foundations. But in the last year, we have seen a number of fiduciaries coming into the conversation and really starting to think about how a focus on impact can support their financial objectives. It's been an exciting 12 months.

**Q What are the challenges around balancing impact outcome and fiduciary responsibility?**

A number of member firm clients are fiduciaries, with very clear and tightly defined

investment mandates that focus on maximising financial returns. They have to be very careful not to be perceived as deviating from that mandate. But when you look at the way that these fiduciaries have been embracing and incorporating ESG as part of their investment approach, you can see the focus has been on how ESG can add value to investment processes and outcomes. These fiduciaries are now looking at how an impact lens can also give them an edge. The focus is on driving financial performance as opposed to taking them off course.

**Q How has the private equity industry's impact journey compared with other asset classes?**

We have observed a very considered approach. Firms preparing to launch impact funds have gone through extensive

internal processes – they have really done their homework – talking to other players in the space and seeing how an impact approach could align with their current activities. They are exploring both how an impact strategy could appeal to their LPs, as well as give them a different perspective on investment opportunities. We have really seen a lot of work going on behind the press release announcements. This isn't just about a fear of missing out. There is determination to invest in a different way.

### Q What types of private equity firms are getting involved?

The great thing about impact investment is that it is such an equal opportunity investment approach. What I mean by that, is that it can be scaled and adapted to all different types of investors, across asset classes, sizes and geographies. What we are seeing now is a far greater breadth of investors getting involved, recognising that potential.

### Q How much differentiation are you seeing between managers in terms of their impact investment approach?

We are seeing a great deal of consistency in terms of a recognition that financial returns matter and that transactions need to meet the specific financial criteria of that investor in order to move ahead. GPs understand that a lot of their LPs are fiduciaries and this is the approach they need to take.

Where we see some differentiation is in the areas of focus for investment – the geographies and sectors that are being pursued. Often this is aligned to the way in which the GP is already investing. Managers want to make sure they are playing off their existing strengths in order to build confidence in their impact approach.

### Q How are LPs responding to these new, and unproven, strategies and what is their approach to due diligence?

Even if an LP has been investing with a GP for years, investing in that GP's impact fund is a very different proposition. The manager may have a superior financial track record, but they won't have an impact track record and that's an important consideration.

LPs are, therefore, undertaking deep due diligence. First and foremost, they want to get comfortable with the integrity and



### Q To what extent do you expect to see private equity impact investment grow further? And what is required for that to happen?

I definitely see this as a growing opportunity for private equity, in particular. In order to help managers exploit those opportunities, we need to see the continued evolution of impact standards. This is already starting to happen, with the work that is being done to create an ISO standard for sustainable finance, for example, as well as the work being done in the EU to create a green taxonomy for sustainable activities. These initiatives clarify what is truly impactful, for investors, and enable them to assess performance and make comparisons.

But I also think we need to get a lot clearer around impact language. Impact continues to conjure up a lot of preconceived notions – in particular, the idea that the considerations of impact will diminish financial returns. In reality, what we are seeing is that impact investment can work in many different ways to suit different investor requirements and that many different types of capital are needed to make the impact movement really successful.

There is a need for concessionary capital, certainly. But there is also a need for early-stage capital, growth capital and institutional capital. Each of these different types of investor, providing these different types of capital, needs to be evaluating opportunities in the context of their own risk and return profile. There are still a lot of blanket statements being made about impact and that is a challenge, for sure.



authenticity of the strategy. They want to understand why the GP is entering the space and to make sure it is not just a fear of missing out. They want to understand the manager's view on how an impact approach will add value and that there is real rigour to that approach. Once deals have been completed, they will look to see how the approach is applied through the investment lifecycle.

### **Q How are these funds being resourced?**

Typically, a GP will hire a dedicated impact team. They are thinking about the types of expertise required to support the success of the strategy and so we are seeing a lot of hiring activity. We are also seeing partnerships with outside advisors, in order to draw in some of the more specialist knowledge needed. Managers are working in a co-ordinated and integrated fashion.

### **Q And what types of opportunity are these private equity impact funds pursuing? Is it primarily focused on environmental considerations?**

It's broader than that, partly because there is a growing understanding that the environment, and climate change, have a social impact as well. GPs are looking at investments that tackle the wide range of challenges that are going to make it difficult for life as we know it to continue, either helping change that path or supporting adaptation. I expect the understanding of investment opportunities to continue to become more holistic going forward.

### **Q How is private equity performing when it comes to both impact and financial returns? Or is it too soon to say?**

Early indications are positive, not least because a number of GPs are now out raising second funds. One could certainly infer from that their initial experience has been positive from a deployment perspective and that the limited partner appetite is there too.

### **Q Is there sufficient dealflow to cater for all the fundraising we are seeing?**

My understanding, from talking to clients,

*“Managers want to make sure they are playing off their existing strengths in order to build confidence in their impact approach”*

is that yes, there is. That was certainly an initial concern for some of the new entrants that have come into the space, but these managers have quickly realised that there is a diverse array of opportunity and a real thirst for capital amongst the growing number of companies that are identifying with a broader purpose. That growth in dealflow is part of what is driving the momentum behind all the fundraising that we are seeing.

### **Q Is there a danger that the changing attitude to the capitalist model that is underpinning the impact movement reflects a temporary wave of public and political sentiment, or do you believe it is truly sustainable?**

There is a real momentum behind this call for a shift towards stakeholder capitalism versus shareholder primacy. I do not believe this to be a temporary phenomenon. And I think that it is going to require everyone that is part of the investment ecosystem to really think about how they can operate in a way that lives up to those expectations. The opportunity, then, is to translate that sentiment into tangible action and to demonstrate how that action is making you better, as an organisation.

### **Q So, it's about communicating net positive impact?**

Absolutely. There needs to be a recognition that impact is inherent in all companies and those companies need to manage that impact to ensure it is net positive. All this is part of a broader understanding that companies are deeply interconnected with the fabric of society. Quite frankly, the more companies that think in this way, the greater the pipeline for private equity firms thinking about where to invest next, and that obviously creates more robust choices for LPs as well.

### **Q And what role does KPMG seek to play in supporting the growth of the impact movement, particularly as it pertains to private equity?**

Our role is to support clients along their individual journeys. In particular, member firms advise our clients to develop an impact strategy and impact management approach that adds value throughout the investment process, and help them to earn the confidence of their investors and stakeholders through our impact assurance services. We also assist with deal sourcing and due diligence, and advise portfolio companies to maximise opportunities for value creation and impact.

We have always sought to play a critical role in supporting the growth and evolution of the broader industry. We have some exciting things planned for 2020 that we look forward to sharing in the coming months. ■



# Blended finance: A model for impact investors?

*Ben Payton asks if blended finance structures can appeal to private equity investors seeking both impact and returns*

Emerging markets can look like a scary place to fund managers. Only 17 percent of capital raised by private equity is invested in emerging markets.

And within this very broad category, the overwhelming majority of funding ends up in more developed regions, such as Asia-Pacific or Eastern Europe. Our recent *LP Perspectives* survey found that just 7 percent of LPs would consider investing in sub-Saharan Africa in the next 12 months.

This is a source of endless frustration for development professionals. Many insist that investors could make outside returns by pouring capital into economies where there is massive potential for growth – and help the world meet the UN’s Sustainable

Development Goals in the process. But for fund managers who have to look after their investors’ money, the risk is often too great.

“They struggle to find investable opportunities due to numerous transactional risks emanating from market volatility, political instability, illiquid markets and so on,” says Ladé Araba, managing director for Africa at Convergence, a network promoting investment in developing countries. “Limited exit options are particularly problematic for private equity investors.”

## **Blending opportunities**

What if there was a way to change the risk-reward equation for emerging markets investors? Might this entice private sector capital into tapping the opportunities

offered by the developing world and, in doing so, turbocharge the fight against poverty, climate change and a host of other ills?

That is the hope of those pushing the model of ‘blended finance’. The concept is relatively simple. While there are multiple ways to structure a blended finance fund, the basic element is that these funds aim to lower risks for private sector capital and offer more attractive returns. With blended finance, “private investors have much less to lose”, argues Cecilia Caio, a senior analyst at Development Initiatives, an NGO advocating for sustainable development.

Typically, development finance institutions or other donor bodies provide the initial first-loss capital on below-market terms, allowing private sector investors in the fund

to benefit from higher rates of return. Alternatively, DFIs might offer risk guarantees or insurance for the fund, again on below-market terms. The fund is normally managed by a GP that specialises in impact investments.

Blended finance structures have most often been used for fixed-income vehicles. But Katrina Ngo, a senior manager at the Global Impact Investing Network, tells *Private Equity International* that similar structures can work well in the private equity sphere. “We’re hoping that private equity investors can see blended finance as a tool that allows them to invest in sectors or regions or themes that they might not have explored due to the risk profile of the investment.”

There is no doubt that the rewards are potentially lucrative for investors prepared to take the plunge into a blended finance structure. One fund manager tells us they expect a 12 percent return on a forestry investment in West Africa, compared with 3 or 4 percent that might be achieved with a comparable venture in Europe.

Many others agree that blended finance can unlock investment opportunities linked to issues such as climate change. “Building climate resilience is about a new investment mindset, to ensure investment into future-oriented companies,” says Alejandro Litovsky, the CEO of Earth Security Group, a strategic intelligence consultancy. Litovsky cites the example of investments in sustainable rice production in sub-Saharan Africa and South Asia, which have vastly improved incomes and improved resilience to disasters.

Another key advantage of some blended finance structures – as opposed to a regular impact fund – is that the DFI does not behave as a typical LP after the initial investment, but instead uses its expertise to support the fund manager.

“Impact fund managers are often quite lean,” points out Yasemin Saltuk Lamy, deputy CIO for catalyst strategies at CDC Group. “So DFIs can use their wide-ranging resources in areas such as managing risk and measuring impact to support the fund.”

The DFIs involvement often extends to providing technical assistance to strengthen the commercial viability of the fund’s investees. “We have realised that investment is one part of the story,” says Maria Teresa Zappia, CIO at BlueOrchard, an impact investment manager. “The other part of

blended finance is having technical assistance facilities and capacity-building alongside investment vehicles.”

That, after all, is not so different to how a more conventional private equity fund works. “It’s really a private equity idea that you can create value by supporting your clients in building a pipeline of bankable projects,” Zappia adds.

### ‘The model works’

There are signs that blended finance could be ready to take off in private equity. Florian Meister, a managing director at Finance in Motion, a German impact asset manager, says that private sector investors are increasingly willing to make commitments at an early stage of a fund’s lifecycle.

In some cases, institutional investors have committed to funds within months of DFIs providing the initial first-loss capital. He believes that “liquidity is pushing people even more into anything that yields”, but adds that “the interest in impact and in putting money to uses beyond just financial returns has grown immensely”.

Fundamentally, blended finance is attracting more interest because it has proven capable of offering both returns and impact. “The model works,” says Meister. Finance in Motion has raised seven funds, and many of its competitors manage funds that use a similar model. “They all work quite reliably.”

Zappia is similarly optimistic. She acknowledges that at present, private equity blended finance funds are normally quite small – in the range of \$50 million-\$100 million. Institutional investors might currently prefer the safer option of putting their money into fixed-income blended finance vehicles.

But these can have an investment period that is as long as in private equity. “At least from a liability perspective, there is not such a huge difference between fixed income and private equity vehicles in blended finance,” Zappia says.

### Not so fast ...

In practice, blended finance still accounts for only a tiny fraction of the funds allocated by DFIs, alongside development banks and donor institutions. The dream of using blended finance to “turn billions into trillions” remains precisely that – a dream.

Convergence collects data on blended

*“It’s really a private equity idea that you can create value by supporting your clients in building a pipeline of bankable projects”*

**MARIA TERESA ZAPPIA**  
BlueOrchard

finance transactions. Its latest annual report shows a steady growth trend in blended finance activities, although the market appears to have stagnated since around 2016 and capital commitments remain below \$20 billion annually.

And the most enthusiastic adopters of blended finance in recent years have been commercial banks. They accounted for 46 percent of the commitments from commercial investors to blended finance transactions between 2016 and 2018.

The share of commitments made by private equity, venture capital and institutional investors has been steadily declining since 2010.

Clearly, both fund managers and investors will take some convincing on blended finance – and indeed on impact investing more broadly. Saltuk Lamy warns that “it takes quite a cultural shift for commercial investors to engage with impact investors”.

Put another way, much of the private equity community simply does not need the hassle of dealing with the complications that come with impact investing, especially when reliable returns are readily available in developed markets.

While some blended finance vehicles have seen increasing interest from private sector investors, firms establishing a fund with a niche objective are likely to face challenges in raising capital.

Zappia says that BlueOrchard’s climate adaptation fund “has been music to the ears of a lot of investors, but it has certainly taken more time than with other mandates to

*“The interest in impact and in putting money to uses beyond just financial returns has grown immensely”*

**FLORIAN MEISTER**  
Finance in Motion

attract funding”. She adds that “because what we’re trying to do is innovative and new, it takes time in a due diligence process to convince investors”.

And there is not a large pool of GPs capable of managing a blended finance fund. The market is dominated by specialist impact investors, along with some larger firms that can invest resources in acquiring the expertise to engage in impact investing. For others, operating a blended finance vehicle – even with the assistance of a DFI – would be outside the scope of their capabilities.

There is no way around the reality that managing a blended finance fund in emerging markets is, almost inevitably, a high-maintenance undertaking.

“A huge amount of effort and expertise goes into the preliminary stages of project and managing development risks,” says Saltuk Lamy.

Meister argues that fund managers must have a physical presence close to their assets in order to manage risks and keep track of investees. “If you do it from a desktop in New York or Singapore, you’re not going to hear the problems – these are very illiquid markets and you won’t have time to react.”

If fund managers take the wrong approach, the damage can be long-lasting. “The catch is that not all the impact funds that are being quickly put together are genuinely creating an impact,” warns Litovsky. “This is a risk, which we have seen sour relationships.”

Indeed, investors have long complained that they need standardised metrics to measure funds’ ESG performance. With impact investing – including when blended finance structures are used – the problem is even more acute. These funds generally have specific objectives – some of which are very niche – meaning there is no obvious way to compare impact performance across funds.

Katrina Ngo from GIIN agrees that there is fragmentation in the metrics being used. But she is still hopeful that “if people start using the same metrics then you can get to that comparability that we’re seeing in other forms of responsible investing”.

So, while blended finance clearly has a role to play in allowing investors to generate impressive returns and, at the same time, address development challenges, not everyone is ready to embrace the model.

This won’t discourage DFIs like the CDC Group from believing in the value of using public sector capital to facilitate private sector investment.

The key, says Saltuk Lamy, is for DFIs to be flexible in how they approach the challenge.

She argues that in some contexts, DFIs can tackle the early stages of shaping the markets – before they seek private sector involvement.

“We believe that DFIs can come in at the initial stage and invite other investors to join us over time,” she says. ■

## Giving private equity a chance

**As institutional investors grow more comfortable with the blended finance approach, they may be more willing to give private equity a chance.**

“If we were to leap forward 10 years, as private equity blended finance builds a longer track record, we will see vehicles increase in size,” says Maria Teresa Zappia, CIO at BlueOrchard. “And the volumes that can be mobilised from commercial investors will increase.”

Alejandro Litovsky, the CEO of Earth Security Group, also believes that a golden age for blended finance in private equity could be around the corner. “Blended finance not only represents a way of engineering public-private financing deals,” he says. “It also embodies a spirit of co-venturing and co-investing, of going at it together to unlock the potential for growth of vast regions of the world that are developing fast.”



# KEYNOTE INTERVIEW

## ESG and impact: Are they on a collision course?



*Amy O'Brien, head of responsible investment at Nuveen, and Rekha Unnithan, co-head of impact investment at Nuveen, chart PE's responsible investment journey*

**Q** What are the fundamental differences between impact and ESG and how does each sit within the broader responsible investment landscape?

**Amy O'Brien:** The responsible investment landscape has expanded significantly over the past few years and that means we have ended up with all these different terms, which can sometimes seem as though they are in opposition with one another. Here at Nuveen – where responsible investing is integral to our approach across all asset classes – we see ESG integration and impact as working hand in hand.

For us, ESG integration is about incorporating material ESG factors into the investment process itself. We believe that doing this enhances performance and better manages risk. Impact, meanwhile, is more about how we measure, manage and drive positive environmental and social outcomes through our investment practices. So,

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these are two distinct approaches, trying to achieve different aims, yet they are partners rather than competitors.

**Rekha Unnithan:** I would add that intentionality is critical when it comes to impact. My team and I focus exclusively on identifying the big problems facing the planet and society and thinking of ways to use private equity and real estate as tools to provide solutions. But, at the same time, we are also coming at these problems from the perspective of an institutional investor and so we are looking for opportunities to both create sizeable impact and strong, risk-adjusted returns.

**Q** Rekha, would you agree then that ESG and impact are complementary forces?

**RU:** Absolutely. Nuveen systematically incorporates ESG factors into investment processes across the entire organisation. And our impact practice certainly has a very strong foundation in ESG. The basic premise of taking care of the environment and of society and having strong governance in terms of how investments are structured and managed, is critical to us as an investor.

This is particularly true in a private equity context, where asset management tends to be more hands on. The key difference when it comes to impact is this issue of intentionality, as well as the way in which we report to our clients about our performance in terms of achieving our impact objectives.

**Q** What is your responsible investment approach, when it comes to private equity specifically?

**RU:** From an impact perspective, we are growth investors. We look for companies with established economics and market fit,

that are looking to grow in scale. We take minority stakes, with very strong governance rights, which means we sit on boards alongside management, setting the strategic agenda from both an operational and impact perspective. In fact, we believe the two go very much hand in hand.

When it comes to ESG, meanwhile, operating in the private domain typically means the disclosure requirements are considerably lower than for public companies. In our work, we require potential portfolio companies to share a high level of information in advance of any deal. The level of due diligence can vary by market and sector, but we place a great deal of scrutiny on ESG practice as we are putting risk capital on the line, after all.

### Q How does that approach differ to other asset classes?

AO'B: I think each asset class does require its own customised approach when it comes to how best to integrate ESG and engagement activities. The tool kits required for imposing change can certainly differ.

But there is a lot of common ground, as well. We are always looking to use critical ESG data factors to exert our influence

in whatever way we can. We may not have a board seat on a public company, for example, but we do take active ownership through proxy voting and dialogue very seriously. From due diligence, through ongoing monitoring, reporting and accountability, ESG is integral to our investment lifecycle here.

### Q What is your approach to ESG due diligence in a private equity context?

RU: We really try to identify plans for ESG evolution as part of our due diligence and underwriting. We do base line assessment of where the company is currently from an ESG and impact perspective, and then look carefully at how it needs to progress as it scales, in order to be successful. We clearly identify areas of risk, or any gaps that may exist, and develop a game plan for management teams to tackle those.

Some of those challenges may, in fact, be highly operational. For example, if a financial services business serving low income customers doesn't have an adequate data strategy in place, that could seriously hinder its future expansion. If it doesn't know who its customers are, what their income levels

*“We wouldn't be putting all these resources into a responsible investment strategy if we thought that returns would suffer”*

AMY O'BRIEN

are, where they are located, or how many of them are women, those things can become very material to operational and financial performance over time. And these metrics also have a bearing on impact, of course: there is a clear overlap. If we ask a company to measure things that seem irrelevant to them, that company is probably not a very good fit for us.



## View with an impact

**In 2017, Nuveen's impact investment arm backed View, a company which produces and installs smart windows that automatically adjust to sunlight.**

Each blue-tinted windowpane has its own IP address and can be controlled from a smartphone app. “Architects love to use glass in buildings, but developers hate it because the energy cost is so high,” says Nuveen's Rekha Unnithan. “Now you can use glass that still provides all the health and wellbeing advantages of that connection to the outdoors, and also reduces your energy footprint by between 20 and 40 percent.”

Since Nuveen's initial investment, View has increased the number of projects it has completed from around 200 to more than 500. It has also gone on to raise \$1.1 billion from Softbank Group's Vision Fund. In addition to reducing energy consumption, the glass significantly increases the amount of useable space in a commercial property by reducing glare and heat from the sun. It also eliminates the needs for blinds altogether. Indeed, Nuveen has become one of View's biggest customers. TIAA's New York office has undergone a \$200 million renovation, including the replacement of every window with View Dynamic Glass.

### Supporting India's smallholder farmers

**In 2019, Nuveen led a \$55.6 million Series D funding round, supporting Chennai-based Samunnati Financial Intermediation's mission to provide financial and agricultural support services to India's smallholder farmers.**

Nuveen came in alongside fellow impact investors Elevar Equity and ResponsAbility, as well as early-stage venture investor Accel. Meanwhile, Dutch development bank FMI and Swiss investor Symbiotics have provided debt financing.

Samunnati has now expanded to 14 states and provided 16 billion rupees in loans. It offers working capital loans to community-based organisations and receivables financing to small and medium-sized enterprises, indirectly supporting two million farmers. The latest round of investment will allow it to expand its expertise into fruit and vegetables and food processing.



#### **Q How is the private equity impact ecosystem evolving?**

**RU:** When I first joined Nuveen, this market was very much still nascent and most of the key players were managing early-stage funds. Potential target companies that identified with a broader purpose were just starting to emerge. Ideas were being formed. Since then, there has been a natural progression. Those ideas have become businesses. They have raised capital and now we are seeing significant opportunities for companies to scale. The market is becoming louder and prouder and more diversified.

As a result, we are starting to see more large buyout investors taking an interest. However, this has left a real gap in the growth and mid-market space. Early-stage investors have validated the investment model and supported these businesses for three to five years but they are not yet ready for the mega-funds.

#### **Q Where is the majority of private equity capital being targeted? Is the focus primarily environmental?**

**RU:** I think there is significantly more overlap between the environment and societal challenges than is often acknowledged. When you think about economically driven mass migration, for example, climate change often has an important role to play. Nuveen, certainly, takes both the environment and social issues into account. Our strategies are focused on both people and planet.

**AO'B:** That's an important point. A lot of the issues we see broadly across the ESG sector cannot be neatly contained within purely the E, or the S, or the G. In fact, we have recently revamped our entire responsible investment policy, purposefully, to get away from that rigid framework. Instead, we think about these things in terms of, what we call, business ethics, transparency and discipline.

#### **Q Where are we currently in terms of the debate around responsible investment and its impact on returns?**

**RU:** We certainly wouldn't be having any of these types of conversation if we felt there was a trade-off. While I don't think it is fair to hold ESG or impact investment to higher standards than "regular" investments from an absolute returns perspective, I do think they perform at least as well.

**AO'B:** I agree. We wouldn't be putting all these resources into a responsible investment strategy if we thought that returns would suffer. That debate does still prevail in certain parts of the market, but I think that comes down to education. The way that this whole area has developed has been a little messy.

Isolated strands of responsible investment have evolved independently, and we are only now trying to bring them all together. In particular, the impact spectrum ranges from philanthropy to a highly re-

turns-driven approach, and that can be confusing. Equally, responsible investment has evolved differently in different asset classes. There was very little talk about ESG in private equity 10 years ago. The focus was more on impact. ESG, meanwhile, grew up in the public markets and that is where we are now starting to see conversations around impact emerge.

#### **Q Given this complex start in life, how do you expect responsible investment to develop going forward, particularly in the private equity industry?**

**RU:** I think any private equity investor not fully taking ESG into account is very much behind the curve because, quite simply, there is huge value in doing these things properly. I think impact will also continue to evolve in the private equity space, where it first began, although that is not to say, it won't be adopted in the public markets as well.

**AO'B:** I think the UN Sustainable Development Goals have played a critical role in bringing people from all asset classes together. The SDGs have received more global attention than any other classification system in the past – and there have been dozens. Investors are looking at those goals, not just in terms of problems to be solved, but as investment opportunities. And there are some very big numbers being floated around, in terms of market potential. ■

# What we learned at the forum

*Almost 300 industry professionals gathered in London last year for PEI's Responsible Investment Forum. Here are the key takeaways. By Carmela Mendoza*

The 10th anniversary of *Private Equity International's* Responsible Investment Forum in London saw spirited debate on the challenges involved in integrating ESG into the mainstream. The difficulties of data collection, the need for better impact management and how to measure returns were among the topics discussed. Here are four things we learned.

## The industry needs good impact management

Standardising the quality of impact reporting is a major pain point, panellists and delegates agreed. This is complicated by several organisations working on the same topic: the International Finance Corporation published its 'Operating Principles of Impact Management' in April, and the Global Impact Investing Network has IRIS+.

The challenge is having clear reporting and metrics on ESG goals, as well as sub-targets that can be compared across portfolios. As David Lomas, BlackRock's global head of sales and marketing for alternatives, pointed out: "There's a wealth of untapped data and resources that would provide great information advancement for GPs – there is value-add there in this space; you've just got to learn to harness it, measure it, manage it and report it."

## SDGs can be confusing for both LPs and GPs

The UN's Sustainable Development Goals are adding another layer of confusion for LPs and GPs, according to Ellen de Kreij, operating advisor for sustainability at Apax Partners.



*"There is value-add there in this space; you've just got to learn to harness it, measure it, manage it and report it"*

DAVID LOMAS  
BlackRock

Anna Follér, sustainability manager at the Sixth Swedish National Pension Fund, added: "There's a lot of talk about SDGs – many want to do things and think this can be a great framework but it's difficult to find the ways to do that. We don't see lots of tangible things being reported to us on SDGs."

## Evaluating net impact returns remains the biggest hurdle

AP6, Dutch asset manager PGGM and LGT Capital Partners were asked where their institutions are when it comes to assessing the net impact returns of their investments.

"We'd love to be able to measure net impact, but we are really far from being able to do such a thing," said Follér. The sheer number of investments in the firm's PE portfolio – about 500 companies to date – makes that challenging, and the level of information accessible is a patchwork, she added.

## Impact investing is an unstoppable one-way trend

Panellists agreed that the industry will see more impact funds sitting alongside mainstream funds in the next decade. GPs and LPs expect more collaboration across the industry as they create solutions to big societal challenges.

Michele Giddens, co-founder and co-CEO of London-based impact investment firm Bridges Fund Management, predicted greater democratisation of impact investing.

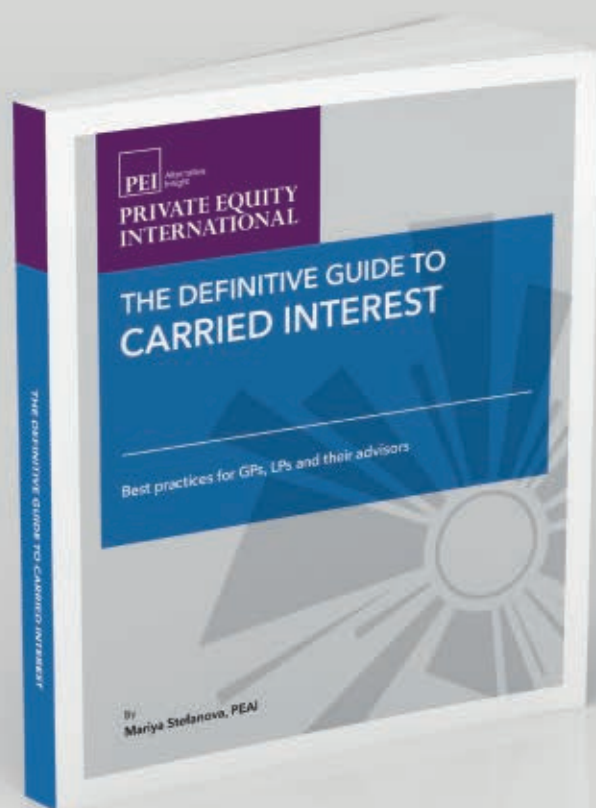
"Pensioners themselves over the next five years will ask where their money is going. This will ultimately drive change; pensioners want their money invested in the causes they care about," Giddens said.

"Technology will unleash a real wave of democratisation and empowerment." ■

Our 2020 Responsible Investment Forums are in New York on 4-5 March and London on 11-12 June. For more details, visit: [privateequityinternational.com/all-events](http://privateequityinternational.com/all-events)



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# Q&A

*Directors have a duty to take ESG into account, says Simon Witney, special counsel at Debevoise & Plimpton*

## Q What are the most important ESG issues to private equity firms in 2020?

It's important for firms to understand how climate change may impact their portfolio. They need to have a strategy in place to manage those impacts and take advantage of opportunities. Private equity firms that have signed up to the UN-backed Principles for Responsible Investment will have to report on certain climate risk indicators from 2020.

Cybersecurity and data privacy are more of an issue for private equity, because of the GDPR but also because society at large is focusing more on these issues. And, of course, anti-corruption is a perennial concern.

Any issue that affects a firm's risk profile can fall within the environmental, social and governance category. In my view, a lot of this is about governance – it doesn't really matter if you classify an issue as being part of ESG. What matters is ensuring good corporate governance and proper risk management.

## Q Do firms have a fiduciary duty to take ESG issues into account or is their duty to prioritise returns?

I don't see ESG and financial returns as a trade-off. It's hard to see how it is not part of a firm's duty to investors to take financially material ESG issues into account when making investment decisions, if these issues could result in damage to the underlying business. Certainly, directors of underlying companies should consider all material risks and opportunities, including those that arise from so-called ESG issues.

I am also not convinced that there are very many – if any – material ESG issues that are not financially material to the fund's risk-adjusted financial returns. To take an example: if a portfolio company is undertaking an activity that has a materially negative impact on the outside world, then it seems unlikely that governments or regulators will



*“I don't see ESG and financial returns as a trade-off”*

allow that to continue indefinitely. It will either be banned or taxed. In the longer term, it clearly isn't sensible for a firm to base its business model on an activity that is causing significant harm to the outside world – for example, to rely on being able to continue to emit high levels of greenhouse gases.

I think that the term 'fiduciary duty' is overused and often misunderstood. Its meaning varies between jurisdictions and is dependent on context. For private fund managers, their fiduciary duty depends, among other things, on what they have agreed with their investors.

## Q How will the new EU disclosure regulation affect private equity?

The regulation requires a wide range of

asset managers to disclose, among other things, their policies on the integration of sustainability risks. The next step is for the EU authorities to draft detailed implementing measures. It's quite hard to know precisely what firms need to do until these are published.

Most firms already have a policy on integrating sustainability risks. They should certainly be getting ready to publish these policies on their websites if they haven't done so already. We can't be certain at this stage, but I think many firms will already publish most of the information required by the regulation, although some changes may be needed.

Whether UK-based firms will have to comply with this EU law depends on the timing and terms of Brexit and any transition period, and on whether the UK government decides to implement it anyway. In any event, firms will probably have to comply if they have EU investors, even if the firms are themselves domiciled outside the EU.

## Q The EU is also drafting a 'taxonomy' regulation, that would establish common language for classifying investments as sustainable. What impact might this have?

It's becoming more and more difficult to invest in a carbon-intensive business for many reasons, and the taxonomy regulation won't change that.

I think the main effect will be to make it easier for investors to identify businesses that are making a positive contribution to resolving the climate crisis. Fund managers that comply will be able to attract more capital.

Having been subject to some disagreement between various interested parties in the European Council and Parliament, the taxonomy regulation has just been agreed at a political level and so it will now move forward at a good pace, I think. ■

## Points of view

E

*“There’s real potential for the destruction of equity value. Even if you’re a right-wing Republican, you have to acknowledge the changes to Australia’s climate”*

A senior executive at a North American investor voices his concern to PEI

*“Even if you have a fluorescent green portfolio, you will still incur climate risk”*

Bertrand Millot of CDPO says all companies are at risk

*“Over 90 percent of respondents to the PRI module report they take ESG into account when selecting investments. Energy efficiency is the most frequently cited consideration”*

Simon Whistler of the Principles for Responsible Investment says standards are rising

S

*“GPs understand that to recruit the best talent they have to change. The best people in the millennial generation will not want to work for a monotone organisation”*

Helen Steers of Pantheon says more needs to be done about diversity

*“We are seeing more push from investors all over the world. They are asking new and deeper questions demonstrating their increasing knowledge of this subject and their growing involvement in industry ESG initiatives”*

Eric Duchon, LaSalle Investment Management

*“Many different types of capital are needed to make the impact movement really successful”*

Tania Carnegie of KPMG sees growing impact opportunities

G

*“Buy-in at the top permeates through to the investment professionals below that are transacting deals and performing diligence”*

Alan Gauld, investment director of Aberdeen Standard Investments, on the need for support at a senior level

*“Any issue that affects a firm’s risk profile can fall within the ‘ESG’ category. What matters is ensuring good corporate governance and proper risk management”*

Simon Witney of Debevoise & Plimpton says ‘G’ is at the heart of ESG

*“We have integrated ESG in our investment process and in the way we select and monitor our investment process”*

Arjan van Wieren of Dutch pension group MN is setting clear ESG goals

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