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Responsible investment: creating value from environmental, social and governance issues

Insight from our survey of the private equity industry

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Contents

Glossary of abbreviations

ESG: Environmental, social and governance

Generation Y: The group of people born in the 1980s and 1990s

GP: General Partner

LP: Limited Partner

PE: Private Equity

RI: Responsible Investment

UN PRI: United Nations Principles for Responsible Investment

About the survey

Based on our experience of working with clients from the private equity (PE) industry, we have seen a notable rise in attention to responsible investment (RI) and the management of environmental, social and governance (ESG) issues over the last few years. We have also observed what seems to be an emerging common challenge – to demonstrate the value of implementing a responsible investment strategy. Does managing ESG issues really help to create value? And if so, how?

Our survey seeks to explore the PE industry's response to this question. We also examine what drives PE houses to focus on responsible investment, and how they are tackling the challenge of valuing and measuring their efforts. And we look ahead, asking how the industry's commitment to addressing ESG risks and opportunities might evolve over the next five years.

This report summarises the results of our survey and presents our view on the key issues arising.

What is responsible investment?

Responsible investment is an investment approach 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 value. Responsible investors believe that companies which are successful in avoiding ESG risks whilst capturing ESG opportunities will outperform over the longer term.

Environmental issues: encompass pollution and contamination of land, air and water; related legal and regulatory compliance; eco-efficiency ("doing more with less resources"); waste management; natural resource scarcity; and climate change. Many environmental challenges also present opportunities for value creation, for example, generation of incremental revenue from new technologies, products and markets such as 'green' / sustainable products and services.

Social issues: encompass the treatment of employees; health and safety; labour conditions; human rights; supply chains; and treating customers and communities fairly.

Governance: in a responsible investment sense, this term is generally held to encompass the governance of environmental and social issue management, plus the areas of anti bribery and corruption, business ethics and transparency.

Our approach

We spoke to 17 private equity houses, including:

- six of the top ten largest global PE houses[1]
- 11 of the top 50 largest global PE houses[1]
- six mid-tier houses
- ten with headquarters in Europe, and
- seven with headquarters in the US.

Interviews were conducted with members of senior management – either with dedicated ESG or sustainability specialists/teams where these exist, or with individuals drawn from other functions and roles (e.g. Operations, Public Affairs, Communications, Investor Relations or Legal Counsel) who have additional responsibility for the ESG agenda.

Interviews were supplemented with desk-based research on each PE house, including consideration of company websites and relevant reports (e.g. Citizenship/Corporate Responsibility reports). Interviews were undertaken during the period from November 2011 through to January 2012, and relied upon a common set of questions being posed to each participant.

Interviews, unless specifically agreed otherwise, were undertaken on a non-attributable basis.

[1] Based on Private Equity International's 2011 ranking of the top 300 private equity firms by size, ranked on the amount of private equity direct-investment capital each firm has raised over a five-year period (www.peimedia.com/Pages.aspx?pageID=3155).

Section 1 – Executive Summary

There are two key drivers of responsible investment in the PE industry: risk management and investor concern

Investor concern, founded on the view that ESG issues have the potential to materially impact the valuation of investments over the longer term, has been ramping up in recent years. Indeed, for some PE houses, this has been the key catalyst for adopting a responsible investment (RI) approach. The importance of investor pressure is set to grow in the near future: **88% of survey respondents believe that Limited Partner (LP) attention to ESG issues will increase in the next five years.** In an increasingly competitive fundraising environment, managing ESG risks and opportunities is another way for PE houses to differentiate themselves and to secure and maximise their access to capital. The other leading driver of RI activity is risk management, followed by cost savings, 'tone from the top' and regulatory pressure.

The PE industry response to responsible investment is evolving rapidly

Notably, **all of the houses we spoke to consider environmental and social issues to some extent during investment appraisals.** However, houses take very different approaches, ranging from ad hoc and case-by-case through to the more progressive approaches, such as that of Apax Partners, where purpose-built ESG due diligence frameworks are followed for every potential acquisition.

There are some interesting contrasts between the approaches of US-headquartered PE houses and that of their European counterparts. The US-headquartered participants tend to focus primarily on realising value through a focus on eco-efficiency initiatives whereas their European-headquartered peers are more likely to incorporate a broader range of environmental and social issues into their investment decision-making processes. Many houses, regardless of where domiciled, are of the view that the PE business model already places great scrutiny on governance and that this issue is already well managed by most.

Interestingly, the survey did not reveal any correlation between the size of the PE house and the maturity of their approach to RI. This finding is consistent with our own experience of the PE market.

Whilst there has been much progress in developing and implementing RI strategies over recent years, our results indicate that there is still some way to go:

- 50% of the houses we surveyed lack a policy on ESG issues and/or responsible investment
- only 40% have put systems in place to measure value created from initiatives (this is particularly relevant for initiatives addressing environmental and social issues which tend to have more direct impacts), and
- 47% of the houses surveyed do not report publicly on their ESG programmes or their responsible investment strategies.

A challenge common to all remains that of quantifying the value of ESG programmes or responsible investment strategies

Whilst a resounding **94% of the participants surveyed believe that ESG activities can create value,** far fewer are attempting to measure the value of these activities. Measuring the value created through environmental and social initiatives, relies on the availability of relevant financial data and for most PE houses this is not yet readily available at a portfolio level. Some PE houses (e.g. KKR and Doughty Hanson) have successfully measured cost savings achieved from eco-efficiency initiatives but even the more advanced PE houses are struggling to measure the intangible benefits of their ESG initiatives. While this challenge is common to other sectors, developing a best practice approach to valuation is perhaps particularly pertinent for an industry focused on creating value.

Attention to ESG issues is set to increase

As of now, the industry's overall response to the RI agenda can be characterised as very much a 'work in progress'. But that looks set to change: **94% of PE houses surveyed said that their attention to ESG issues will rise over the next five years.** What will they be focusing on? Many have plans in place to develop their responsible investment or ESG programmes further, citing policy development, valuation and reporting as focus areas for 2012 and beyond.

Summary survey findings

A snapshot of the present

Investment cycle

Policy	Acquisition	Hold	Exit	Reporting
50% of participants lack a policy on ESG issues and/or responsible investment	All participants consider ESG issues to some extent during investment appraisals	Approaches to managing ESG issues during the hold period are diverse	It is difficult to quantify the extent to which strong ESG management contributes to a good exit valuation	47% of participants provide no, or limited, reporting on ESG issue management

Five years from now

94% of participants believe that ESG issues will become more material to their business	**The majority of participants believe that LP attention to ESG issues will increase**	**94% of PE houses believe their attention to ESG issues will increase**

Recommendations

Drawing on our experience, we have four recommendations which we believe can help PE houses, and their portfolio companies, to enhance their ability to create value from RI, and stay ahead of the competition.

1) Access the right expertise

Many of the houses we spoke with cited lack of internal capacity and expertise as a barrier to implementing their RI goals. Hiring in to build in-house teams is an unlikely option, given the 'lean' structure of many PE houses and the current economic climate. PE houses need to think innovatively to access the right expertise (in particular on environmental and social issues) and keep their RI programmes on track. There are already some great examples of this in the marketplace: PE houses are forging collaborations with third parties, hosting knowledge-sharing events for their portfolio companies, offering ESG training to deal teams and securing external expertise when required.

2) Adopt best practice approaches

Approaches to managing environmental and social issues during the investment cycle are diverse. Following best practice will help PE houses to maximise value from their RI activities. This would include adopting a consistent and systematic approach to ESG due diligence, and ensuring that action points from the pre-acquisition phase are integrated into the 100 day plan. Procedures should also include consistent tracking and reporting of ESG performance.

The most progressive PE houses strive to capitalise on environmental and social opportunities, rather than using ESG due diligence only as a means of 'de-risking' their investments.

3) Measure the financial value created

Measuring ESG performance improvements and ascribing financial value to these remains a challenge for many. Standard valuation methodologies (such as discounted cash flow models) can be used to quantify the value of RI initiatives. This includes both direct and indirect value drivers. The key challenge in conducting these exercises is the availability of ESG relevant financial data: given enough data, it is possible to establish a credible link between ESG activities and intangible value.

Tips for measurement and valuation include focusing on quality not quantity, aiming for consistency not uniformity (given material issues for each portfolio company will vary depending on their sector and geographic location), and considering qualitative assessment options if the costs of gathering quantitative data are prohibitive.

4) Ramp up reporting

One notable survey finding is the relatively limited external reporting on RI by the PE industry; most participants agreed reporting is still 'quite superficial'. PE houses can benefit and adapt from the considerable progress made on ESG reporting in the corporate sector (and integrated reporting more broadly).

Several PE houses are relying on the use of case studies for reporting. Case studies can be a highly effective means of showcasing progress and success, but there are several pitfalls to be aware of: there is the risk of unbalanced (i.e. 'good news' only) reporting, and the need for transparency regarding the role of the PE house in bringing about ESG improvements in the portfolio companies. Finally, PE houses could consider proactively engaging with LPs to help define future ESG reporting requirements.

Section 2 – Findings

2.1 Drivers for responsible investment activities

We asked each of the PE houses what motivates them to pursue a RI approach. Many cited the same drivers – but not necessarily in the same order of importance. These are the most commonly cited reasons (from most common to least).

Risk management and investor interest are the two most significant drivers for action, by some margin

Risk management	Importance of identifying and understanding ESG risks and managing regulation and compliance throughout the lifecycle of an investment.
Interest from investors	Increased interest (and questions) from LPs, many of whom are signatories to the UN PRI, prompted participants to define their RI approach and collect information from portfolio companies.
Opportunities for cost savings/ operational efficiencies	Participants can see opportunities to realise additional value through performance improvement and operational efficiencies, in particular eco-efficiencies.
Tone from the top	Those at the top of the organisation place a great emphasis on the importance of a RI approach.
Regulation	For participants operating in the UK both the UK Bribery Act and the UK Government's Carbon Reduction Commitment Energy Efficiency Scheme were cited as drivers for action.

Risk management and interest from investors are the two most significant drivers, by some margin. Value creation did feature among the top four reasons, but generally only in terms of cost savings – as achieved through eco-efficiency programmes (doing more using fewer resources saves money and benefits the environment). Several participants pointed to the increased saleability of portfolio companies as a driver – but there was a general consensus that it's 'too early to show proof of concept'.

Most PE houses agreed that LP concern is a significant reason for increasing engagement with the RI agenda. Indeed, some are timing their activities (e.g. drafting RI policies) to tie in with their upcoming fundraising. However, there was a notable split in opinion about the role LPs play in driving change. Many houses said that interest from LPs was their main driver – but this was more common among PE houses with their headquarters in Europe.

"Incorporating ESG concerns into the investment process is about good, long-term investing – GPs and their portfolio companies need to manage these issues appropriately to minimise risks and maximise returns."

David Russell
Co-head of Responsible Investment
Universities Superannuation Scheme

The United Nations Principles for Responsible Investment (UN PRI) initiative also came up during our discussions about LPs. This is a voluntary framework which investors can use to incorporate responsible investment into their decision-making and ownership practices[1]. Many LPs have signalled their commitment to the RI agenda by signing up to the UN PRI, and they need to demonstrate compliance publicly (including probing general partners on their approach to responsible investment). Similarly, as investors themselves, more and more PE houses are signing up to the UN PRI too. To date, 41% of the houses we surveyed have signed up.

A few houses mentioned reputation and competitive differentiation as drivers for RI activities – but not major ones. Or as one participant put it:

"This [managing ESG issues] will not differentiate players for long … after all, in five years, everyone will be doing it."

European-headquartered PE House

Finally, it's worth noting that at least three of the PE houses said that Generation Y is becoming an increasingly important driver of the RI agenda. They're key stakeholders, as either potential employees or consumers. And they have higher expectations and demands for responsible products and services than their parents.

Our point of view

In the near future, certainly for European-headquartered houses, **the UN PRI is likely to take on more significance as a driver of RI.** There is anecdotal evidence that many PE houses are seriously considering signing up to the UN PRI. If they do, they'll have to report publicly and regularly on their approach to ESG issue management – and that, in turn, is likely to sharpen their focus on procedures and metrics. Progress will need to be demonstrated from one reporting period to the next to retain credibility.

In our experience, **another driver for RI is moving into growth economies –** whether it's the PE house itself that's expanding, or its portfolio companies. ESG risks and opportunities are inherently higher in growth economies – because national and regulatory frameworks are generally weaker and due to cultural differences. As a result, we've noted that many PE houses apply greater scrutiny to ESG issues when their portfolio companies are expanding into growth economies.

The challenging nature of ESG risk management in growth economies is consistent with findings from our recent report Getting on the Right Side of the Delta: A Deal-maker's Guide to Growth Economies[2]. This report found that doing deals in growth economies remains incredibly challenging.

[1] By 2011, GPs and LPs representing US$30 trillion of assets (representing 20% of the world's capital) had signed up to the UN PRI. www.unpri.org/publications/annual_report2011.pdf
[2] www.pwc.com/gx/en/deals/doing-deals-in-growth-economies/index.jhtml.

In terms of the allocation of day-to-day responsibility for managing RI programmes, different houses adopt different approaches. At one end of the spectrum, there is a small number of PE houses with dedicated in-house RI teams. Most of the others have made RI activities an additional responsibility of an existing role or team (usually public affairs, investor relations, operations or legal counsel). This type of set up is at times resulting in the PE house having to limit their RI focus to a sub-set of portfolio companies, rather than being able to adopt a portfolio-wide approach. Many PE houses agreed that lack of internal capacity and expertise is a barrier for progress in the management of environmental or social issues.

2.2 Internal capacity

Virtually all the participants we talked to were able to identify a senior or executive level sponsor with ultimate responsibility for overseeing the house's RI strategy. Three of the PE houses we interviewed have Executive-level committees that are responsible for overseeing their responsible investment strategies.

With regards to rewards and incentives, at least one PE house with a dedicated in-house expert told us this individual is assessed and rewarded on exactly the same basis as their colleagues in the operational efficiencies team (whose job is to realise operational efficiencies across portfolio companies). Only one house mentioned that ESG objectives are woven into the job specifications of all staff.

Our point of view

Lack of internal capacity and expertise can be a major barrier to implementing responsible investment programmes. Hiring in to build in-house teams is an unlikely option, given the 'lean' structure of many PE houses and the current economic climate. What can PE houses do to access the right expertise?

- **Develop internal capacity of deal teams** (e.g. via training programmes) to help integrate management of environmental and social issues into investment decision-making.
- **Forge partnerships and collaborations** – examples in the market include KKR and Carlyle partnering with the Environmental Defense Fund to drive eco-efficiencies, and portfolio companies working closely with special interest groups such as the Marine Stewardship Council and the Forestry Stewardship Council to generate revenue from new product ranges (sustainable seafood and sustainable timber, respectively).
- **Facilitate knowledge sharing** between portfolio companies – Apollo Global Management and TPG have both hosted portfolio company events for this purpose.
- **Join/consult with industry associations** which provide guidance, e.g. UN PRI and the British Private Equity and Venture Capital Association have developed RI guidelines.
- **Engage external consultants** to support with the development and implementation of RI strategies.

Private equity industry associations could also consider providing training programmes on RI for their members.

2.3 Policies and procedures

50% of the houses we surveyed lack a responsible investment policy

Policies

The vast majority of the houses we surveyed believe that ESG issues will become more material to their business and 94% believe ESG activity can help create value (see section 2.4). Despite this 50% are yet to develop a specific policy to manage it.

Two of the participants we talked to said they were in the process of developing a policy, or expected to have one within the next 12 months. Anecdotal evidence shows that houses with formal policies usually have more sophisticated procedures to manage ESG risks.

Several participants felt that even though they don't have a formal policy, it doesn't necessarily reflect a lack of commitment or action on their part. They argue that paying attention to ESG issues has always been 'business as usual' – so it exists, even though it's not officially called 'ESG' or 'responsible investment'.

Our point of view

Publishing a RI policy in the public domain will create an expectation with stakeholders and make PE houses accountable for following through and putting their plans into action.

An effective policy:

- clearly sets out the investment ethos of the house and drives consistency of approach
- lists excluded sectors and clearly communicates minimum standards, and
- explains how commitments are underpinned by robust procedures.

All the houses we spoke to consider ESG issues to some extent during investment appraisals

Investment cycle – acquisition

Everyone we spoke to said they think about potential ESG issues as part of due diligence procedures. However there are considerable differences in the formality of the processes and the depth of analysis performed.

A number of the houses we surveyed are carrying out ESG due diligence on an ad-hoc, case by case basis (excluding basic legal/compliance checks). By contrast, the more progressive houses, such as Apax Partners, have committed to carrying out ESG due diligence on every potential acquisition – and have a purpose-built framework for doing so.

Very few PE houses are explicitly linking these due diligence assessments to concrete actions in the hold period. Only one of the participants we surveyed said their ESG assessment feeds directly into the ESG targets they set for their portfolio company as part of the 100-day plan.

Our point of view

- During the pre-acquisition phase, houses could **do more to explore opportunities** associated with environmental and social issues rather than just using ESG reviews to 'de-risk' their existing investments.
- PE houses should **consider the best way to act on findings from pre-acquisition ESG assessments**. Unless findings are built into the 100-day plan (or other targets set for the hold period), there's a risk that environmental and social action points will be sidelined as niche issues rather than being integrated into core business strategy and practice.

Houses take very different approaches to ESG issues during the hold period

"There's real potential to lose value in a portfolio company if you fail to focus sufficiently on managing ESG risks."

European-headquartered PE house

Investment cycle – hold period

The way PE houses manage ESG risks and opportunities in their portfolio companies during the hold period varies considerably – from ad hoc, to well-established, systematic procedures.

Those with a more systematic approach tend to have a process in place which:

1. identifies potential ESG risks and opportunities (e.g. eco-efficiencies or health and safety performance improvement) across their portfolio of companies
2. establishes action plans and targets to realise opportunities or mitigate risks, and
3. monitors ESG performance (or progress against action plans) on an ongoing basis.

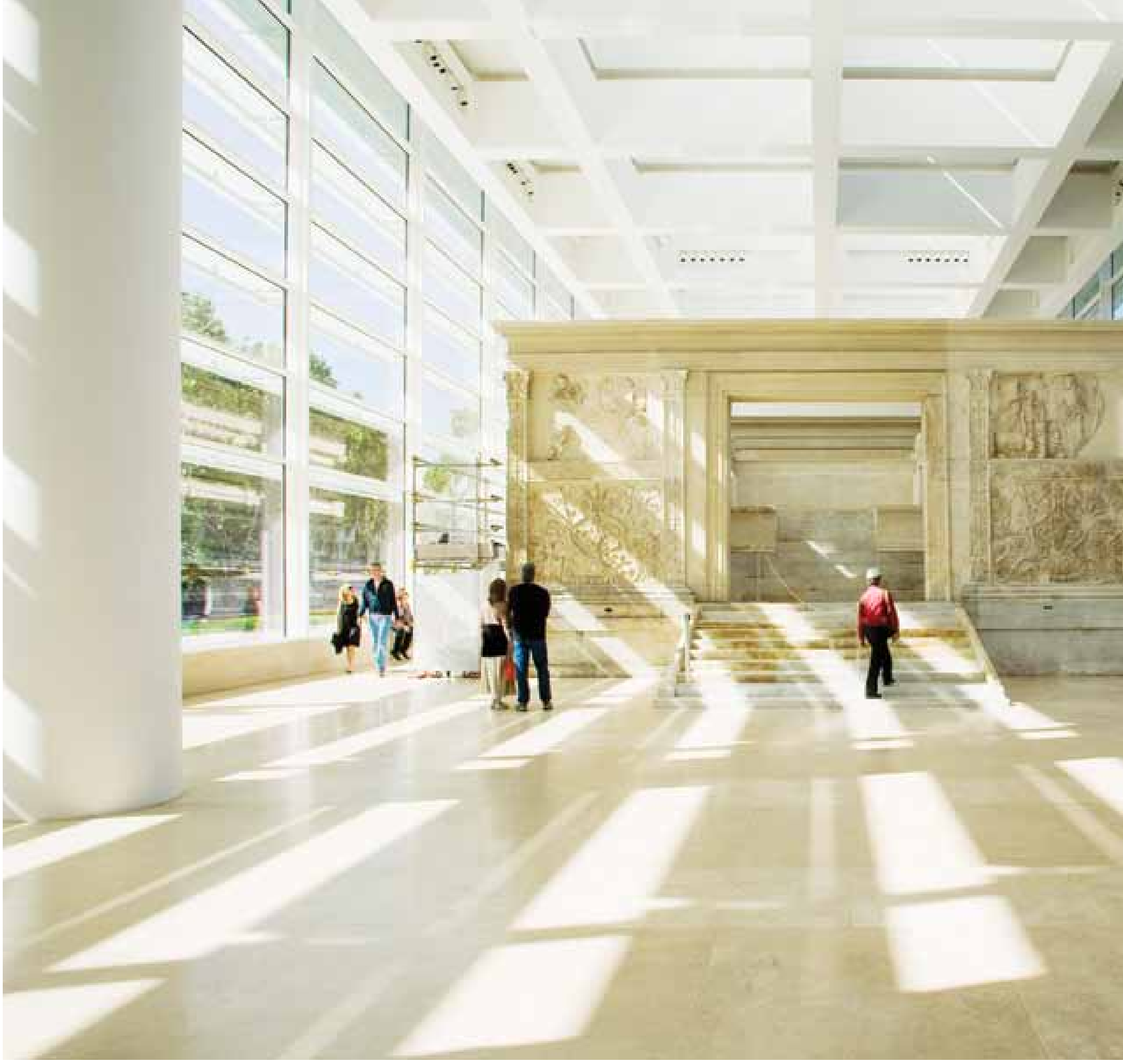
Many of the major US-headquartered houses we interviewed are following a common model, where in-house teams essentially act as consultants to portfolio companies. These 'consultants' focus almost exclusively on achieving environmental efficiency in portfolio companies, rather than on the wider environmental, social or governance issues. Typically they spend a considerable amount of time with one company to produce positive results, before moving on to the next.

Two of the US-headquartered houses we interviewed – Apollo Global Management and TPG – shared their novel approach to engaging portfolio companies on ESG issues and demonstrating the opportunity to create value. They both run 'knowledge-sharing conferences' for the benefit of their portfolio companies, where they can showcase their most successful eco-efficiency activities and show how they've led directly to cost savings, as well as fostering the deployment of solutions, programs and goals across portfolios.

Our point of view

During the hold period, PE houses could undertake the following steps to enhance management of environmental and social issues in particular:

- form partnerships with portfolio companies to identify and address environmental and social priorities
- set ESG objectives and targets with portfolio companies
- baseline existing ESG initiatives to understand what is in place and so that progress can be measured going forward
- require regular upward reporting on ESG improvements, and
- provide portfolio companies with external support and expertise.



It's difficult to quantify the extent to which strong ESG management contributes to a good exit valuation

Investment cycle – exit

Most participants agreed that good management of ESG issues in portfolio companies certainly 'doesn't hurt' the exit valuation. But they were less certain about how much of any rise in value can be put down to ESG activities. One participant said:

"A sound approach to ESG issues can enhance both earnings and multiples. Companies with strong policies and practice in this area are much easier to sell."

Patrick Dunne, 3i

Whilst it is clearly a challenge to quantify the impact of ESG management activities on sale prices, there is anecdotal evidence that it can be a factor in the sale price. One participant, Actis, shared an example of how a purchaser paid an enhanced purchase price for one asset, partly on the grounds of the company's corporate responsibility credentials. Another interesting insight shared by Actis was that they assess the ESG credentials of potential buyers of their portfolio companies, before agreeing a sale.

"Good ESG issue management might lead to a small uplift in EBITDA multiples on exit, and will improve saleability of the asset."

European-headquartered PE house

> *"Portfolio companies will be reporting back to us for the first time this year on what they commit to measure."*
>
> **US-headquartered PE house**

> *Quantifying the value that ESG activities create is still a work in progress for most*

> *"The issue is to show how [we] are using ESG levers to create value. Only tangible benefits are tracked, but there is a strong belief in the intangible value too."*
>
> **European-headquartered PE house**

2.4 Measuring value

A resounding 94% of the participants we surveyed believe that ESG activities can create value. But only 40% have begun to measure this value by putting formal processes in place to track the impacts of ESG initiatives.

Indeed, many of the houses that we spoke to are still in the early stages of collecting ESG performance data from their portfolio companies in a systematic manner. Just identifying appropriate ESG metrics which are applicable across a portfolio can be challenging given the broad range of sectors and geographies comprising the portfolios of most houses; while ensuring the integrity and comparability of the reported data is an ongoing management issue. The fact that LPs are asking PE houses for more data on ESG management, but in a non-standardised way, makes developing an effective measurement framework for ESG activities even more complicated.

Moreover, to assign a financial value to ESG initiatives requires PE houses to collect ESG-relevant financial data. For example the upfront investment in eco-efficiency measures and the corresponding cost savings in terms of energy, water or waste management, in addition to ESG performance information (e.g GHG emissions, water use, waste generation). Again, few houses are systematically collecting such data.

Some houses have begun to attach a financial value to ESG initiatives by tracking their direct benefits. These include cost savings achieved from eco-efficiency initiatives or revenue growth achieved from new more sustainable products. For example:

- In December 2011 KKR reported that since its inception in 2008 the portfolio companies which have participated in its Green Portfolio Programme have achieved "more than $365 million in financial impact and avoided 810,000 metric tons of GHG emissions, 2.2 million tons of waste, and 300 million litres of water" [1].
- In their 2011 report 'Private Equity and Responsible Investment' Doughty Hanson reports savings and additional income of €18 million through a focus on ESG issue management resulting in the avoidance of 200,000 tonnes of carbon dioxide, 150,000 tonnes of waste and the release of 260,000 cubic meters of water. Doughty Hanson estimates that another €21 million per annum is achievable[2].

However, few if any houses appear to have successfully quantified the indirect value arising from RI. Indirect value includes intangible factors such as the contribution of ESG initiatives to customer loyalty, brand value or maintaining preferred supplier status and the benefits of RI programmes in terms of protecting against reputational risk.

There are a number of challenges in valuing the indirect benefits of ESG initiatives. These are similar to those faced in attaching a value to other business intangible assets such as organisational know-how, customer relationships or an engaged workforce. They include the absence of a market price for the asset (since intangibles often can't be separately traded) and the fact that their worth to one company may be completely different to another since companies may have different opportunities to exploit an intangible asset through their networks, relationships and innovation processes.

[1] www.green.kkr.com/results

[2] www.doughtyhanson.com/responsible-investing/~/media/Files/D/Doughty-Hanson-Co/Attachments/WWF%20report%20Final.pdf

"This is an imprecise science and will evolve over time."

European-headquartered PE house

"Where it is feasible to measure – do it."

European-headquartered PE house

However, despite these difficulties, the markets are effectively attaching a value to business intangible assets every day. One way in which they do this is to use non-financial and qualitative indicators. This is an approach which has been adopted by several houses to measure ESG activities (tangible and intangible). Whilst such approaches do not provide data to support valuation exercises, they do allow the PE house to track progress on ESG issues from year to year, and from company to company. For example, at least one PE house has developed a defined set of qualitative measures, applicable to all portfolio companies, which it uses to monitor company performance once a year (using a red/amber/green light system). Another approach which was mentioned is to score portfolio company performance on key ESG issues (e.g. environment, workplace, community and so on) against pre-defined 'maturity levels'. Again, this enables comparison between companies, funds and year to year performance.

Finally, whilst virtually everyone we surveyed believes ESG activities can create value, not everyone believes that this needs to be measured and quantified. However, as an interesting counterpoint to this viewpoint, respondents from at least three PE houses said that despite scepticism about their programmes at first, it was easier to get senior colleagues and deal teams on board once the hard evidence of financial savings started coming in.

Our point of view

Why value the impacts of responsible investment?
There are a number of benefits to quantifying the financial value of RI for a PE house. These include helping to focus RI engagement with portfolio companies on the most value adding activities, facilitating communication with potential investors about RI in terms that they can understand and establishing a robust business case for further engagement with portfolio companies on ESG issues.

How to value RI activities?
We use standard valuation methodologies (such as discounted cash flow models) to quantify the value of RI initiatives. This includes both direct and indirect value drivers. Commonly used methods such as conjoint analysis and real options analysis can be applied to indirect value drivers and can be used to impute values to different attributes of a brand or product. The key challenge in conducting these exercises is the availability of ESG relevant financial data: given enough data it is possible to establish a credible link between ESG activities and intangible value.

A recent publication by WWF and Doughty Hanson discusses methods for ascribing value to ESG activities in more detail. We provided technical advice and guidance to WWF during the preparation of that publication[1].

Some tips for getting started:

- **Take small steps.** RI reporting is a journey. Initial expectations for portfolio companies can be set low and raised up over time.
- **Borrow and adapt.** There exist global reporting frameworks for ESG issues (e.g. GRI sustainability reporting guidelines or ISO26000) and issue specific standards (e.g. GHG protocol). These can be easily adapted to needs of PE houses and adopted gradually.
- **Consistency, not uniformity, is key.** The material issues for each portfolio company will vary depending on their sector and geographic location. Consider defining a core set of metrics that are required by all portfolio companies, together with some sector specific metrics.
- **Strive for quality not quantity.** It is usually better to focus on establishing robust reporting protocols and processes for a subset of data going forward than to try to cover all the possible indicators or to seek historic data of dubious quality.
- **Consider qualitative approaches.** Qualitative self assessment approaches are a useful option if the costs of gathering quantitative data appear prohibitive.
- **Valuation: start with value drivers.** If valuation is your eventual goal, the first step should always be to map the key pathways through which RI creates financial value and seek some basic business data that will help determine materiality. This will help identify the relevant metrics to inform your RI reporting framework.

[1] www.doughtyhanson.com/responsible-investing/~/media/Files/D/Doughty-Hanson-Co/Attachments/WWF%20report%20Final.pdf

There is limited public reporting of how ESG issues are managed – external reporting is a focus area for 2102

"We need to explain how we work and the benefits we provide to society."

US-headquartered PE house

"A lot of LPs are asking how this gets measured... they are looking for integrated financial reporting."

US-headquartered PE house

2.5 External reporting

One notable finding to come out of this survey was the relatively limited amount of external reporting by some PE houses on their RI approaches and activities. On their websites, almost half (47%) either don't mention RI, or only mention a high level commitment to managing these issues. Most participants agreed reporting is still 'quite superficial'. Many also said external reporting is an area they'll be focusing on in 2012.

In many cases, there is more activity going on than is being reported externally. There seem to be two main reasons for this 'under-reporting':

1. PE houses are nervous to say too much because there's limited common understanding of what constitutes best practice in reporting (so they find it difficult to predict how they might be viewed), and
2. PE houses are cautious about making any statements or claims about their RI policies and procedures unless they're confident they have strong enough procedures in place to underpin their strategies – or solid stories to tell about how management of ESG issues creates value.

Those that are reporting externally tend to use case studies to highlight the ESG management 'success stories' of value creation in their portfolio companies. However, based on our conversations, some in the market are troubled by the use of case study based reporting. They query the role of the PE house in the 'success story' and, in particular, whether the achievements are down to the portfolio company management's own strategic vision and planning, rather than an outcome of the PE house's RI approach.

Our point of view

To develop and improve reporting, PE houses should:

- **link their environmental and social risk management activities to value generation**
- **identify material ESG factors** and focus on these
- **proactively engage with LPs** to shape and streamline future RI reporting requirements – this will put PE houses on the 'front foot' rather than having to react to multiple requests for information presented in different ways
- **be transparent** – share successes as well as challenges and make sure that claims are not made that cannot be supported
- **report against targets,** including year-on-year, and
- learn from considerable progress made on sustainability reporting, including integrated reporting, elsewhere in the private sector.

Right now, the UN PRI is reviewing its annual assessment process of signatory compliance. This review **will affect the reporting and disclosure requirements** (Principle #6). It's possible that there will be an element of mandatory reporting for signatories in the future. For those PE houses that are (or are soon to be) signatories, it would be wise to revamp their reporting to include better quality, more robust information.

For more guidance on good practice reporting, including sustainability reporting and integrated reporting, please visit our dedicated portal at www.pwc.com/corporatereporting.

Beware the **pitfalls of using case studies:**

- Unless PE houses show how their RI approach played a role in bringing about ESG improvements, they run the risk of being challenged. Is the portfolio company's sustainability success down to management's strategic decision-making, rather than driven by the house RI strategy? The harshest sceptics may see such reporting as an attempt to take credit for the portfolio company's work.
- PE houses also run the risk of being accused of unbalanced reporting, i.e. 'good news' reporting only.

A geographic perspective: contrasting approaches between US and European-headquartered PE houses

One interesting theme to emerge from our survey is the difference in attitude and approach to RI between the US-headquartered PE houses and those in Europe.

US-headquartered PE houses are focusing squarely on the environmental pillar of the responsible investment agenda – in particular, eco-efficiency. Such initiatives deliver cost savings from using less energy and water, cutting waste and making production processes 'leaner'. The efficiencies achieved are relatively easy to measure and can be expressed in cash terms.

By contrast, European-headquartered PE houses appear to be addressing a broader range of issues, on the whole – not just the environmental aspects, but the social and governance ones too. Several houses described how they're working with their portfolio companies to improve the way they manage 'social' issues like labour issues in supply chains, health and safety, and employee management. In these cases, the benefits are intangible (e.g. decreasing turnover and attrition, boosting morale to increase productivity and retention, attracting new customers, and enhancing reputation and brand).

Most of the US-headquartered PE houses said that social issues are 'on their radar' and conceded that they are yet to be tackled in earnest. A few mentioned this would be an important focus area for 2012.

Likewise, governance is an area that came up much more frequently in our discussions with European-headquartered PE houses. Many of these houses noted that the UK Bribery Act (which came into force in July 2011) has helped to deepen their understanding of the way their portfolio companies manage bribery, corruption and ethical risks. As a result of their recent efforts to comply with the Act, many houses are now armed with better quality management information on bribery/corruption. As a result, there's more focused effort going into strengthening any weaknesses in this area. Anecdotal evidence suggests that the next step for some of these houses is to apply the same level of scrutiny to governance across all of the companies in their portfolio – especially in emerging markets.

Are large PE houses doing more on the responsible investment agenda?

From our own experience of the PE market, there does not seem to be a correlation between PE house size and commitment to a RI. Our survey backs this up – we found no clear dividing line between the two groups of PE houses. In fact, contrary to expectation, 50% of mid-tier participants are UN PRI signatories, compared to 36% of larger houses.

Interestingly we also found little evidence that RI approaches are more developed in publicly owned PE houses. Indeed, a higher proportion of non-listed PE houses had RI policies compared to their listed peers.

These findings seem to imply that a key determinant of commitment to the RI agenda is the PE house strategy/ethos, rather than simply size of assets under management or type of ownership.

2.6 Looking ahead

We also asked the PE houses we surveyed how they think responses to ESG issues might evolve over the next five years. We discussed future trends in three specific areas: the materiality of ESG issues, how much attention LPs will pay to ESG management, and how their own approach to RI will change.

Will ESG issues be more or less material?

94% believe ESG issues will become more material over the next five years.

They also broadly agree that demographic shifts in their customer base (Generation Y) will have an influence. The next generation tend to have higher demands and expectations for responsible products and services.

"[ESG issues will be] no less important but there is likely to be a lull due to financial markets. But these issues will return and grow stronger in time."

European-headquartered PE house

"They [ESG issues] will become more important. However, financial uncertainty will serve to push management of these issues down the agenda."

European-headquartered PE house

"More important – especially the environmental area."

European-headquartered PE house

Will investors pay more or less attention to ESG issue management by PE houses?

With only two exceptions, all of the PE houses we interviewed believe that LPs will pay more attention to ESG issues over the next five years. Of the two who disagreed, one believes that LPs will shift their focus to other issues over time. The other believes they won't pay any more or less attention to ESG issues than they do now.

Many of the European-headquartered PE houses said they had seen a clear rise in questions from LPs on how they manage ESG issues, and many expect this trend to continue. As we've already noted, this increased attention from investors has been a catalyst for several PE houses to formalise and strengthen their RI approach. So it seems LPs will continue to be an important driver of ESG activity in the PE sector.

"Interest will grow – especially if value can be shown."

European-headquartered PE house

"Yes [interest from LPs on the management of ESG issues will increase]. But to some extent, it will depend on progress in the political arena on climate change."

European-headquartered PE house

Will PE houses do more or less about ESG issues?

We asked each of the PE houses we surveyed whether they expected their own ESG activities to increase, decrease or stay the same over the coming five years. Once again, the vast majority shared the same opinion: 94% said they expected it to go up. When prompted to describe how their approach to RI will evolve, some of the answers were:

- formalising a policy
- increasing internal and external reporting on how ESG issues are managed – many said they expect to be requesting more upward reporting from their portfolio companies in the near future
- a greater focus on measuring ESG improvements and attempting to quantify value, and
- increased engagement with deal teams, portfolio companies and LPs.

"We will focus on developing a more structured programme with our portfolio companies. By the end of 2012, we will have met with each portfolio company at least once to discuss monitoring [of ESG performance]."

US-headquartered PE house

"We will be doing more, not less, especially in terms of measuring impacts/performance improvement, and in reporting."

European-headquartered PE house

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