*The PwC Private Equity (PE) responsible investment survey shows there is more opportunity for value protection and creation through Environmental, Social and Governance (ESG) issue management for the private equity industry.*

# Putting a price on value

**79%**
of PE houses believe investor interest in ESG issues will increase in the next two years

**71%**
of PE houses include ESG management in their due diligence at acquisition

**15%**
Less than 15% of PE houses calculate the value they create through ESG activity

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# Contents

This report summarises the findings of the PwC PE Responsible Investment Survey 2013, and sets out our thinking on how better ESG management can create value in private equity.

# Foreword: finding the value in ESG

*Better environmental, social and governance (ESG) management provides an opportunity for the private equity sector to generate more value – more value for their portfolio companies, for their investors and for society at large. But better ESG management isn't easy. It needs specialised skills, dedicated resources and new ways of thinking about how companies are managed and where economies and growth are headed. And the link between ESG issues and value creation is not always easy to measure. Even the most sophisticated Private Equity (PE) houses see the challenge in understanding, quantifying and communicating the value that good ESG management can deliver.*

Across the industry, increasing efforts are being made to understand ESG issues, reduce ESG risks and leverage ESG opportunities. And there is certainly a widespread belief in the value of ESG management. Many private equity investors (the Limited Partners (LPs)) are asking questions of PE houses about how they are approaching ESG issues. PE houses themselves have carried out due diligence on environmental, health and safety risks for many years. Now, more and more are monitoring their portfolio companies' ESG performance, with some looking at risk in the supply chain too. Others are starting to look for ESG opportunities in a systematic way, and beginning to quantify and prioritise them. But many PE houses are missing the opportunity to put financial numbers on their ESG efforts and to value them.

This year, we carried out the largest ever survey of the private equity industry's attitude to ESG issues (see the 'About the survey' box). More than 100 PE houses in 18 countries responded, managing more than $860 billion of assets (see page 22 for the list), and the findings reinforce what we have learnt through working with our private equity clients.

What we found from the research is that ESG management is still mainly geared towards risk, rather than opportunity. ESG activity levels are high at acquisition with PE houses sensibly keen to identify potential problems, but reduce during the hold period, with few measuring the difference they've made at exit.

We believe that not only is there clear benefit in better ESG management, but also that it is possible for the value to be quantified and communicated to investors, acquirers and wider stakeholders. In some cases, we've seen LPs declining to invest in PE houses without minimum ESG standards. Some elements, like more efficient resource use, flow measurably through to the bottom line – although even here, many PE firms are still not capturing and communicating the value generated. In other areas, such as employee retention, job creation, or better social acceptance of private equity, the value is less tangible, but is no less real – and the tools exist to put a figure on it.

I would like to thank the PE firms that took the time to respond to this survey. They recognise the growing importance of this issue. Indeed, there is a virtuous circle to be unlocked. If private equity firms can demonstrate that the resources they dedicate to ESG management generate value, then they are likely to increase their efforts in this area. Putting a price on that value will produce genuine benefits for the PE sector and beyond.

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### *About the survey*

The private equity industry is embracing responsible investment (RI). It is spending more time and resources managing the underlying environmental, social and governance (ESG) issues.

But in our work with the sector, we have found that many PE houses are struggling to quantify exactly how RI and ESG management add value. And they are struggling to communicate that value to their investors and wider stakeholders.

To explore this issue in more depth, we conducted the largest survey yet of attitudes to responsible investment within the PE sector of existing practices in ESG management, and of plans and intentions for the future.

We received responses from 103 PE houses to an on-line survey, conducted in May 2013 across 18 countries. Follow-up phone calls and meetings were held with selected respondents.

This report summarises the findings of the survey, and sets out our thinking on how better ESG management can create value in private equity.

### *Responsible investment defined*

Responsible investment is founded on the view that the effective management of environmental, social and governance (ESG) issues is not only the right thing to do, but is also fundamental to creating long term value. Responsible investors believe that companies that are successful in avoiding ESG risks while capturing ESG opportunities will outperform over the longer term.

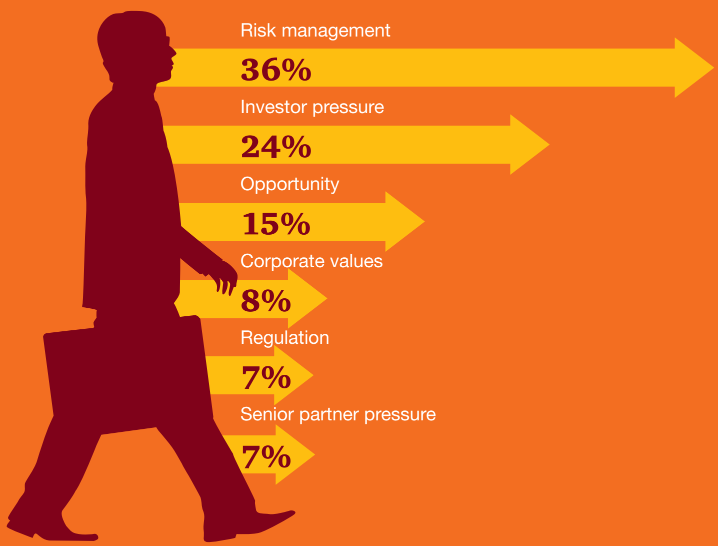
Environmental issues include pollution of land, air and water and related compliance; eco-efficiency; waste management; natural resource scarcity; and climate change. Environmental challenges also present opportunities for value creation, for example, generation of incremental revenue from new technologies, products and markets.

Social issues encompass the health and safety, labour conditions and human rights of employees and those in supply chains; and treating customers and communities fairly. Value creation opportunities might include improving productivity, and increasing brand loyalty or product integrity.

Governance in this context is generally held to encompass the governance of environmental and social issue management, anti-bribery and corruption measures, business ethics and transparency. Initiatives implemented here might avoid negative financial surprises and reduce reputational risk.

# ***Results:*** how PE houses view ESG management

## Chart 1: What's driving ESG issue management?



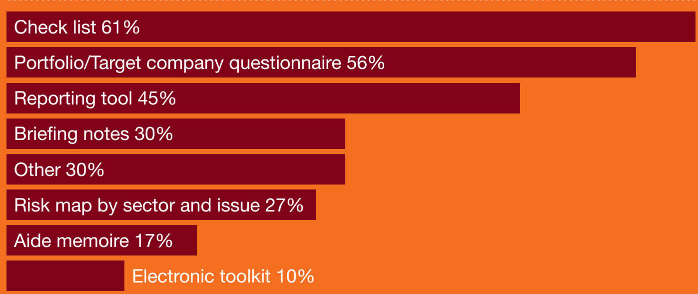

## Chart 2a: Current approach to ESG management

**57%** Formalised public commitments on ESG management

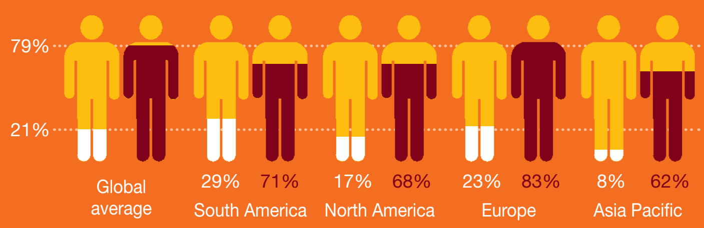
**55%** ESG policy in place

**48%** Tools to implement any ESG policy

## Chart 2b: What tools are used?

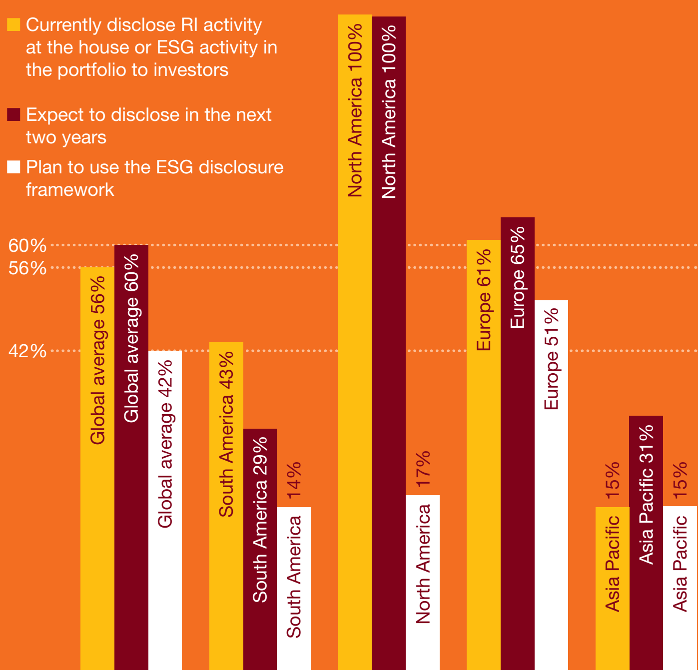



## Chart 3: Are investors interested in ESG issues?




- Investors interested in ESG issues
- Expect interest to increase within two years

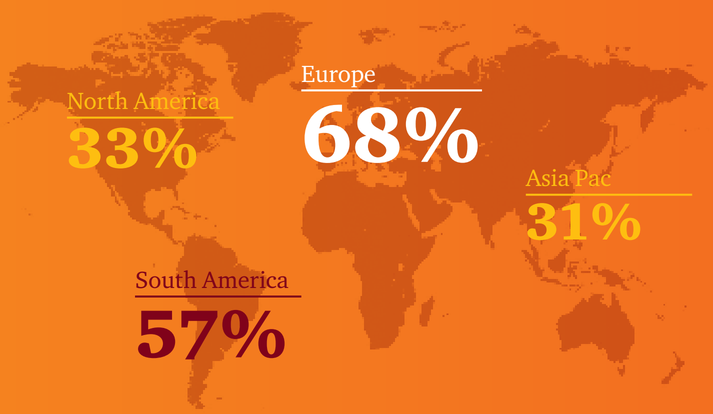
## Chart 4: Disclosure to investors




Source: PwC Global PE Responsible Investment Survey 2013

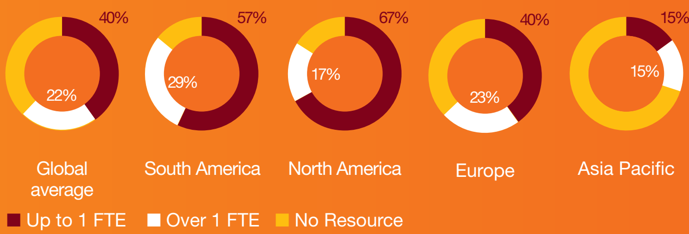
## Chart 5a: Who's driving ESG management?

**60%** PE houses have a Partner responsible for ESG issues, but this varies by region

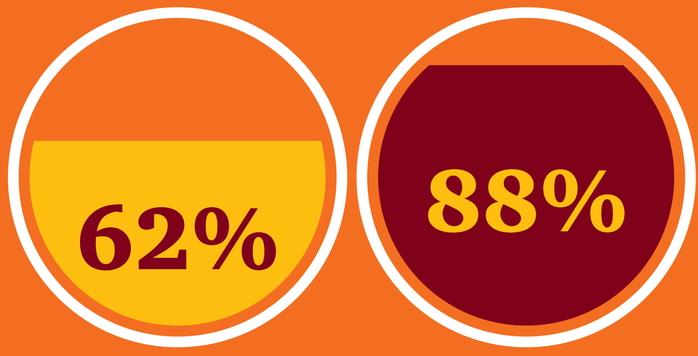



**50%** of these Partners have support


## Chart 5b: Resourcing by region



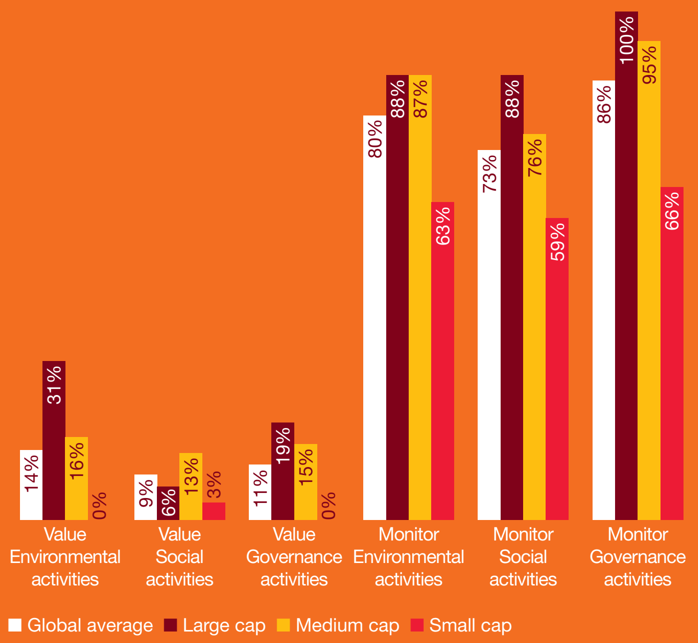

## Chart 6: Levels of reporting




Portfolio companies regularly reporting ESG monitoring results to their boards

Portfolio companies formally reporting ESG monitoring results to their house

## Chart 7: Valuing ESG activity




## Chart 8: ESG management features throughout the deal life cycle

# ESG risk management is developing fast…

*Responsible investment has been on the private equity agenda for a number of years. Some in the industry may have suspected that concern about ESG issues would be a passing fad. But our experience with the sector shows that the attention that investors and PE houses are paying to ESG management is growing.*

### Clear drivers

Our survey results highlight five drivers for ESG management (see Figure 1).

### Value is core to ESG management effort

Belief in generating value is already at the heart of private equity's embrace of ESG issue management, whether it's protecting it through reducing and managing risk, or generating incremental value by spotting ESG opportunities.

PE houses have long scrutinised portfolio companies pre-acquisition for environmental, health and safety risk. Here, the value case is perhaps most easily appreciated by senior management: an exposure overlooked at acquisition can prove costly. According to our survey, risk management remains the most important single reason for PE houses to address ESG issues, cited by 36% of respondents. This figure rises to 67% in North America, while it is 40% in Germany and 43% in Spain.

A minority identifies the other side of the value coin – with 15% citing 'opportunity' as the primary driver for their responsible investment activity. PE houses we have worked with have found

**Figure 1: Drivers for ESG management**


Source: PwC Global PE Responsible Investment Survey 2013 All respondents

> ***"Investors and private equity managers increasingly believe ESG management adds value – the challenge now lies in quantifying it"***
>
> Phil Case, PwC UK

**“ESG management extends beyond risk - PE firms are recognising strategic, operational, reputational and financial benefits”**

Lauren Koopman, PwC US

opportunities to cut costs within portfolio companies: reducing energy emissions and waste and improving water use and health and safety performance. They’ve also encouraged portfolio companies to develop revenue-generating initiatives, such as new cleantech products, or identify new markets that address emerging macro environmental and social trends.

We think that both risk management and opportunity identification can create value in portfolio companies – but, from the survey, the balance within the PE sector as a whole is skewed heavily towards risk management. As more PE houses quantify the incremental value of these ESG initiatives, the focus on risk management may change to recognise the upside potential of ESG management.

## Investors are a driving force

PE houses understand the needs of their stakeholders, and recognise that their clients, the LPs, are becoming increasingly engaged on responsible investment. Investors have been instrumental in driving the ESG agenda within private equity and one in four of our survey sample states investor pressure as the primary driver.

But that figure does not do justice to the extent of investor concern. 85% of PE houses said that at least some of their investors have shown interest in responsible investment over the last two years. In France, 43% said a majority of their investors were concerned about the issue.

## Regulatory pressures build

A small number of PE houses – 7% of respondents – already cite regulation as a driver for their responsible investment activities. Generally speaking, these regulations relate to the social and environmental impacts of portfolio companies, rather than to their investors.

However, the financial sector in general, and private equity in particular, is also subject to increased regulatory oversight. Much of this regulation relates to governance and transparency, and is in part a consequence of the 2008-09 financial crisis. But the private equity sector is also subject to some direct environmental and social regulation.

In the UK, for example, the CRC Energy Efficiency Scheme applies to private equity houses and their investee companies as well as to companies, such

“ESG [management] is a barometer of the health of the management of the companies in our portfolio. The robust financial performance of our companies is vital, but how this growth is accomplished is also very important because it ensures future performance”

Oliver Millet, Chairman of the Executive Board, Eurazeo PME

**60%**

**In 60% of responding PE houses globally, responsibility for ESG issues lies at the partner level.**

as retailers, with a larger environmental footprint. Regulatory pressures have been a particular driver for some PE companies in France, where Article 224 of the Grenelle II Act requires investors to disclose how they integrate ESG criteria in their investment processes. More regulation is on the way.

In Brazil, the introduction of two draft resolutions submitted for public consultation in 2012 by the Brazilian Central Bank will bring expectations to improve sustainability disclosure and accountability to the financial sector. The first resolution proposes that all financial institutions be required to create and implement socio-environmental responsibility policies well-matched to the extent of the impact of their business. This policy will need to address issues such as climate change. The second resolution creates the requirement for the financial sector to elaborate and assure annual Socio Environmental Responsibility Reporting.

The pull from outside the sector and the push from within are combining, in leading countries, to make sound ESG management a minimum standard. Only one of 20 respondents in the UK, for example, does not have or is not developing a responsible investment policy.

## *Corporate values play a part too*

But it's not only about external pressure. In our survey, 15% of responding PE houses said that corporate values, or a lead from a senior partner, is the primary motivation for their responsible investment activities. In 60% of responding PE houses globally, responsibility for ESG issues lies at the partner level.

Clearly, senior leaders in many PE firms understand the business case for ESG management. This is sometimes expressed intuitively: "It is simply better business", one respondent notes. But there is an increasing recognition that good environmental and social performance is often associated with better business performance – and stakeholders are increasingly making that link.

How PE houses are perceived can be important in attracting the best and brightest talent. Concern about ESG issues is high among the next generation of employees and it has a bearing on their choice of potential employer.

## *The PE sector is responding…*

These drivers are leading PE firms to take action on ESG issues.

More than half of responding PE houses globally have made public commitments to responsible investment, and that figure rises to 80% in the UK and the US, and 90% in France. Over half (55%) have developed formal RI polices, with another one in four having policies under development (see Figure 2). Again, more advanced jurisdictions have moved further: 100% of respondents in the US either have, or are developing, a policy. In the UK, that figure is 95%. Interestingly, not everyone has the tools to implement their responsible investment policy yet reflecting a lack of best practice sharing and helpful guidelines. Getting started is usually the hardest part – as we have found in the corporate sector.

***"Regulation is set to reshape the environment for ESG management"***

Carlos Rossin, PwC Brazil

*"The number of pure ESG due diligence initiatives is increasing strongly - they concentrate on real strategic issues, are more and more linked to financial issues, and are short-, mid- and long-term performance oriented."*

Sylvain Lambert, PwC France

**Figure 2: Managing ESG issues**

| 55% | 48% |
|---|---|
| Responsible investment policy in place | Tools to implement any Responsible investment policy |

Source: PwC Global PE Responsible Investment Survey 2013 All respondents

They are also increasingly putting these commitments into practice. The survey shows high levels of attention paid to ESG issues – at least during parts of the investment cycle. At acquisition, screening for ESG risk and opportunities is widespread, with 71% of houses doing so 'always' or 'frequently'. In the UK, that figure rises to 90%. Less than 5% globally never consider ESG factors during diligence.

Post acquisition, at the 100- or 180-day post-acquisition planning stage, the figure has fallen away somewhat, from 71% to 51%, with just over half of PE houses saying they regularly include ESG issues in their post-acquisition plans. Again, the figure in the UK is much higher, at 85%.

The monitoring of portfolio companies' performance on ESG issues during the hold period is surprisingly widespread. Environmental issues are tracked by 80% of respondents, social issues by 73%, and governance by no less than 86% of PE houses.

The UK is out in front in terms of including ESG issues in the programme for exit, with 50% carrying out vendor due diligence for ESG issues, or including ESG information in the data room, for example.

### *...and is disclosing to investors*

Given the extent of investor interest in the issue, it is high on the agenda for reporting by PE houses. Just under 60% of PE houses already disclose their responsible investment activity to their investors. That figure rises to 80% in Sweden, 86% in France, and 100% in the US.

This disclosure takes a number of forms. Some produce an annual ESG report. Some integrate ESG information into their quarterly reporting. For others it remains an ad hoc process, as and when material ESG issues emerge, for example a labour dispute or changing regulation.

# …and more is to come

*Responsible investment is a work in progress for the PE sector. Our clients in the industry anticipate greater interest from investors, and expect to make greater efforts internally on ESG management. And even the leaders recognise that they need to do more.*

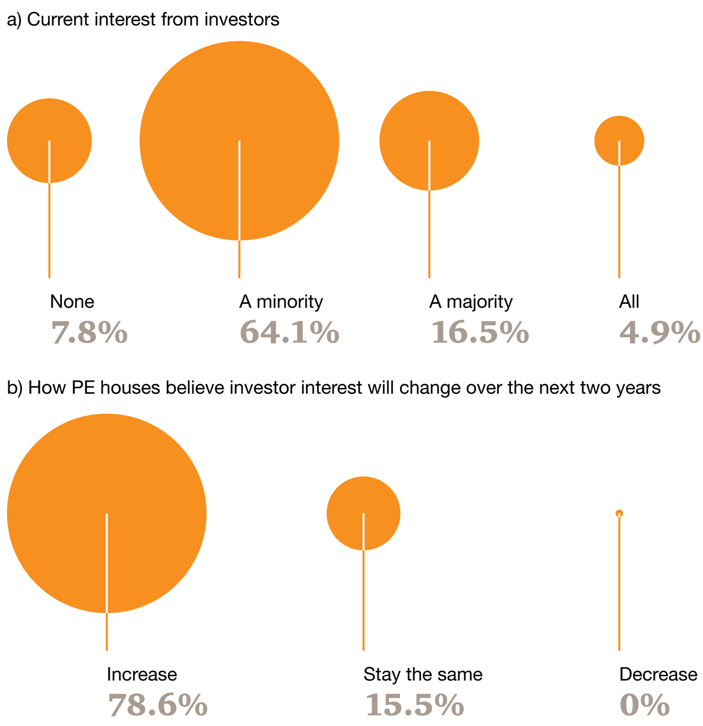
Our survey shows that PE houses believe investor interest in responsible investment will continue to rise (see Figure 3). Almost four out of five PE houses expect the level of investor interest to rise over the next two years. Not a single respondent expects it to decline.

## ESG reporting on the rise

And, as we've seen, the PE industry is responding. The already high level of disclosure is likely to get higher. When asked if they expected to disclose responsible investment activity in the next two 60% said yes (see Figure 4), with only 8% saying no and 26% yet to decide.

This trend towards greater disclosure is finding support from industry initiatives. For example, in March 2013, the PE industry came together to publish the ESG Disclosure Framework. Created by GPs and LPs in collaboration, it is intended to improve the dialogue between investors and PE houses on ESG issues (see ESG Disclosure Framework box on page 14). Our discussions with clients lead us to believe

**Figure 3: Investor interest**




Source: PwC Global PE Responsible Investment Survey 2013 All respondents the framework is likely to gain widespread uptake, particularly in countries where the debate around ESG issues is most advanced.

### *Integrating ESG management*

Not only do more houses expect to disclose, but they expect to do so in a more systematic and integrated way.  Attention to ESG issues is currently highest at acquisition, reflecting the PE sector's traditional focus on risk. But results show that some houses are also embedding their ESG processes throughout the investment cycle.

### *Staying ahead*

It is striking how quickly ESG management can become the industry norm. In France, for example, a handful of firms led on the issue, and they were quickly followed by the rest of the market. They were supported by leading LPs demanding ESG information as a condition of investment, and by the active engagement of AFIC, the PE industry association. Responsible investment moved from a niche pursuit to business as usual within three years. When PE houses are motivated to act on an issue, they act quickly.

**Figure 4: Disclosure to investors**


Source: PwC Global PE Responsible Investment Survey 2013 All respondents

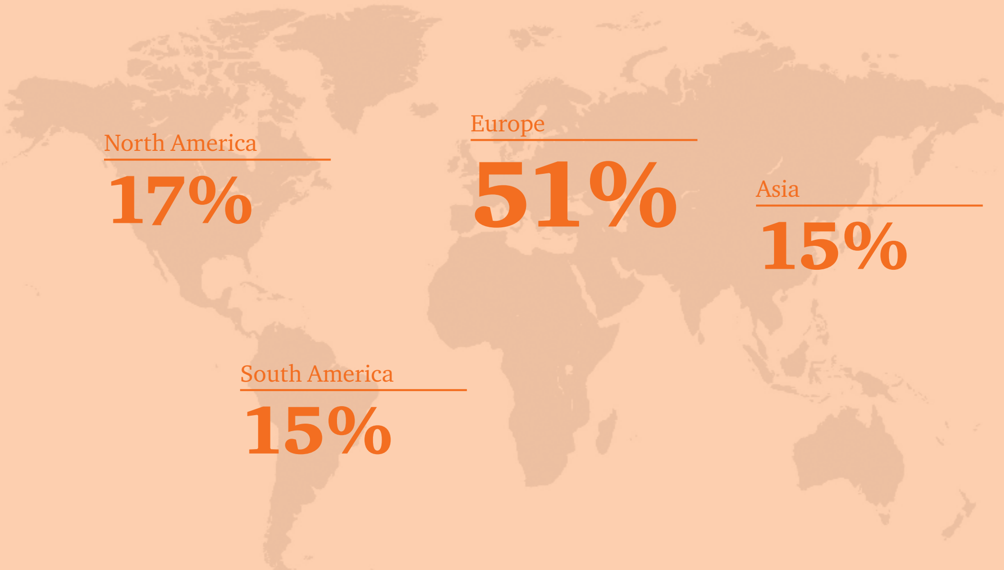
## *ESG Disclosure Framework*

In March 2013, a group of 40 LPs, 20 industry associations and 10 leading GPs published the ESG Disclosure Framework. It has two objectives: to help GPs better understand why LPs want ESG information; and to help rationalise the increasingly numerous ESG information requests from LPs.

It suggests a number of disclosures that GPs should consider during fund raising, and during the life of a fund. However, it is not designed to be prescriptive. It instead aims to provide guidance on the rationale behind ESG-related questions and facilitate informed dialogue between GPs and their LPs.

Its authors hope that the wide involvement of both sides of the industry means it will gain equally wide acceptance. The framework was published just a few months before the survey was carried out. Nonetheless, our survey shows that, in the UK and France, some 70% of respondents expect to disclose in accordance with the framework. Elsewhere – perhaps where industry associations have been less active in promoting it – awareness is lower.

**Plans to use the ESG Disclosure Framework**




Source: PwC Global PE Responsible Investment Survey 2013

# 29%

***Only 29% of respondents say all investment team members are formally trained in responsible investment.***

## *Resourcing ESG management*

The survey has generated a wealth of information about the internal resources that PE houses dedicate to responsible investment. 38% of respondents report no dedicated manpower, while 24% say they have one full-time equivalent, and 13% say they have two or three. 29% of respondents say all investment team members are formally trained in responsible investment. But at 45% of responding houses, none are.

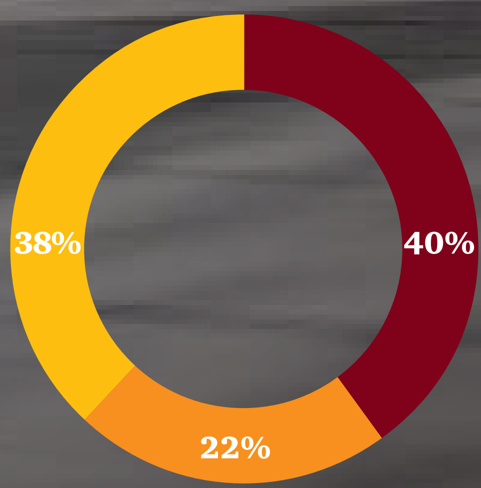
We believe it is important that staff have adequate training for the role: ESG management does require specialised, often technical, skills. This is not a subject for enthusiastic amateurs.

Equally, the survey shows a variety of departments supporting partners on responsible investment. Two-thirds are supported by Investor Relations departments, while the Group General Counsel is involved in almost half of cases. Marketing and communications staff provide support for 31% of respondents.

This variety of responses illustrates different approaches to responsible investment, as well as reflecting different house sizes.

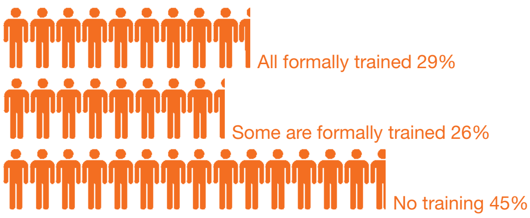
There is a debate about how ESG issues should be managed within organisations of all kinds – whether by a centralised ESG function, or by integrating ESG skills more broadly. There is no right or wrong approach – it depends on the culture of the PE house involved – but at the end of the day a dedicated resource (partial or full time) will most likely be needed. This should be considered as an investment (not a cost) because ESG matters are directly linked to performance.

### Dedicated resource for ESG management




Up to and including one
More than one No resource

### Formal training for resource



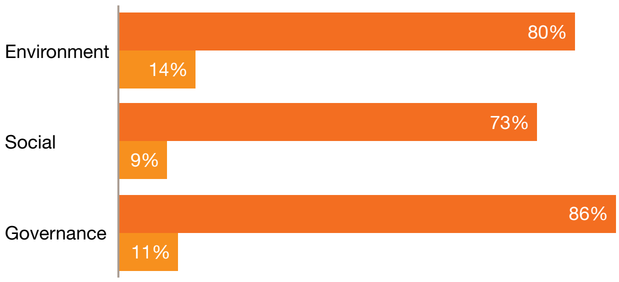

Source: PwC Global PE Responsible Investment Survey 2013

# But the opportunities are not being grasped

*ESG management has evolved rapidly in the PE sector – and is continuing to do so. But while PE houses appear to be adept at monitoring ESG activities, they are struggling to measure the value created by ESG initiatives.*

It's clear that investors and many PE houses believe that there is value in better managing ESG issues. If they didn't believe in the benefits, they wouldn't expend such time and effort doing so. And there are some cases – such as reduced energy use, investment in health and safety measures (which reduce accidents and increase productivity) or in talent management programmes that minimise employee turnover – where better management demonstrably feeds through to enhanced returns and performance. But it is also clear that more needs to be done to identify, quantify and communicate that value.

**Figure 5: Gap between monitoring and valuation**




Monitor ESG initiatives  Measuring value from ESG initiatives

Source: PwC Global PE Responsible Investment Survey 2013 All respondents

We mentioned earlier that 15% of survey respondents cite value creation as the primary driver behind their responsible investment activities. But only 14% of respondents say they estimate the value created by environmental initiatives within portfolio companies. The scores were even lower for social and governance issues, at 9% and 11% (see Figure 5).

**60%**

**Some 60% of US respondents say they estimate the value created by their portfolio companies' environmental initiatives – far higher than the 14% global average.**

### *The US – an eco-efficiency outlier*

Some 60% of US respondents say they estimate the value created by their portfolio companies' environmental initiatives – far higher than the 14% global average.

This reflects the fact that leading US-headquartered PE houses have embraced an eco-efficiency driven approach to ESG management. This focuses on cost savings through reducing energy, fuel and water use, cutting emissions and other waste streams, and making processes leaner. Such an approach lends itself to measurement and valuation.

> ***"A recurrent theme is that PE houses are not sure what to measure, or what benchmarks to use"***
>
> Valerie Arnold, PwC Luxembourg

**Figure 6: Including ESG issues in the life cycle**


Source: PwC Global PE Responsible Investment Survey 2013 All respondents

### *Why is it proving so hard to make the value case?*

We believe that the sector's traditional skew towards Environmental, Health & Safety (EHS) risk means that opportunities are being neglected. Around the world, PE houses have traditionally looked at ESG issues through a risk lens (the US being a notable exception). There is no doubt that better ESG management reduces risk – without it in the due diligence stage at acquisition, missed risks can impose a heavy price on a new deal. However, the value of that risk reduction is difficult to quantify: PE houses are protecting themselves against potential situations that didn't materialise because they were anticipated.

A more systematic approach to ESG management is likely to unearth opportunities that could generate top-line growth for portfolio companies. These might include new 'responsible products' eg. eco-efficient, fair trade or organic, cleantech products, or services aimed at underserved socio-economic groups, such as micro-credit or off-grid electricity provision.

### *Asking the right questions*

PE firms tend to be hands-on owners of the companies in their portfolios, and good information is fundamental to good management. Our survey shows high levels of monitoring of portfolio companies' ESG performance. But it also indicates low levels of value estimation from this ESG performance. This gap between monitoring and valuation implies that the right questions aren't being asked. There are a number of potential explanations. One is that the monitoring taking place is insufficiently rigorous to allow financial conclusions to be drawn. Another – which is often given by PE respondents – is that the methodologies don't exist to allow value to be estimated.

### *Resourcing to tease out value*

There is a growing range of approaches that can put a value on ESG performance (see page 18 'Putting a value on ESG activity'). This is an emerging field. But that doesn't mean that the tools don't exist to put a robust figure on the value created by improved ESG performance. Indeed, leading US houses have blazed a trail with environmental eco-efficiency initiatives, which focus on reducing emissions, waste and energy and water use (see 'The US - an eco-efficiency outlier' on page 16). But it's not only environmental metrics that allow for valuation. Techniques exist to estimate credibly the value of less tangible ESG issues, such as employee satisfaction, engagement and attrition, job creation, or supply-chain labour relations.

### *Risk that ESG value is being left on the table*

At the end of the day, a company is only worth what someone will pay for it. And it's at exit that PE houses are rewarded for their management of their portfolio companies. At present, only one in three respondents regularly includes ESG issues in the programme for exit. This risks leaving ESG value on the table by failing to tell a compelling ESG story to potential purchasers. Neglecting ESG issues at exit means that the effort to manage ESG issues during ownership is potentially going unrewarded and the resulting benefits aren't being quantified.

## *Putting a value on ESG activity*

Our survey shows that many PE houses feel that the methodologies don't exist to allow them to estimate the value generated by their ESG methodologies. It is true that there is no generally accepted methodology for quantifying the financial value generated by sustainability initiatives. But there is a growing number of tools available that can put numbers on ESG performance.

## *Sustainability from the bottom up*

Of particular value to private equity investors are bottom-up or accounting-based methodologies. They aim to identify the specific financial contribution of an ESG initiative or programme. While this may sound simple, the challenges lie in understanding the linkages between the activity and the bottom-line, and in finding the data that makes quantification possible. This might be straightforward in, say, an energy efficiency investment. It becomes more complex when assessing the full direct and indirect effects of an entire ESG programme.

However, while it is complex, it is not impossible. PwC has developed a sustainability valuation methodology that identifies the key drivers of value within an ESG initiative or programme. It then draws upon a toolkit of valuation techniques to place a value on both tangible factors, such as reduced energy costs, and more intangible ones like improved brand and better stakeholder relations.

A failure to consider ESG risks systematically allows buyers to impose discounts on the purchase price. If the vendor can't provide reassurance – and evidence – that it has addressed potential ESG problems, it will be expected to factor the uncertainty into the price. A survey of trade buyers we carried out for the UN Principles for Responsible Investment found that 80% of acquirers reduced the value of an acquisition target – or pulled out of a deal – over ESG exposures.[1]

And these exposures may not necessarily be found within the portfolio companies themselves. We believe there is scope for PE houses to take a wider view of ESG risk, and consider their investments' entire value chain. We've found that some PE houses still take the view that ESG risk is a low priority for their business. In Australia, for example, a number of firms have told us that, because they tend to invest in companies in well-regulated OECD countries, they do not consider themselves unduly exposed to ESG risk issues. But supply chain ESG risks in less well-regulated regions can dwarf direct exposures. Furthermore, good host-country regulation does not necessarily mitigate environmental, social or governance risks, as PE investors in care homes and arms manufacturers have found.

1 UN Principles for Responsible Investment: The integration of environmental, social and governance issues in mergers and acquisition transactions, December 2012 http://www.pwc.com/gx/en/sustainability/publications/esg-impacts-private-equity.jhtml

***"We're seeing more and more questions asked by LPs, so GPs are asking us how they should communicate around ESG issues"***

John Tomac, PwC Australia

## *Wider returns from responsible investment*

In addition to potentially better valuations at exit, there are benefits from responsible investment related to how a PE house – and the sector at large – is perceived.

Communicating an ESG message to investors can, in some markets (eg. the UK and France), offer differentiation. Providing evidence of sophisticated ESG management, and the value that it brings, offers differentiation in any market. For major corporates, good ESG management is seen as a proxy for good management more broadly. The same will be true in private equity.

Conversely, ignoring ESG management can expose PE houses to fund-raising risk. A growing number of LPs are including questions on ESG factors in the request for proposal (RFP) process, and there is anecdotal evidence from Japan and Scandinavia of PE houses that have been rejected for investment by an LP because they were unable to provide the ESG information required.

## *Clearing the hurdles*

Our survey shows that the uptake of responsible investment varies widely between countries, with France and the UK leading. What are the barriers that hold back PE engagement in ESG management?

### A lack of investor interest

Demand from LPs is a critical driver. It is no coincidence that countries like Japan, where more than one third of respondents reported no interest from investors in the prior two years, are lagging on ESG management.

### Senior partner indifference

ESG management is not yet business as usual for everyone. It requires new ways of thinking about risk and opportunity, plus additional resources, and management attention. All these require leadership. Countries that report low levels of partner engagement for responsible investment tend to score less well in terms of maturity.

### Reliance on regulation

Regulation can be a driver for PE engagement on ESG management, but it can also hold it back. German PE houses set great store in complying with regulation – but if the focus is too much on compliance, are potential value-creating opportunities missed? Similarly in Australia, where regulation is also strong, we see fewer firms driving ESG initiatives. A generally robust regulatory environment does not remove ESG risk altogether: consider BP's Gulf of Mexico disaster, CalPERs's exit from gun manufacturers, or care homes scandals in the UK and Finland.

### Lack of trade association leadership

In leading countries, PE associations have played a key role in promoting the responsible investment agenda to their members (eg. the BVCA in the UK and AFIC in France). The flip side of this is that, where associations have not been so active, PE uptake has been low.

### Keeping the 'private' in private equity

Not all PE houses have embraced transparency. And some remain unwilling to publicise the work they are doing around responsible investment. In the US, for example, we believe there is considerable activity happening, more than that reflected in the survey. Some PE firms, across the regions, are understandably reluctant to go public before they feel they have the full story.

### Value demonstration

The private equity sector is nothing if not focused on returns – and skepticism about the degree to which ESG management adds value, or a perceived inability to measure that value, remains the most important hurdle. But our work in the sector shows that value can be ascribed to ESG management and performance. As this evidence becomes clearer and more widely communicated, the hurdles discussed here will come down.

# Realising value from ESG initiatives

*So how should the industry respond to the responsible investment challenge? We recommend that PE houses looking to generate and realise value from better ESG management should:*

### Take a more structured approach to identifying the ESG opportunity

Rather than primarily focusing on risk, firms should also look more carefully for opportunities for performance improvement in ESG management – whether in terms of eco-efficiency, or in new product lines and revenue streams. This is particularly relevant at acquisition. PE firms work hard at developing detailed 100-day action plans to ensure that they maximise the impact of their ownership. An ESG plan of action should be included in the acquisition plan for the same reason.

### Aim for better analysis of ESG value during the hold period

Our survey suggests that a great deal of effort already goes into monitoring ESG performance. But the fact that few PE houses estimate the value those activities generate suggests that this information is, at best, unexploited. At worst, the monitoring may be insufficiently rigorous to allow for proper analysis.

### Explore methodologies that can put a financial value on both tangible and intangible ESG benefits

This is, without doubt, an emerging area. But methodologies are available that allow either a top-down or bottom-up assessment of the value created by ESG activities (see page 18 'Putting a value on ESG activity').

### Present a better ESG case at exit

From our experience, this is ultimately where the ESG value that portfolio companies generate is monetised. Improved efficiencies will already have fed through to bottom-line performance, but the identification of potential ESG opportunities will help to show how the company is positioned for growth. Buyers will be on the look out for discounts due to unanticipated ESG risk. Vendor ESG due diligence can

***"PE houses are very focused on managing ESG risk and meeting regulations, but are not exploiting opportunities"***

Hendrik Fink, PwC Germany

***"The point of exit is too late to start looking for value from ESG issues – the process needs to start much earlier"***

Hannah Routh, PwC Hong Kong

help to close down potential exposures.

Companies with lower ESG risk, and with a positive ESG story to tell, will be attractive to more buyers and will command higher valuations.

Effective ESG management takes resources – in terms of tools, and capacity. There is a debate about the degree to which PE houses need ESG expertise in-house, and whether those skills should be centralised or integrated (see page 15 'Resourcing ESG management). Improved ESG management requires adding to the skillset of the typical private equity investor. But those additional skills should help PE houses add value to their portfolio companies, their investors, and to society at large.

### *Moving ahead – five questions PE houses should ask themselves*

1. How are you preparing to respond efficiently to questions from LPs, or prospective LPs, on how you are managing ESG issues in your funds?
2. Do you have a clear view on your portfolio companies' material ESG risks and opportunities, and how they are responding to them?
3. Can you put a value on your firm-level ESG activities, and the ESG performance of your portfolio?
4. To what extent are you managing ESG issues across the value chains of your portfolio companies?
5. Are you in a position to tell a compelling ESG story at exit?

"We view value as something more than just measurable financial value. We value de-risking our businesses, enhancing their reputation and brand, and helping to build better managed businesses that are easier to sell and more attractive to buyers or the markets."

Doughty Hanson

# Contacts

*PwC is helping a range of PE houses to assess the implications and address the practical challenges of ESG management. If you would like to discuss any of the issues raised in this report, please speak to your regular PwC contact or one of the following:*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A further 31 PE houses also participated but chose not to be named.

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