Principles for Responsible Investment

INTEGRATING ESG IN PRIVATE EQUITY

A GUIDE FOR GENERAL PARTNERS

UNEP Finance Initiative
Changing finance, financing change

United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

1 We will incorporate ESG issues into investment analysis and decision-making processes.

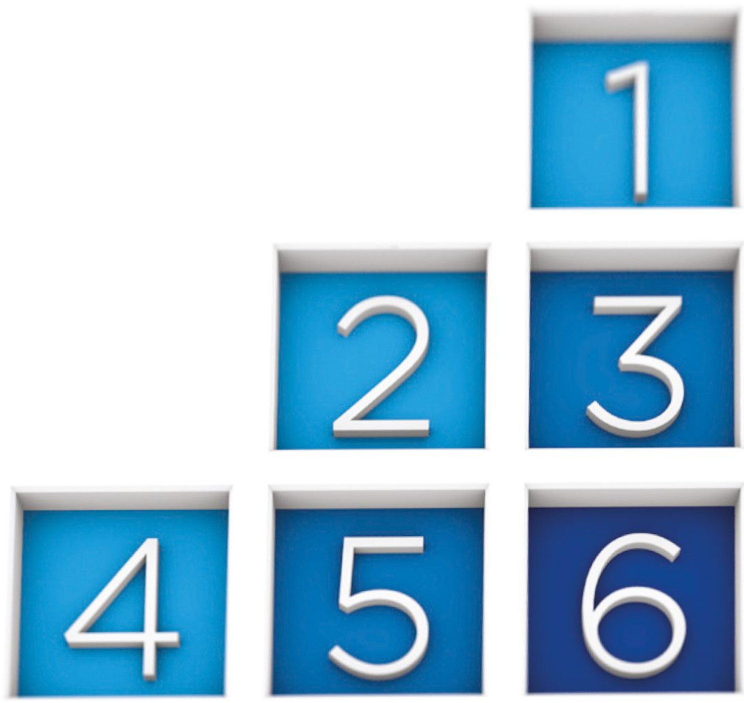
2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.



This publication is intended to promote the application of the Principles for Responsible Investment (PRI). The PRI Initiative was launched by the United Nations in 2006 after former UN Secretary-General Kofi Annan brought together a group of the world's largest institutional investors, academics and other advisors to draft a set of sustainable investment principles. At the heart of the six Principles for Responsible Investment is the premise that investors have a duty to act in the best long-term interests of their beneficiaries and this means taking into account environmental, social and governance factors.

The PRI engaged Spring Associates to conduct the research and develop the content for this Guide. The document was co-written by Spring Associates and the PRI Secretariat with input from the PRI GP Guide Working Group. The list of contributors can be found in the section "Preparation of this document".

spring associates

Spring Associates is a strategy consulting firm with a focus on adding sustainable value. Founded in 2005, Spring Associates is active in a range of sectors and particularly in regulated markets, such as Energy and Financial Services. The company has a clear vision on what it means to operate and invest responsibly and how to marry this theme with value creation. Spring Associates combines a deep understanding of ESG issues and developments with core due diligence skills and business expertise and is specifically experienced in developing and implementing comprehensive ESG methodologies for PE firms.

CONTENTS

ABBREVIATIONS

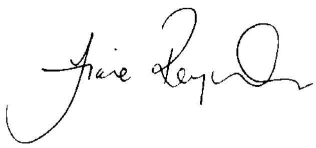
DFI = Development Finance Institution
ESG = Environmental, Social and Governance
GP = General Partner
IA = Industry Association
KPIs = Key Performance Indicators
LP = Limited Partner
NGO = Non-governmental Organisation
PE = Private Equity
PRI = Principles for Responsible Investment
VC = Venture Capital

FOREWORD

Fiona Reynolds, Managing Director, *PRI*

A WORD FROM OUR DIRECTOR

The PRI is dedicated to providing practical support to our signatories to help them implement the six Principles. GPs can use this document as guidance for **incorporating ESG** risks and opportunities into their investment analysis and decision-making processes. The long-term investment horizons and stewardship-based style of private equity investing enable GPs to be **active owners** of the companies they invest in. This guide provides suggestions on how to incorporate ESG factors into ownership practices and processes, including **seeking appropriate disclosure** from these companies on ESG risks and opportunities and **reporting** on this to their stakeholders. Through the sharing of good practice in this guide, GP signatories are **working together** with their peers and stakeholders to advance responsible investment practices within private equity. We encourage all our signatories to use this publication to **promote acceptance and implementation** of the Principles within the private equity industry.



PRI PRIVATE EQUITY PROGRAMME

By the end of 2013, more than 130 LPs and 150 GPs had signed up to the PRI, growing from just 2 GPs in 2008. Recent surveys[1] show a growing number of LPs have begun to pay increased attention to understanding how ESG issues can impact the future value of their investments. A fundamental driver for this momentum is the recognition that ESG issues are becoming more material to the success of companies and to the economy overall. Following the 2008 financial crisis, investment returns are now more closely linked to the ability of managers to protect and create value, and there is an improved understanding of how ESG issues can manifest into investment risks and opportunities. A PRI report on **The integration of ESG issues in mergers and acquisitions transactions**[2] showed that poor performance on ESG factors can affect the likelihood of a deal taking place, while good performance can increase the motivation of a trade buyer to complete a deal.

While many GPs have historically included environmental and social impact analysis in their investment activities, they are responding to LP requests and industry developments by adopting a more comprehensive and structured approach to managing ESG issues. GPs are starting to recognise that in order for ESG factors to be effectively integrated into their investment cycle, they must first be integrated into their organisational governance, structure and culture. The PRI PE programme provides a global collaborative platform for GPs and LPs to understand and develop good practices for ESG integration in PE investments. It engaged Spring Associates, a strategy consulting firm, to work with the PRI GP Guide Working Group to develop a practical guide to provide a framework for GPs to integrate ESG factors into their PE investment activities, for the first time linking this with organisational governance, structure and culture. Interviews were carried out with over 50 GPs and LPs worldwide to understand what ESG practices are being carried out today and what industry resources are available to assist GPs and LPs. The interviews showed that through experimentation and learning from peers and industry resources, many GPs have implemented robust practices through which to identify and manage ESG risks and opportunities.

The PRI is pleased to share this resource with the PE community. We hope it will inspire LPs and GPs to get started on ESG integration, or, for those who have already developed strategies, to reflect upon and improve their ESG practices.

Fong Yee Chan

Senior Manager of the private equity programme

PRI

1 Putting a price on value, PWC, 2013; ESG in Private Equity - 2013, MSP, 2013

2 The integration of ESG issues in mergers and acquisitions transactions, PRI, 2013

BLUE WOLF

When Blue Wolf was founded seven years ago, the founders had the strong belief that incorporating ESG factors into each facet of investment decision-making would positively contribute to a company's performance and a fund's overall return. This belief remains a core part of our investment strategy; we are convinced that incorporating ESG factors into our investment decision-making has contributed significantly to the returns we have achieved over the years.

Having been involved with ESG integration and the PRI for several years, we wanted to share a few thoughts and lessons. We recognise that starting down this path can be hard for organisations for many reasons, including a lack of resources, obstacles within the organisational structure and the challenges involved with expanding the focus of an organisation (large or small). Moreover, because the industry is still evolving and no common standards exist, it can be challenging for an LP or GP to locate and adopt industry best practices. It can also be difficult to find the right resources to learn about what is needed to begin integrating ESG issues into the investment process. Blue Wolf faced some of these challenges over its history, and we wanted to share our view that the benefits were well worth the effort.

This guide provides the building blocks for a PE firm to begin integrating ESG factors into its investment process. We also want to reiterate that there is no one precise way of doing so; every LP and GP we know has crafted a slightly different approach, be it emphasising certain ESG issues more than others, or deciding to build an in-house ESG capability versus utilising outside expertise. In our view, this is an evolutionary journey, and we are thankful that the PRI launched this initiative to try and promote implementation more broadly within the industry. We are very grateful to the PRI and Spring Associates for their leadership and effort, and feel privileged to have chaired the PRI GP Guide Working Group which created this guide. It was truly a collaborative effort by numerous individuals and organisations from across the world, and we would like to extend our thanks to everyone involved for their hard work and insights in making this a success.

Haran Narulla

Partner, *Blue Wolf Capital Partners*

Chair, *PRI GP Guide Working Group*

SPRING ASSOCIATES

The integration of ESG into a GP's overall operations has been on the private equity industry's radar for some years now. The private equity industry has the potential to maximise the impact of ESG factors in portfolios, thanks to the critical mass and maturity of the companies in which the industry invests and the governance controls that a GP generally negotiates as part of its investment. The good news is that private equity players, both GPs and LPs, with well-advanced ESG processes and systems have demonstrated that ESG integration can add value to a portfolio, as the case studies supplementing this guide illustrate.

The concept of ESG integration has gained velocity in recent years thanks to the work of the PRI and other organisations affiliated with it. As a result, an increasing number of institutions have recognised that ESG issues are critical and have responded by taking steps to incorporate ESG considerations into their organisations. The number of GPs who are signatories to the PRI has increased significantly over the years. However, many GPs are cautious about incorporating ESG into their organisations, primarily because of a lack of information on how to begin. We hope this guide helps to bridge that gap.

Like many GPs and LPs, we appreciate that incorporation of ESG factors into a portfolio has many direct benefits, from financial benefits (such as reduced energy costs, employee turnover related-costs, and reduced workers compensation costs) to social benefits (such as fewer safety incidents, increased job satisfaction and a more productive workforce) to an overall alignment of interests through better governance infrastructure. And, just as many other constituents do, we recognise that ESG integration helps create leaner, healthier and more sustainable enterprises while encompassing the varied interests of the many stakeholders within a company's ecosystem, all to create a more balanced society.

There have been numerous success stories in ESG integration at specific PE portfolio companies, and many GPs have taken steps to create value through ESG integration on a portfolio level. We believe we can all aspire to something greater, and that with concerted effort, the PE industry can universally create significant value, just as certain large companies, such as Unilever and Patagonia, have done.

We hope that all players in the private equity industry find this guide useful. As we conducted the interviews, certain points were continually reinforced. We believe the most critical was the notion that for ESG integration to be successful, an organisation needs to be aligned on the importance of this initiative, and be cognisant that a good ESG policy and framework will help drive value creation potential in their portfolios. We hope this guide provides a basis from which GPs can start a very exciting journey.

Ebel Kemeling

Partner, *Spring Associates*

EXECUTIVE SUMMARY

The integration of ESG factors is about having the processes in place to help GPs identify, manage and report ESG related risks and opportunities in their investment decisions and monitoring activities. This document provides guidance on the processes involved in developing a framework and is divided into two sections covering both the integration of ESG factors within a GP organisation and its investment process.

INTEGRATING ESG FACTORS WITHIN A GP ORGANISATION

It is important for a GP to have an appropriate organisational structure and culture in place, as this enables it to take into account the full spectrum of ESG issues in its business analysis. This could include:

- Commitment to ESG integration – a formal commitment from the top of the organisation to guarantee sustained institutional dedication and resources; a person or team responsible for ESG considerations with the relevant expertise; employees educated on the rationale, strategy and practices for integrating ESG; linking ESG objectives to employee evaluation.
- Setting ESG objectives – set and communicate objectives for ESG integration; establish an operations group or use consultants to monitor portfolio companies.
- Engage with stakeholders – engage with collaborative initiatives; engage with LPs.

INTEGRATING ESG FACTORS INTO THE INVESTMENT PROCESS

GPs could use the following general tips in developing and deploying their framework:

- Align your framework for ESG integration with existing tools and standards to ensure it is based on international standards and good industry practices.
- Ensure the investment team has access to ESG expertise.
- Be sensitive to regional differences which may influence the due diligence process and the level of engagement with portfolio companies during ownership.
- Perform a "pilot run" of the framework for ESG integration – trial it with the current portfolio and use the results to "demystify" ESG factors for your investment team.

This guide suggests more specific practices[3] which a GP could utilise to integrate ESG considerations into the due diligence, investment decision and agreement, and ownership phases of the investment process:

DUE DILIGENCE

Screening

- compile a checklist to screen for high-level ESG risks
- establish an exclusion list for high-level checks

Company deep dive

- consider resource allocation for ESG due diligence
- use due diligence questions in industry toolkits

INVESTMENT DECISION

- include ESG considerations as standard practice in investment committee discussions
- include ESG findings from due diligence in the investment memorandum

INVESTMENT AGREEMENT

- share ESG objectives, policies and practices with portfolio company
- use templates from existing industry toolkits to integrate ESG clauses into investment agreement

3 Please note that this is a non-exhaustive list of suggested practices.

- seek formal commitment from portfolio company by incorporating ESG issues into the deal documents and/ or the 100 day plan
- collaborate with portfolio company to draft 100 day plan
- formulate a roadmap with a 3-5 year horizon with clear process benchmarks

OWNERSHIP

Engagement

- collaborate with portfolio company to set up an ESG programme
- leverage portfolio company board to implement ESG initiatives
- leverage ESG expertise and experience across the portfolio
- conduct periodic site visits

Monitoring

- define company specific or portfolio wide ESG indicators
- prioritise ESG issues and focus on the most important issues in the short/medium term
- ensure ESG considerations are consistently on the portfolio company's board agenda
- provide portfolio company with tools to monitor and measure ESG practices
- collect information on ESG developments from portfolio company and include in annual review
- monitor ESG developments in internal review meetings

Reporting to LPs

- agree upon the form and frequency of reporting

ABOUT THIS GUIDE

This document provides practical guidance on how GPs can develop a framework for the integration of ESG factors within their organisation and investment cycle and points to industry resources and case studies. GPs are encouraged to use the practices and examples presented here as a starting point and adapt them to their organisations and investment styles. PRI GP signatories can use this resource to help implement the types of practices that are consistent with the PRI Reporting Framework.

LPs can also use this guide to understand the different ESG integration practices being implemented in the market, which will in turn facilitate a more informed discussion with their GPs during both fund selection and monitoring.

A supplement of case studies has also been made available, which present more details on the practices described.[4]

The selected case studies cover a range of geographies, investment strategies and GP sizes, and also highlight practices from GPs which are at different stages of ESG integration.

Appendices include (A) an overview of the various industry tools publicly available to help GPs with integration of ESG factors, and (B) resources for further reading.

Over 50 GPs and LPs across the globe were interviewed during the development of this guide and the guidance points presented are reflective of current practice. All quotes that are highlighted throughout the document have been lifted from these interviews. Please see Appendix D for the list of participating GPs and LPs as well as an explanatory note on the interview selection process.

4 Integrating ESG in private equity – a guide for general partners: Case Studies, PRI, March 2014

INTRODUCTION

The concept of responsible investment refers to an approach to investing which explicitly acknowledges the relevance of ESG factors in investment decision-making, as well as the long-term health and stability of the financial market as a whole. Furthermore, it recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well-governed social, environmental and economic systems.[5]

As discussed in the PRI's **Guide for limited partners**,[6] PE is particularly suited to responsible investment through its long-term investment horizon and stewardship-based style. A number of developments are driving interest in this area from the PE industry:

- **Risks and opportunities** - a growing number of investors believe ESG developments can and do play a significant role in the long-term performance of investments.[7] Historically, an integral part of the GP's role has been to manage ESG risks through the mitigation of operational risks and the consideration of liability costs. In recent years, the sector has become more active in identifying and managing ESG opportunities, sometimes by turning risk into opportunity.
- **LP expectations** - LPs are increasingly asking GPs to demonstrate they have a structured approach to managing ESG risks and opportunities.[8] This has prompted many GPs to set up ESG programmes to more effectively manage ESG issues upon acquisition and at the portfolio level.
- **License to operate** - another notable development is the increased demand for public accountability fuelled by the rise of instant global communication (i.e. social media). The risk of reputational damage and the potential for financial damage through a high profile ESG-related incident is also a driver for LPs to expect their GPs to effectively manage ESG risks and for GPs to manage their ESG risks to prevent such outcomes.
- **Regulation and investor-led initiatives** – While regulation is another key driver, its impact is dependent on the region to which it is applied. For instance, in France Article 225 of the Loi Grenelle II stipulates that companies of a certain size (>500 employees and >EUR 100m in total assets or net annual sales) are required to include information on their environmental and social performance, including all of the company's subsidiaries, in their annual report.[9] The UK Bribery Act and the UK Government's Carbon Reduction Commitment Energy Efficiency Scheme are also cited by GPs as drivers for action.

In addition, there are various investor-led and self-regulatory ESG initiatives (e.g. PRI, ESG Disclosure Framework for Private Equity) which are increasingly required practice by LPs, peers, and the industry at large to stay competitive.

5 See Introducing responsible investment on the PRI website

6 Responsible investment in private equity – A guide for limited partners (2nd edition), PRI, June 2011

7 Handbook on Responsible Investment Across Asset Classes, Institute for Responsible Investment at the Boston College Center for Corporate Citizenship, 2007

8 PRI currently has over 130 LP signatories. Additionally, 40 LPs were involved in the drafting of the ESG Disclosure Framework for Private Equity. These are signals that the LP community is increasingly seeking to adopt a more structured approach to managing ESG factors.

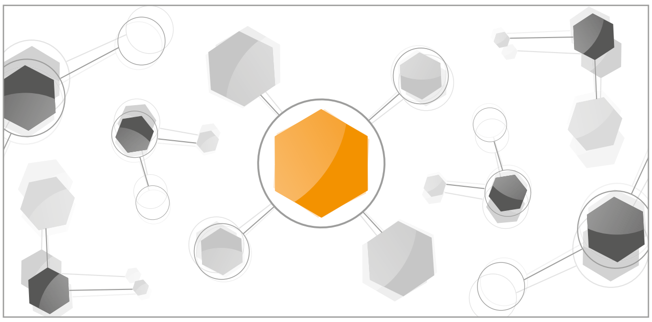
9 The Grenelle II Act, passed in 2012, is a governmental mandate in support of sustainability integrated reporting. The legislation requires companies to include information on their environmental and social performance, including all of the company's subsidiaries, in their annual report. See http://www.capitalinstitute.org/sites/capitalinstitute.org/files/docs/Institut%20RSE%20The%20grenelle%20II%20Act%20in%20France%20June%202012.pdf

OBSERVATIONS ON THE CURRENT STATE OF ESG INTEGRATION

1. There are obvious differences in the approach and maturity of ESG integration across different regions. GPs operating in regions where companies are in the early stages of understanding the impacts of ESG factors may experience difficulties in implementing ESG initiatives in their portfolio companies. GPs operating in Asia who were interviewed for this guide cited this as a common challenge, and attributed it to typically lower levels of influence with their portfolio companies. GPs operating in Europe, North America and Oceania appear better enabled to engage with and monitor their portfolio companies. Despite this, GPs operating in Asia can learn from the practices of their peers. GPs and LPs should therefore consider regional differences when selecting and adapting the practices proposed in this guide, and reach out to their peers for advice.

"The low level of sophistication... makes it difficult to go beyond compliance: if you try too hard and are too detailed they don't get it, if you push too hard you get pushback. We focus on the top three high priority issues and go from there."

2. Many GPs and LPs are in the early stages of integrating ESG factors into their organisations and their investment processes. Most ESG integration efforts are currently focused around risk management and operational efficiency. Many of the GPs and LPs interviewed are learning from companies such as Patagonia, Nike and Unilever, which integrate ESG factors into corporate strategy and value proposition. By doing so, they highlight how ESG integration can lead to value creation by access to new markets, brand enhancement and innovation. There are examples of GPs which have had portfolio companies create value through the incorporation of ESG factors. For example, during the Dutch PE firm Egeria's ownership of Royal Mosa, the tile manufacturing company obtained a silver Cradle to Cradle certification for its production line. Cradle to Cradle design is an innovative approach to sustainability which seeks to create systems that are not only efficient but also waste free. In addition, a selection of Royal Mosa's tiles positively contribute to the LEED status of a building. In short, sustainability has become an intrinsic part of the company's value creation proposition.



Like corporates, the PE industry has developed a better understanding of how issues such as resource management and energy supply can be intelligently translated into incremental investment returns and ultimately to GP/LP goals and KPIs. The good news for GPs who have just started to embed ESG factors into their organisation and investment cycle is that they can accelerate this process by learning from others and from the practices presented in this guide.

INTEGRATING ESG FACTORS WITHIN A GP ORGANISATION

There is no one-size-fits-all approach to ESG integration.

The process involves more than simply formalising what a GP is already doing. A GP has to examine, in depth, whether it is taking into account the full spectrum of ESG issues in its investment analysis and working with portfolio companies on all issues relevant to the business. To do this, it is important that an appropriate organisational structure and culture is in place.

This section examines some of the steps which could be taken to integrate ESG factors within the organisation and governance structure. Figure 1 suggests actions which a GP can take in three areas.

Figure 1: A non-exhaustive list of practices that a GP could utilise to integrate ESG factors into its organisation. Source: Spring Associates analysis

SUGGESTED PRACTICES FOR INTEGRATING ESG FACTORS WITHIN A GP ORGANISATION

1 COMMIT TO ESG INTEGRATION	2 SET ESG OBJECTIVES	3 ENGAGE WITH STAKEHOLDERS
Ensure formal commitment from the top to guarantee sustained institutional dedication and resources	Set and communicate objectives for ESG integration	Engage with collaborative initiatives
Appoint a person or team responsible for ESG-related processes with the relevant expertise	Establish an operations group or use consultants to monitor portfolio companies	Engage with LPs
Educate employees on the rationale, strategy and practices for ESG integration		
Link ESG objectives to employee evaluation		

1. COMMIT TO ESG INTEGRATION

The first step is to establish and communicate the organisation's willingness to commit to ESG integration. This helps ensure the organisation has the support necessary to develop an approach to ESG integration which is both aligned and embedded within its overall mission and strategy.

1.1 ENSURE FORMAL COMMITMENT FROM THE TOP TO GUARANTEE SUSTAINED INSTITUTIONAL DEDICATION AND RESOURCES

A GP could appoint one or two senior partners (or other senior individuals) to champion the implementation of an ESG programme. Lack of internal support and resources are two frequently cited hurdles to integrating ESG factors. Strong commitment from senior executives can ensure that ESG integration is recognised as part of their organisational strategy and incorporated into their investment practices.

"One partner was the sole catalyst for ESG at our firm."

1.1 IN PRACTICE

Examples of dedicated senior partner commitment can be found across regions and investment strategies, whether in North America with GPs like First Reserve and TPG or the France-based GP Apax Partners MidMarket.

At Apax Partners MidMarket, a senior partner personally oversees the process of integration and leads the team with a focus on ESG considerations. This team reports directly to the firm's President. This buy-in from the top signals to the other employees that ESG considerations are important.

1.2 APPOINT A PERSON OR TEAM RESPONSIBLE FOR ESG-RELATED PROCESSES WITH THE RELEVANT EXPERTISE

A GP could:

- Appoint a dedicated individual or team to be responsible for ESG integration who is knowledgeable and experienced with the PE investment process. Employees with PE investment experience will be more likely to influence their colleagues on the value of integrating ESG factors.

- Assemble an ESG committee involving employees from across different functions and levels of seniority to oversee the process of ESG integration. Such a committee could be used to handle specific ESG issues identified in the investment process and also to provide support to the investment/operational teams in case of ESG-related incidents.

Assigning responsibility to a person, team or committee should not be seen as a way to compartmentalise ESG integration. Instead, the purpose is to ensure accountability for embedding ESG considerations within the organisation and investment processes.

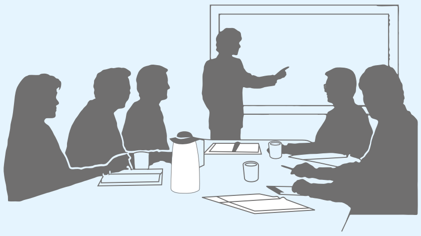
"You need to have a dedicated person; otherwise you will hit a brick wall."

1.2 IN PRACTICE

Permira, a UK-headquartered PE firm, has instituted an ESG working group which brings together investment professionals, the Chief Risk Officer and a member of the Investment Committee to monitor ESG issues and facilitate engagement and discussions with those less engaged on these topics.

UK-headquartered GP Doughty Hanson's ESG efforts are coordinated by a dedicated Head of Sustainability who is a Partner within the private equity team. In-house ESG expertise is supported by a wide network of external specialists.

First Reserve, a US-based GP, has appointed a team to implement its ESG policy. First Reserve's Legal and Compliance Team conducts an ongoing review to ensure that First Reserve is complying with its ESG policy.



1.3 EDUCATE EMPLOYEES ON THE RATIONALE, STRATEGY AND PRACTICES FOR ESG INTEGRATION

A GP could:

- Commence the ESG integration process with an offsite training day for all staff, or make use of appointed time within a firm's annual offsite meeting. Discussion topics could include: a general introduction to ESG factors and how these factors can impact investment performance, the organisation's beliefs and values with regard to ESG factors, what integration entails for a GP and an overview of what its peers are doing.
- Include training on ESG factors in the induction process for new employees.
- Introduce continuous training or knowledge sharing through the use of newsletters, regular presentations on topical issues, themed case studies or other ESG-related findings revealed through reporting from portfolio companies.

By investing in employee training, the GP can ensure that knowledge and messaging on ESG integration is spread throughout the workforce.

"We try to raise awareness of what our firm stands for."

1.3 IN PRACTICE

EQT, a PE firm founded in Sweden, assigns an associate on a rotational basis to their ESG working group, which also consists of the responsible Partner, the Responsible Investment Director and a Legal Manager. During this one or two year rotation, the associate will be given an in-depth introduction to ESG and its relevance to the PE industry, investment and operations. An advantage of involving the new generation of investment advisors is that they often demonstrate a keen interest in ESG and will typically apply dedication and vigour to their role. The ultimate outcome is that ESG knowledge and experience are being continuously integrated into the firm's culture.

France-based GP Ardian's Mid Cap Fund employs an external consultant to conduct an annual ESG survey on the portfolio. As part of this process, the consultant applies an internal ESG appraisal system by which all portfolio companies are compared on their ESG performance. This survey has proven to be a good inroad for training the investment teams to embed ESG into their monitoring processes. Investment managers have the opportunity to review and learn from good ESG practices across the portfolio. This collaborative exercise is complemented by a naturally competitive element among the investment teams when comparing portfolio companies on their ESG performance – this and the practical approach of focusing on the business of portfolio companies means that the survey process has gained traction with the investment teams as an effective way to engage with them on ESG integration.

1.4 LINK ESG OBJECTIVES TO EMPLOYEE EVALUATION

A GP could explicitly link ESG-related value creation and protection to employee evaluation. This will help a GP ensure that its employees are committed to its ESG objectives. One way of doing this is to create an association between employee evaluation and the specific ESG-related performance of the fund and/or portfolio companies. For this to be effective, a GP could have a fund and/or portfolio company level reporting structure which links relevant indicators for the fund and/or portfolio company to the GP's ESG objectives and targets. This will help employees understand what is required from them and will reinforce the GP's commitment to ESG integration.

2. SET ESG OBJECTIVES

2.1 SET AND COMMUNICATE OBJECTIVES FOR ESG INTEGRATION

A GP could formally determine and communicate its objectives for incorporating ESG considerations. It could set broad objectives such as achievement of operational excellence and/or value protection and creation.

By starting out with clearly defined objectives for ESG integration, a GP can increase the efficiency of the integration process. It may be more difficult for the GP to effectively integrate ESG factors without this point of reference to guide its efforts in this field.

2.2 ESTABLISH AN OPERATIONS GROUP OR USE CONSULTANTS TO MONITOR PORTFOLIO COMPANIES

A GP could deploy a dedicated operational team or employ external advisors to bring technical expertise on ESG matters to the table when reviewing portfolio companies. This allows the GP to better understand the business potential of the investment, to calculate ESG impacts and to assess the quality of company management. During due diligence or ownership, this operational team or external advisor could be responsible for performing a baseline review to assess the ESG factors impacting the portfolio company. This would in turn help with monitoring any changes or advancement towards the GP's specific ESG objectives and targets.

2.1 IN PRACTICE

Blue Wolf Capital Partners, a US-based PE firm, has built its value creation proposition with a focus on the social dimension. Over the years Blue Wolf has gained considerable experience with underperforming companies, almost always involving significant social issues. By aligning incentives, improving overall industrial relations and engaging with various constituencies, such as governments, unions and local communities, the firm actively solidifies the foundations of its portfolio companies.

2.2 IN PRACTICE

The US-headquartered investment firm KKR's Green Portfolio Program, which KKR launched with the US-based NGO Environmental Defense Fund,[10] is a well-known example of a GP deploying a dedicated team of operations experts to assist participating portfolio companies with their ESG activities. At the core of this program is a set of analytic tools that helps portfolio company management teams to identify and monitor improvements across various environmental performance areas (e.g. greenhouse gas emissions, water and waste) with the aim of improving a company's impact and bringing about measurable business benefits.

10 See http://green.kkr.com/

3. ENGAGE WITH STAKEHOLDERS

3.1 ENGAGE WITH COLLABORATIVE INITIATIVES

A GP could engage with collaborative initiatives to support ESG integration both within their firm and the broader PE industry. There is valuable information available for GPs which are proactive and engaged. In this regard, joining global and/or regional initiatives which support ESG integration (e.g. industry associations or the PRI) can help a GP to obtain a better understanding of the field. These initiatives may provide useful guidance in the form of resources, topical programmes or events.

Many GPs and LPs have been promoting ESG integration within the PE industry by sharing knowledge with their peers via case studies, articles and speaking at industry events. Additionally, many GPs and LPs cooperate to develop resources such as this document. GPs and LPs are also encouraging parties in the wider investment sector to engage on this issue, such as consulting with bankers, lawyers and accountants.

3.2 ENGAGE WITH LPs

A GP could engage with its LPs to better understand their ESG-related expectations. This is particularly relevant for GPs which are in the early stages of integrating ESG into their operations.

It can be difficult for a GP which is new to ESG integration to know which questions to ask LPs, and in turn what level of reporting requirements LPs expect them to achieve. GPs could look to the ESG Disclosure Framework for Private Equity which aims to facilitate an informed discussion between GPs and LPs. It is a practical guidance tool which provides a set of relevant questions that may be helpful in guiding the dialogue between LPs and GPs on ESG disclosure. This framework was developed in collaboration with LPs, GPs and PE associations.

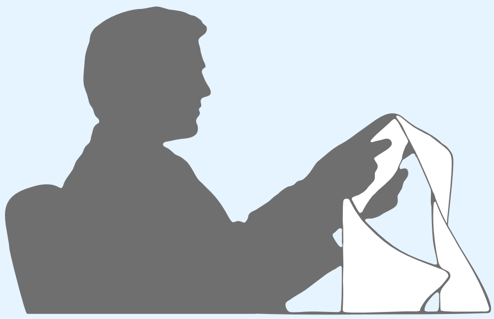
It is also important to note that LPs have differing ESG-related expectations, and GPs should find a way of efficiently addressing all or most of those varying expectations.

3.2 IN PRACTICE

Apax Partners MidMarket conducted a survey of their LPs to gauge levels of interest in ESG integration. The survey focused on three main topics:

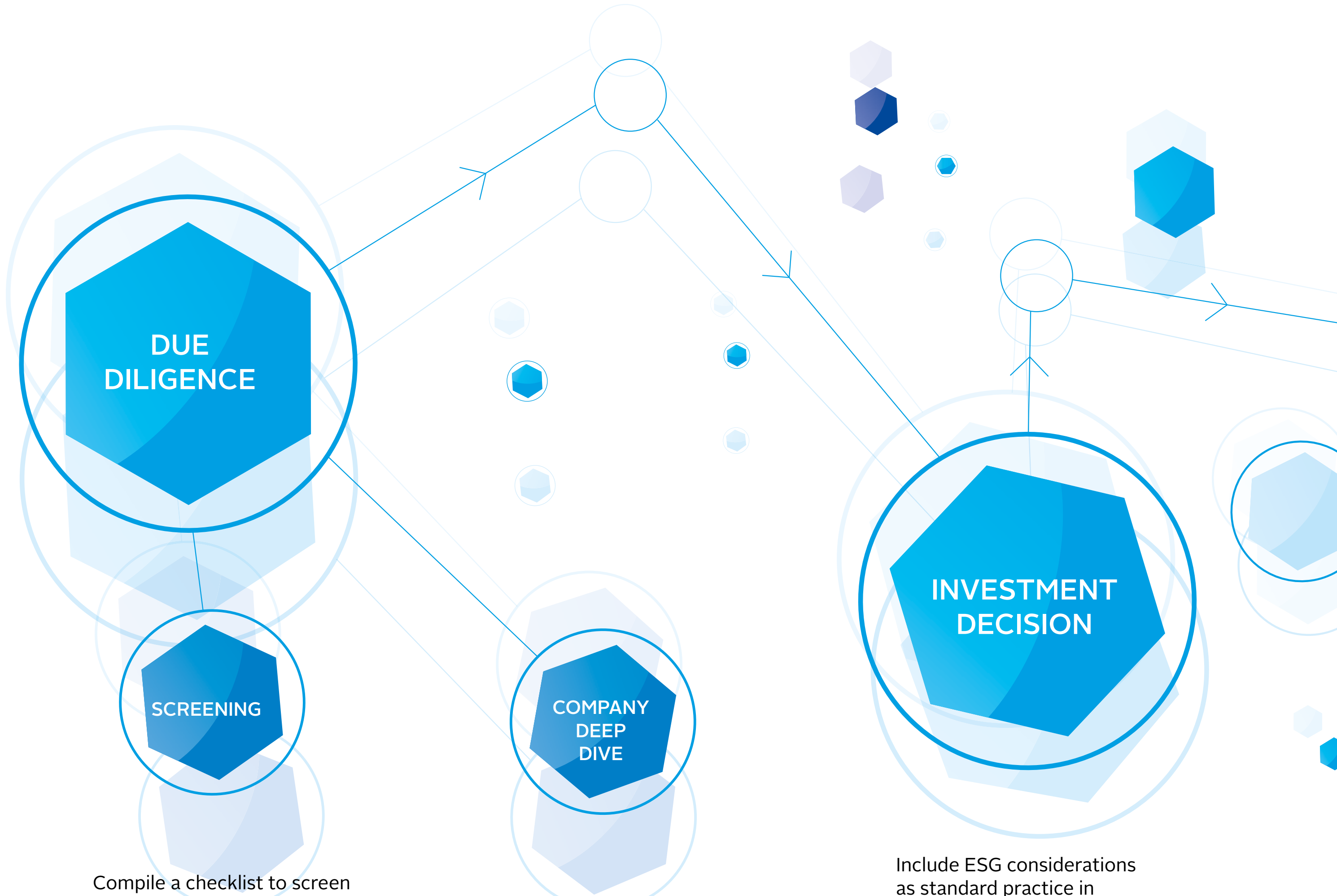
1. Whether a GP should address ESG because of risk management issues or value creation potential
2. What the LP was currently doing to assess a GP's ESG practices
3. How the LP was currently following up after due diligence

The survey revealed that the majority of respondents see ESG issues as increasingly important, beneficial from a risk management perspective, and a means to create value. For Apax, this reinforced their commitment to their ESG strategy.



INTEGRATING ESG FACTORS INTO THE INVESTMENT PROCESS

Figure 2: A non-exhaustive list of practices that a GP could take to integrate ESG factors into its investment process
Source: Spring Associates analysis



Compile a checklist to screen for high-level ESG risks

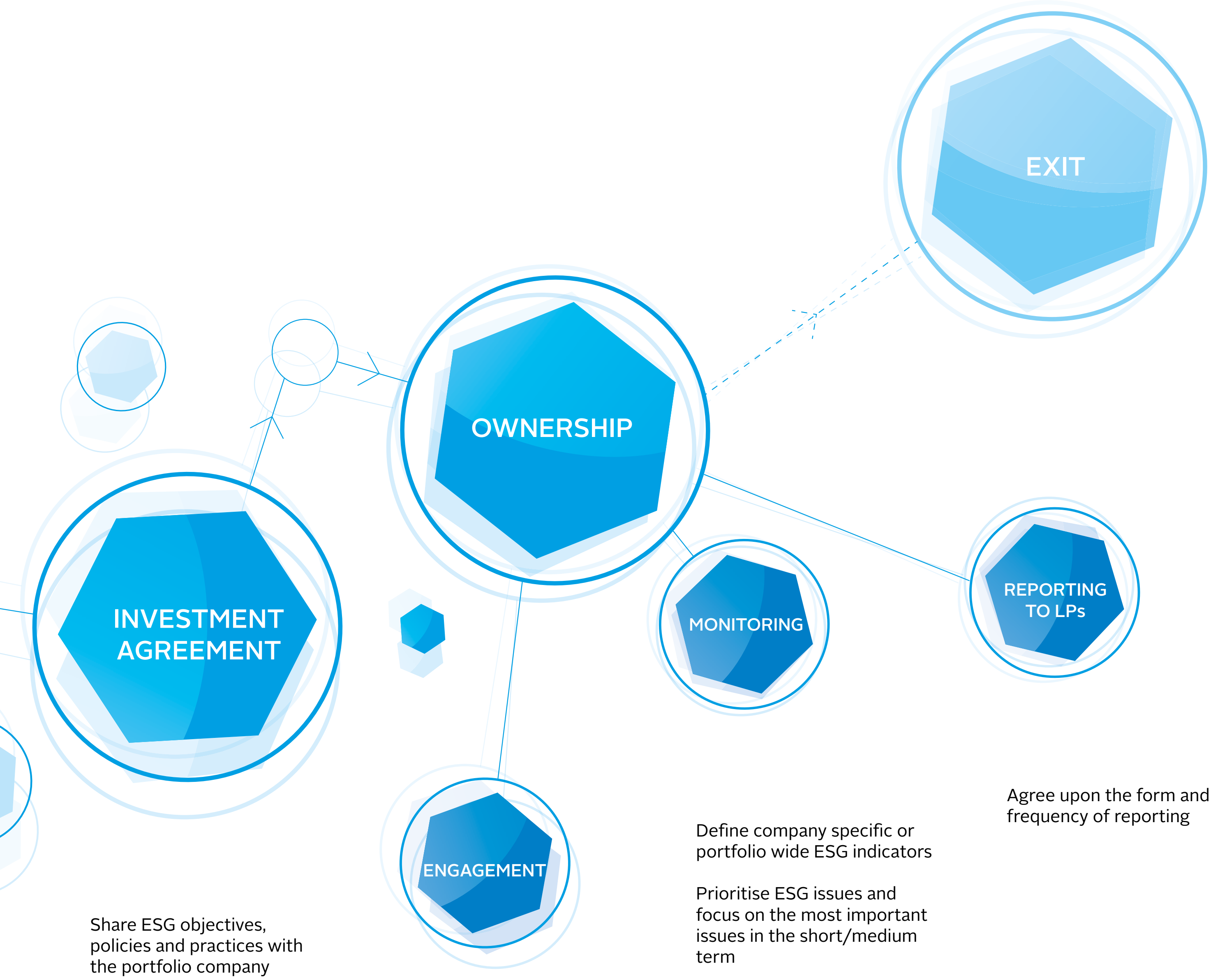
Establish an exclusion list for high-level checks

Consider resource allocation for ESG due diligence

Use due diligence questions in industry toolkits

Include ESG considerations as standard practice in investment committee discussions

Include ESG findings from due diligence in the investment memorandum



Agree upon the form and frequency of reporting

Define company specific or portfolio wide ESG indicators

Prioritise ESG issues and focus on the most important issues in the short/medium term

Ensure ESG considerations are consistently on the portfolio company's board agenda

Provide portfolio company with tools to monitor and measure ESG practices

Collect information on ESG developments from portfolio company and include in annual review

Monitor ESG developments in internal review meetings

Share ESG objectives, policies and practices with the portfolio company

Use templates from existing industry toolkits to integrate ESG clauses into investment agreement

Seek formal commitment from portfolio company by incorporating ESG issues into the deal documents and/or the 100 day plan

Collaborate with portfolio company to draft 100 day plan

Formulate a roadmap with a 3-5 year horizon with clear process benchmarks

Collaborate with portfolio company to set up an ESG programme

Leverage portfolio company board to implement ESG initiatives

Leverage ESG expertise and experience across the portfolio

Conduct periodic site visits

Including ESG information relevant to the company's industry, geography, and business model in the investment analysis and post-acquisition management helps a GP to:

1. Holistically account for material risks and potential opportunities which may make the business more or less attractive for investment.
2. Identify and develop action plans for strengthening the target business.
3. Ensure that their investments are aligned with their LPs' interests.

This will help GPs and their LPs create and maintain the value of their investments.

GPs will have their own systems for integrating ESG considerations into their investment process. In practice, effective systems typically exhibit the following characteristics:

- They are practical and can be adapted for different investment strategies and portfolio companies.
- They are aligned with existing tools and standards.
- They allow GPs to compare risks and opportunities across a diverse portfolio.
- They allow for prioritisation of the most important topics per company and for the portfolio.

This section discusses actions which a GP could take to develop their own frameworks for integrating ESG factors into their investment cycle.[11] Additionally, this section presents examples of GPs carrying out these practices. Where appropriate, this section will refer readers to industry toolkits for more detailed guidance or templates.

"A good policy is never a substitute for actual behaviour."

1. GENERAL TIPS

1.1 ALIGN A GP'S FRAMEWORK FOR ESG INTEGRATION WITH EXISTING TOOLS AND STANDARDS

A GP could draw ideas for its framework for ESG integration from toolkits made by DFIs, NGOs and also from their peers. Appendix A contains examples of various toolkits which can assist the development of a due diligence tool. Using these toolkits is one way to ensure that a GP's framework for ESG integration is based on international standards and on good industry practices. A GP can also draw upon established and industry specific standards (e.g. LEED[12]) in their analyses and target-setting.

"We have tailored the CDC toolkit to our specific needs."

1.1 IN PRACTICE

When Capman Russia, an investment partnership of the Finland-based PE fund manager CapMan Group, started building its framework for ESG integration, they reviewed previous work conducted by some of their DFI LPs on the subject. They used this as a basis for their own system. DFI LPs such as the IFC and EBRD set high performance requirements for ESG issues and have been an important driver for increased attention to ESG issues in Russia and Eastern Europe over recent years. The standards which they set can provide the basis for exclusion lists, post-investment action plans and reporting templates.

Kendall Court, a Singapore-based GP, has built its framework for ESG integration by reviewing the international standards recommended by DFI toolkits and the local rules that are applicable to their regions of operation. Between international and local standards, Kendall Court will endeavour to select the one with the highest standard.

1.2 ENSURE ACCESS TO ESG EXPERTISE

It is important that GPs fully consider the spectrum of relevant ESG issues in their investment decision-making by ensuring that they have access to expertise on ESG matters.

As suggested previously, a GP can develop a separate work stream to focus on ESG analysis and management or integrate ESG-related skills and knowledge within the investment team. As referred to in the due diligence section below, a GP can consider using external expertise and/or existing industry resources to supplement its internal

11 The scope for this report does not cover how to integrate ESG factors into the exit process.

12 Developed by the U.S. Green Building Council, Leadership in Energy and Environmental Design (LEED) is a green building certification program that employs a set of rating systems to recognise best-in-class building strategies and practices. To receive LEED certification, building projects satisfy prerequisites and earn points to achieve different levels of certification. See http://www.usgbc.org/leed

capabilities. The allocation of human resources will depend on the GP's business strategy and model. With either approach, the GP should ensure that ESG analysis and management are not isolated from the other investment processes such as commercial, financial and legal due diligence and portfolio company oversight.

1.3 BE SENSITIVE TO REGIONAL DIFFERENCES

When integrating ESG considerations into the investment process it is important to be sensitive to regional differences. For example, in some markets deals may involve very competitive bidding processes with very limited exposure to the target companies. In such cases, the depth of ESG due diligence is limited because only a high-level screening can be performed. In addition, certain regional characteristics, such as the predominance of minority PE transactions in emerging markets, will influence how a GP can engage with and monitor a portfolio company.

1.4 PILOT YOUR FRAMEWORK FOR ESG INTEGRATION

A GP could perform a "pilot run" of their framework for ESG integration with existing portfolio companies instead of trialling their framework with new investment opportunities. This is a good opportunity for a GP to collaborate with their portfolio companies to identify and subsequently adapt their processes for monitoring ESG developments.

There are three key benefits of a "pilot run". Firstly, by applying the framework for ESG integration to the existing portfolio, the GP can verify whether any improvements are needed. Secondly, a GP will gain experience in considering ESG information when reviewing a business; this experience will be helpful for integrating ESG factors in the due diligence stage. Finally, a GP could use examples from the pilot to demonstrate the practical application of the framework to its investment team. This can help to "demystify" ESG factors for investment teams by revealing new opportunities and/or improved risk management without creating an unnecessary burden.

"After we had used the toolkit for the first time we had an example we could share; it led to demystification, showing it is not bureaucratic and probably is a value-added process."

1.4 IN PRACTICE

Egeria used an "ESG pilot run" to help with identifying whether their current portfolios contain any hidden ESG risks. These pilot runs helped them gain experience in examining a business through an ESG lens, instead of through a solely financial and commercial one, before applying ESG criteria to due diligence. Among other things, these pilot runs helped the firm's investment managers to become more familiar with the issues associated with ESG.

2.1 IN PRACTICE

Bridges Ventures, a UK private investment firm, has devised a comprehensive impact methodology to assess its investments, throughout the deal cycle and across all fund types.[13] Due diligence analysis always includes an initial review of whether the potential investment is aligned with Bridges Ventures' envisioned target outcomes, i.e. using investment to address pressing social and environmental challenges. Whilst impact analysis is tailored to each of Bridges' three funds, there are certain key impact features that are common to all investments. Bridges Ventures will look primarily at these three areas during analysis: thematic impact (linking the investment output with the target societal outcomes), additionality (whether the investment will create positive change relative to what is likely to happen otherwise) and ESG factors (identifying other environmental, social and governance factors that signal both risk and opportunity for value creation). Bridges Ventures uses tailored, practical indicators for impact measurement and puts an emphasis on consistency and comparability of results. Impact returns and risks are analysed at both the portfolio and investment levels in order to understand the overall impact risk/returns profile of each fund.

"We apply the WSJ-test: we ask ourselves how we would feel if a certain issue or deal made the front page of the Wall Street Journal."

13 See http://www.bridgesventures.com/sites/bridgesventures.com/files/IMPACT_REPORT_2013_FINAL.pdf

2. DUE DILIGENCE

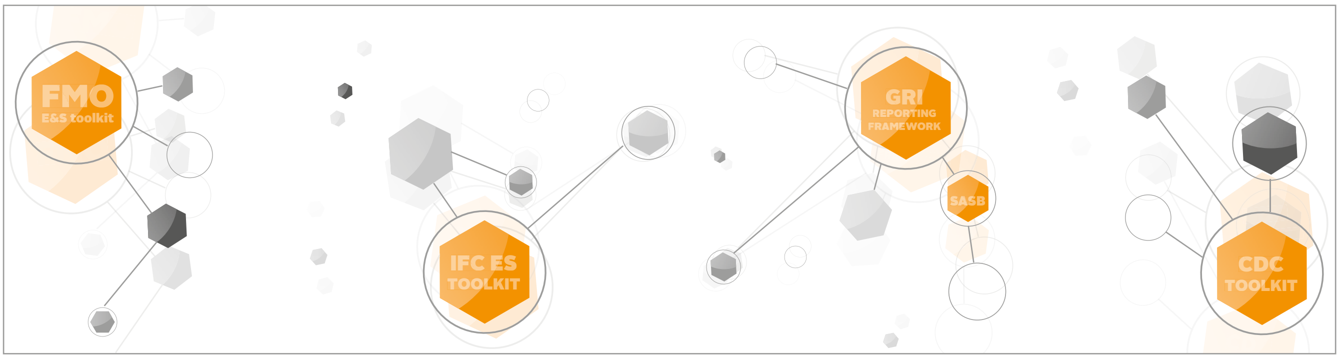
2.1 SCREENING

The initial screening of an investment opportunity can provide an early stage assessment on how it aligns with a GP's ESG objectives.

A GP could:

- Compile a checklist to screen for high-level ESG risks before embarking on detailed due diligence. The content of this checklist will be dependent on both LP demands and on the GP's own strategy. High-level checks may also look at the sectoral and geographic-related ESG risks and opportunities. A GP could periodically review this list to incorporate new developments or insights which may significantly influence its composition.
- Exclude controversial industries and activities (e.g. cluster munitions) or follow the UN and EU guidelines on country exclusions.

PUBLICLY AVAILABLE TOOLKITS



- The Dutch DFI **FMO** offers an easy-to-use tool which provides the GP with an initial assessment of E&S risk against IFC Performance Standards regarding a particular investment. The assessment is based on the sector and geography where the company is active. The tool also provides E&S opportunities/value add for the GP to look into.
- The **IFC ES-Toolkit** offers GPs an extensive overview of templates and tools which can be deployed during the due diligence phase of the investment process. For example, the toolkit includes an overview of the eco-labels which are available in the industry. This sort of information can help GPs develop a better understanding of existing initiatives and a general sense of where a particular industry is heading with regard to environmental trends. This can in turn help focus the due diligence process.
- The **SASB standards** can be used to identify the relevant ESG issues for a company by industry and the **GRI Sustainability Reporting framework** includes sector guidance to identify ESG issues. A GP can review the issues highlighted in these frameworks and incorporate the consideration of these into its due diligence process, as relevant.
- The **CDC toolkit** provides a comprehensive overview of issues related to geography, sector and industry and supplies frameworks for GPs to map these out during due diligence. During the interviews, this toolkit was repeatedly referred to as a helpful resource for GPs integrating ESG into the due diligence process and their operations.

See Appendix A for further information on these and other tools which can be useful for the integration of ESG into the due diligence process.

A GP may find, however, that dedicated training of staff on integrating ESG considerations into due diligence can have more impact than using elaborate formats and frameworks.

2.2 COMPANY DEEP DIVE

Due diligence on ESG factors (through desk research and site visits) is an iterative process with repeated interaction between the different actors (the portfolio company, investment manager, external ESG consultant and/or internal dedicated team of ESG operational specialists).

"Management of ESG issues is not necessarily different from managing other aspects of the investment; you just have to have the will."

On the whole, repeated interaction helps to unearth the information necessary to obtain a full understanding of all relevant ESG issues.

A GP could:

- Hire an external advisor to conduct detailed ESG due diligence. GPs, particularly smaller GPs, may find it difficult to have in place a fully dedicated ESG professional or team due to resource constraints. Making use of external support services is one way of overcoming resource challenges whilst ensuring access to expertise on ESG matters during due diligence. For example, rather than just hiring a chemicals expert, a GP can additionally (or instead) hire an external advisor to understand the environmental risk associated with the chemicals used at the production facilities of a target company.

"GPs complaining about the cost of hiring an ESG consultant should reconsider their due diligence legal bills. The savings in avoided risks alone are already worth it."

- Tailor its approach for due diligence on ESG matters to the industry sector, geographical region and business model of the target company. The relevance and materiality of ESG factors for an investment will vary depending on its characteristics. Industry toolkits can help a GP to identify relevant ESG regulations, standards and risks and opportunities specific to a geographical region and industry sector. A GP can then adapt this guidance to the specific target. Please see Appendix A for a list of publicly available industry toolkits.

3. INVESTMENT DECISION

Including ESG considerations as standard practice in investment committee discussions will demonstrate to employees that these issues are being taken seriously.

A GP could include key ESG findings collected during the due diligence in the investment memorandum so as to ensure that the investment committee is informed on ESG matters. It may be useful to include this as a separate section in the investment memorandum even if no ESG risks were identified, as it will demonstrate that a thorough focus on ESG matters was performed during due diligence. The ESG findings could indicate how the target company performs relative to its peers.

OBSERVATION ON COSTS

Based on the interviews, it appears that the costs associated with ESG analysis during due diligence typically range from US$ 5,000 to US$ 20,000, depending on the size, industry and location of the potential investment. This expenditure is typically for hiring external advisors to map the ESG issues associated with a particular investment. This may include factory site visits, resource utilisation analysis and/or mapping the scope for improvements. The estimated costs put ESG due diligence at less than 10 to 15% of total due diligence expenditure. These findings suggest that conducting in-depth ESG due diligence may not be as costly as perceived by some GPs.

3. IN PRACTICE

Idinvest Partners, a GP headquartered in France, includes an ESG Profile Review of the potential investment in its final investment recommendation. This review highlights all the main findings from ESG due diligence as well as an overall ESG risk assessment score of 'high', 'moderate' or 'low'. Idinvest's investment committee is charged with examining all ESG Profile Reviews for its prospective investments, and will take the ESG risk rating into account when making the investment decision. Investments with a 'high' ESG risk rating are excluded.

"Our ESG expert sits in with the Investment Committee to offer any additional information or guidance on a particular topic or industry."

4. INVESTMENT AGREEMENT

During investment negotiations with the portfolio company, clear articulation and agreement about the GP's ESG policies and guidelines can ensure that the portfolio company is aware of the GP's ESG expectations.

To clarify their ESG expectations to the portfolio company, a GP could:

- Leverage industry toolkits for templates on how to integrate ESG clauses into investment agreements. The CDC toolkit, for example, contains such a template.
- Seek formal commitment from the portfolio company to adhere to ESG items, an ESG policy or guidelines, for example by including issues identified during due diligence on ESG matters in the 100-day plan.[14] The process for translating due diligence findings into the 100-day plan and/or deal documents will depend on the depth of due diligence carried out prior to closing. A GP may choose to only identify significant ESG risks during due diligence and conduct an in-depth ESG review after the deal has been completed. Alternatively, a GP may conduct extensive due diligence on ESG matters prior to the investment agreement. Regardless of the approach, a GP could incorporate its ESG findings in its dealings with the portfolio company.
- Collaborate with the portfolio company management to draft the 100-day plan. This will help to achieve targets which are both meaningful and manageable whilst simultaneously ensuring buy-in from the company management, who are ultimately responsible for executing the plan.
- Formulate a roadmap with, for example, a three to five year horizon which identifies clear KPIs, milestones and targets, including possible certification schemes. The plan could also detail the size and nature of the identified ESG risks and opportunities, as well as how these are to be tackled over time.

5. OWNERSHIP

5.1 ENGAGEMENT

The way in which a GP engages with portfolio company management during ownership will depend on its investment strategy and governance model. For example, GPs which are majority shareholders with active board positions may be better positioned to influence portfolio company management compared with GPs which are minority shareholders. Additionally, GPs will experience varying levels of support from portfolio companies on ESG initiatives depending on the company's culture or region

4. IN PRACTICE

Doughty Hanson is an example of a GP which collaborates with portfolio company management to identify, manage and act upon ESG risks and opportunities. This takes the form of an on-going action plan specifically designed to be flexible and capture information on an on-going basis whilst taking into account change management. If issues arise or are identified which were not in the original action plan, they are simply added to it. In addition, Doughty Hanson seeks to play an active supporting role in the event of an ESG incident or crisis.

In certain cases the issues identified during the due diligence phase provide grounds to increase the monitoring of certain ESG issues. During the due diligence process for one of its portfolio companies, Direct Capital, a GP headquartered in New Zealand, realised that the company had experienced some health and safety issues in the past. Based on this finding, Direct Capital decided to actively benchmark the company's performance in this area against the entire industry in order to more effectively monitor the situation. Direct Capital will work directly with the board of the portfolio company to establish specific metrics with which to monitor issues such as these. Direct Capital will also exert influence on the portfolio company to report on ESG issues through quarterly board reporting and to regularly monitor alignment with industry standards or external regulations.

5.1 IN PRACTICE

Global Environment Fund, a GP headquartered in the US, actively takes into consideration the environmental effects of their investments. For example, when it acquired Red Ambiental – a Mexican integrated waste management company – due diligence yielded various opportunities for environmental improvements in its management and footprint, and areas of potential liability, including drainage pumps, additional permits and community engagement. These were discussed with management and incorporated into the ESG action plan.

14 The first 100 days is defined as the first 100 calendar days counted from the day the transaction is closed. If a GP subscribes to the view that this critical period will ultimately determine whether the transaction will evolve from promise to performance, then they may devise a "100 day action plan" with pre-determined progress milestones to manage the portfolio company against.

of operations. Regardless of the approach taken, GPs are encouraged to find the right balance between stimulating active management of ESG factors and placing unrealistic expectations on portfolio companies.

A GP could:

- Persuade its portfolio companies to implement ESG initiatives by helping senior company executives and management better understand the potential impact of ESG risks and opportunities on the value of their business. It may also be the case that the GP can learn from a portfolio company's practices and share these practices with other companies in their portfolio.
- Work with its portfolio companies to set up an ESG programme, which could include drafting a policy, assigning responsibility for ESG operations and setting up processes to manage ESG activities. The company could also engage internal or external technical consultants to achieve operational ESG improvements. The company will be responsible for day-to-day management and as such it is important that they have the systems and resources in place to effectively manage ESG risks and bring to fruition the identified opportunities.

5.1 IN PRACTICE

During the investment agreement stage, Kendall Court will stipulate that the portfolio company forms an ESG committee. This will typically consist of 3-6 people, including the portfolio company's CEO and CFO whenever possible and at least one Kendall Court employee. The rationale behind this ESG committee is that inter-departmental coordination on ESG matters is crucial to avoid a silo mentality when it comes to ESG implementation. Moreover, meaningful change usually requires human capital and/or resources, which is why Kendall Court endeavours to ensure that the CEO and the CFO are on the committee as they have the necessary decision-making power.

"100% of our portfolio companies have an ESG policy and most have an ESG officer."

- Make the portfolio company's board explicitly accountable for ESG initiatives. This could be achieved by placing a representative on the portfolio company's board who is responsible for overseeing ESG initiatives. Alternatively, a GP could form an ESG committee within the individual portfolio companies.
- Leverage expertise and experience on ESG matters across the portfolio by encouraging sharing of knowledge and good practices between different companies. A GP could organise periodic meetings with representatives from all of its portfolio companies to discuss ESG topics. Similarly, a GP may organise dedicated sessions or webinars for portfolio companies around particular themes and topics.
- Conduct periodic site visits. Site visits can help GPs to verify the portfolio company's reported information, reveal the full extent of the company's ESG activities, and demonstrate to the company that the GP is fully committed to working with them on ESG activities.

5.2 MONITORING PORTFOLIO COMPANIES

A GP could:

- Define company specific or portfolio wide ESG indicators, depending on the characteristics of the portfolio companies, and monitor these on a regular basis. A GP could perform a pilot run with a subset of their portfolio companies to determine the most relevant ESG metrics to monitor.
- Prioritise the relevant ESG issues and focus on the most important issues in the short or medium term. The CDC toolkit – see Appendix A – contains an overview of what are considered to be the more pressing issues for various industries. Likewise, the SASB standards focus on the determination of materiality. Both tools can assist GPs in determining which the important or material issues are for their portfolio companies and what (if anything) they should consequently be targeting in the short or medium term.
- Ensure that ESG developments are consistently on the portfolio company board's agenda. The underlying logic here is that these developments capture, to some extent, how a business is performing overall. When a company is experiencing ESG issues, it generally means that other operational issues are also at play which the board should be aware of. Additionally, it is the board's ultimate responsibility to review all the relevant information to enable them to make informed decisions.
- Provide tools to help portfolio companies monitor and measure ESG practices. For example, a GP could provide templates for calculating potential cost savings and upside from ESG practices.
- Collect information on ESG developments from portfolio companies using structured reporting templates. Such templates can range from simple questionnaires with yes/no questions to complex matrices of quantitative metrics. A GP could also leverage templates and guidance from industry toolkits.

The CDC toolkit offers templates for reporting from portfolio companies to GPs.

- Integrate the discussion of ESG developments into existing annual reviews with portfolio companies. This will help provide a holistic view of the company and reinforce the fact that ESG issues are an integral part of the company's strategy and operations.
- Monitor ESG developments in its internal portfolio review meetings (i.e. investment team meetings, operational team meetings, internal investment committee meetings and/or the meetings with LPs, possibly with the ESG team and/or selected external speakers/advisors).

"We only hold companies for 3 to 5 years. Thus you only have 1 to 2 years wherein you can actually work on ESG in the sense that management is receptive for ESG-based changes."

5.3 REPORTING TO LPS

As previously mentioned, GPs are increasingly indicating that LPs are asking them to demonstrate a structured approach to managing ESG risks and opportunities, which also includes reporting on ESG matters. In some cases, LPs are themselves under increasing pressure from their stakeholders to provide greater transparency on how ESG considerations are integrated into their investment processes, and these LPs, in turn, have elevated expectations regarding reporting on ESG developments.

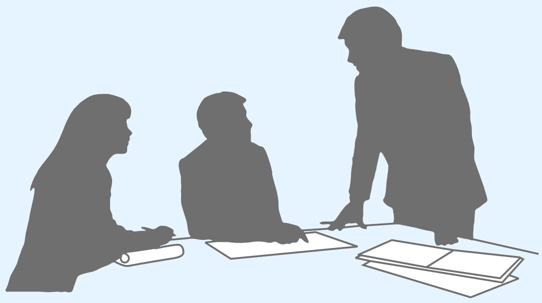
Well-developed monitoring practices can help a GP to report on ESG matters to its stakeholders. This section provides high-level guidance on how GPs may report ESG matters to their LPs. This is an evolving topic and today, no universal, industry-wide LP reporting templates exist. GPs and LPs are therefore encouraged to work together to develop a framework for reporting which allows the GP to disclose the information that is relevant to its LPs.[16]

If LPs indicate a desire for regular reporting, it may be best for the GP and the LPs to agree in advance upon the form and frequency of reporting. GPs should be aware that, in certain cases, LPs could look for disclosures outside of the

5.2 IN PRACTICE

UK-based GP Actis' Africa Real Estate Fund incorporates environmental building measures into its greenfield developments. These include: One Airport Square and The Exchange in Ghana, Heritage Place in Nigeria, and Garden City in Nairobi. The ESG and real estate teams worked closely to benchmark each development against internationally recognised rating schemes (LEED and Green Star). All the developments mentioned above are on course to be LEED or Green Star certified. The team has ensured that all developments are at least 25% more energy efficient than similar buildings in the locality.

Permira has a team dedicated to monitoring and reviewing its investment KPIs, including those related to ESG. In the event that this team identifies a potential or actual problem within a portfolio company (i.e. a red flag), the team increases monitoring levels with increased requests (i.e. every two weeks) for feedback. Where relevant, these can include specific ESG KPIs from the company.[15]



ESG DISCLOSURE FRAMEWORK FOR PRIVATE EQUITY

The ESG Disclosure Framework for Private Equity is a tool developed by an international group of LPs, GPs and private equity associations to provide guidance on the disclosure of ESG considerations between LPs and GPs. By applying this guidance, GPs can provide LPs with clarity that (i) the fund is being managed in accordance with ESG policies agreed at fund formation, (ii) be informed of any material changes to the ESG risks and opportunities facing the portfolio, and (iii) be informed of any material incidents and how these were addressed.

15 Consult the various tools listed in Appendix A for selected examples of ESG related KPIs.

16 It might be useful for GPs to look to reporting examples in the public markets.

regular reporting cycle, for example if there is a material incident at a portfolio company. Amongst the many variables that affect the frequency of reporting are the type of fund, geographical and industrial coverage, and LPs' expectations. GPs could work with their peers, industry associations, the PRI and other constituencies to find a blend that is optimal for them and their LPs. In addition to regular reporting requirements, LPs have also indicated that amongst the key items they focus on are whether ESG topics will be a discussion point at LP advisory committee meetings or at the annual LP meetings, as well as the circumstances under which an LP could discuss ESG considerations more broadly with a GP and its affiliates.

In some cases, the LP's need to implement its responsible investment policy and/or provide transparency into its portfolio may lead an LP to try and understand key ESG developments at specific portfolio companies and/or across the fund. A GP could (subject to any confidentiality obligations) use information collected during the monitoring of portfolio companies to input into its fund level reporting to LPs. Reporting at the fund level also allows for the disclosure of confidential and more granular information, as most fund documents provide for confidential treatment of information communicated to LPs.

"Reporting creates its own reality... it helps to embed ESG into the daily practice and thinking of both management and the investment team"

CONCLUSION

This guide is intended to provide an overview of current practices for the integration of ESG factors into private equity. We encourage GPs to use the practices and examples in this guide, and to refer to the resources and further reading in the Appendices, to influence and improve their approach to integrating ESG considerations within their organisation and investment processes. GPs can use these suggestions as a thought-provoking exercise and then share their reflections with their colleagues, working together to develop practices which are meaningful for their firm and their portfolio.

It should be noted that the rapid developments in recent years around the consideration of these factors in private equity makes it a dynamic integration process which is being continually refined. We encourage GPs to contribute to and promote industry-wide development by sharing experiences and good practice with their peers. It is important to highlight the positive role that private equity is already playing to this effect. By contributing to this effort, private equity investors are aligning their investment practices with the broader objectives of society and the long-term health and stability of the market as a whole. To this end, PRI invites you to share your feedback on this guide and your own experiences of ESG integration with the aim of incorporating this into a future edition.

APPENDIX A – INDUSTRY TOOLS

The table below provides an overview of the providers of publicly available tools and resources to assist GPs with the integration of ESG information in their investment processes.

Figure 3: Overview of Industry Tools / Tool Providers

Institution/name	Type of organisation	Industry/sector specific recommendations	PE-Focus
BVCA (British Private Equity & Venture Capital Association)	IA	No	Yes
CDC Group	DFI	Yes	Yes
CDP (formerly known as Carbon Disclosure Project)	NGO	Yes	Yes
EBRD (European Bank for Reconstruction and Development)	DFI	No	No
EDF (Environmental Defense Fund)	NGO	No	Yes
ESG Disclosure Framework for Private Equity	IA	No	Yes
EVCA (European Private Equity and Venture Capital Association)	IA	No	Yes
FMO (Entrepreneurial Development Bank)	DFI	Yes	Yes
GRI (Global Reporting Initiative)	NGO	Yes	No
IFC (International Finance Corporation)	DFI	Yes	Yes
ILPA (Institutional Limited Partners Association)	IA	No	Yes
PRI (Principles for Responsible Investment)	IA	No	Yes
SASB (Sustainability Accounting Standards Board)	NGO	Yes	No

British Private Equity & Venture Capital Association: Responsible Investment: A guide for private equity and venture capital firms

This resource provides advice on how ESG factors can be managed throughout the life cycle of PE and VC. It also includes various case studies for further study. The report is particularly relevant for PE firms which are looking for more examples of ESG implementation within their process (i.e. selecting KPIs).

CDC Group: Toolkit on ESG for fund managers

The CDC's Toolkit for Fund Managers is designed for PE GPs investing in the emerging markets, although GPs investing in developed markets will also find this toolkit useful. This resource provides tools for integrating ESG analysis into investment decisions and investment management. The Toolkit provides short summaries of the relevant ESG-related international standards and conventions; an extensive list of questions which can be asked during an ESG due diligence; an ESG reporting framework template (with additional information and insights relating to sample industries with high ESG risks), an action plan template and advice on ESG reporting.

CDP Questionnaires

The CDP questionnaires help companies and municipalities to measure, disclose their impacts on the environment and natural resources and take action to reduce them . CDP collects information on climate change, water and forest-risk information and puts these insights at the heart of strategic business, investment and policy decisions.

GPs may find the CDP questionnaires useful for identifying and monitoring relevant environmental issues at their portfolio companies. CDP questionnaires contain various industry specific modules (e.g. Oil & Gas, Auto, ICT, Electric Utility, Food Beverage and Tobacco sectors). CDP offers an analytical tool which enables a quick comparison of responses across geographies, sectors or to particular questions on the climate change questionnaire.

The CDP is working on a pilot project for private equity, aiming to work with investors and their portfolio companies to drive environmental disclosure and action. CDP will work with private equity investors to build a targeted list of questions for their portfolio companies based on specific sector materiality considerations, and to analyse the collected data.

European Bank
for Reconstruction and Development

The European Bank for Reconstruction and Development: Performance Requirements and guidance for clients

The EBRD Performance Requirements and guidance for clients presents the project requirements which must be met by lenders if they are to receive financing from the bank. The bank has defined ten environmental and social performance requirements, such as “Biodiversity Conservation and Sustainable Natural Resource Management”, “Labour and Working conditions” and “Information Disclosure and Stakeholder Engagement”. The documents which accompany these requirements include possible mitigating actions and specific targets for each area.

GPs can refer to these documents in order to obtain a better understanding of and how to mitigate against environmental and social issues.

EDF ENVIRONMENTAL DEFENSE FUND

Environmental Defense Fund: ESG Management Tool for Private Equity

EDF’s ESG Management Tool for private equity is a self-assessment tool whereby a GP’s current ESG-related management practices are benchmarked against current best practices. GPs will find this tool helpful in understanding how they are performing against current best practice areas and in identifying where they can improve.

ESG Disclosure Framework for Private Equity

The ESG Disclosure Framework for Private Equity

The ESG Disclosure Framework for Private Equity outlines eight objectives common to many LPs who want more structured ESG disclosure from their PE investments. The first five objectives relate to the fund due diligence process, and the final three relate to disclosure during the life of the fund. Guidance is also provided on the disclosure of information around unexpected events which might pose reputational risks to an LP, GP or portfolio company. GPs can obtain a better understanding of LP expectations and how to achieve those expectations.

EVCA EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL ASSOCIATION CREATING LASTING VALUE

European Private Equity and Venture Capital Association: Handbook of Professional Standards

The EVCA Handbook of Professional Standards aims to assist and educate GPs on the principles and standards (relating to governance, transparency and accountability) that the association expects from its members. GPs can use this guide to review how their processes, especially with regards to governance, compare with the EVCA standards.

FMO
Entrepreneurial
Development
Bank

FMO: E&S Risk Management Tool for Private Equity Investment

The Dutch development bank's (FMO) E&S toolkit is based on the IFC Performance Standards. It provides an overview of the most relevant E&S risks for a particular investment, a score for the effectiveness of E&S risk management and the main E&S opportunities. The tool also distinguishes between sector and country risks. For individual investments, the tool enables a structured approach to E&S due diligence and E&S management reviews. At the portfolio level, the tool provides a graphical overview of the aggregated E&S situation of the entire investment fund.

Global Reporting Initiative™

The Global Reporting Initiative

The GRI has specific guides and guidelines for reporting in different industries and sectors. The GRI offers a wealth of sector-specific guidance on sustainability metrics and reporting. This includes a Sustainability Reporting Framework, with guidelines, templates and checklists.

The templates for sustainability reporting in different industries offer GPs an idea of the various issues which it may encounter at its portfolio companies.

IFC International Finance Corporation World Bank Group

International Finance Corporation: Environmental and Social Management Toolkit for Private Equity

The IFC has developed the Environmental and Social Management Toolkit for Private Equity to operationalise its performance standards. It is designed to assist GPs in assessing and managing the environmental and social risks and opportunities of their investments. The toolkit is organised into a three-phase investment cycle (screening, appraisal, management) and generates the main E&S issues to be addressed for each investment. An online assessment engine (the 'ES-gine') offers resources and templates to help tackle the identified E&S issues.

IFC International Finance Corporation World Bank Group

International Finance Corporation: FIRST for Sustainability

The IFC's FIRST for Sustainability portal provides financial institutions with guidance on how to manage environmental and social risks and opportunities in their investment activities. The portal covers ESG factors across different sectors and regions. The portal also provides guidance on how to implement an Environmental and Social Management System, how to conduct E&S due diligence for investment opportunities and how to create a pipeline of new business opportunities which target specific environmental needs.

Institutional Limited Partners Association: Standardised Due Diligence Questionnaire

The ILPA Due Diligence Questionnaire Tool covers topics related to fund diligence with one section dedicated to governance and another section dedicated to risk/compliance/ESG. This checklist gives GPs a clearer idea of LPs' ESG expectations during the fundraising period. The tool presents metrics which can be used to assess a GP on ESG, including an overview of the various ESG initiatives which GPs can join.

PRI Reporting Framework 2013/14

Signatories of the PRI are required to report on their implementation of the Principles through the annual reporting and assessment process.

GP signatories and non-signatories can use the indicators included in the Direct – Private Equity module as guidance on how to integrate ESG factors into their investment processes and the Overarching Approach module as guidance on how to integrate ESG factors into their organisation. GPs can also refer to the SAM (Selection, Appointment and Monitoring) Module to understand how LPs might be considering integrating ESG considerations into manager selection and monitoring processes.

PRI: Responsible investment in private equity: A guide for limited partners (2nd ed)

The LP guide helps LPs assess the extent to which a GP's investment and ownership processes are consistent with the LP's own commitments as a PRI signatory. The guide applies to LPs with different PE strategies. For GPs, this LP Guide offers an overview of the possible ESG related issues which LPs may want to discuss with them with examples of associated questions.

Sustainability Accounting Standards Board

SASB is developing industry-specific sustainability standards for the recognition and disclosure of material ESG impacts by companies which are traded on U.S. exchanges. SASB is mapping the relevant ESG issues for each of the sectors that it currently covers: Health Care, Financials, Technology & Communications, Non Renewable Resources, Transportation, Services, Resource Transformation, Consumption, Renewable Resources & Alternative Energy, and Infrastructure. For each of the industries in these sectors, SASB identifies which ESG factors are likely to be material and provides associated accounting metrics.

GPs can use these standards to determine which ESG issues are likely to be material within different industries and the associated metrics which can be used for reporting.

APPENDIX B – RESOURCES FOR FURTHER READING

- DB Climate Change Advisors / Deutsche Bank Group, Sustainable Investing - Establishing Long-Term Value and Performance, (June 2012)
- Doughty Hanson &WWF-UK, Private equity and responsible investment: an opportunity for value creation, (2011)
- Josh Dowse, ESG and Due Diligence, (Keeping Good Companies, pp659-664, December 2009)
- Institute for Responsible Investment at the Boston College Center for Corporate Citizenship, Handbook on Responsible Investment Across Asset Classes, (November 2007)
- Institutional Limited Partners Association, Private Equity Principles Version 2.0, (2011)
- International Finance Corporation, Performance Standards on Environmental and Social Sustainability, (January 2012)
- KPMG / Vincent Neale and Jonathan Martin, Responsible Investment – The time is now: Modelling how Environmental, Social & Governance factors can impact risk-adjusted returns, (May 2011)
- Malk Sustainability Partners, ESG in Private Equity - 2013, (2013)
- MSCI ESG Research, Integrating ESG into the Investment Process: From Aspiration to Effective Implementation, (August 2011)
- Novethic, Where do private equity businesses stand on the integration of ESG issues?, (Working paper, July 2009)
- Price Waterhouse Coopers, Putting a Price on Value, (2013)
- Private Equity International, The Guide to Responsible Investment: Creating value in private equity with effective ESG management, (ed. Tom Rotherham, March 2011)
- Robeco Sustainable Private Equity Program, Responsible Entrepreneurship Report 2010, (2011)
- Jason A. Scharfman, Private equity operational due diligence: tools to evaluate liquidity, valuation, and documentation, (The Wiley finance series, no.731; April 2012)
- The Environment Agency Pension Fund mandate with Robeco Private Equity, Responsible Investment in Sustainable Private Equity: A Case Study, (2011)
- Maaike van der Schoot, How can GPs integrate ESG? An LP's perspective, (PEI Guide to Responsible Investment, March 2011)

APPENDIX C – EXAMPLES OF ESG FACTORS

Figure 4: A non-exhaustive list of ESG factors
Source: Responsible investment in private equity – a guide for limited partners (2nd edition), PRI, p. 24

EXAMPLES OF ESG FACTORS		
ENVIRONMENTAL	**SOCIAL**	**GOVERNANCE**
Air and water pollution	Customer satisfaction	Accounting standards
Biodiversity	Data protection and privacy	Anti-competitive behaviour
Climate change *	Diversity and equal opportunities	Audit committee structure
Deforestation	Employee attraction and retention	Board composition
Ecosystems services	Employee engagement	Bribery and corruption
Energy efficiency	Government and community relations	Business ethics
Hazardous materials	Human capital management **	Compliance ****
Land degradation	Human rights	Executive remuneration
Resource depletion	Indigenous rights	Lobbying
Waste management	Labour standards ***	Political contributions
Water scarcity	Labour-management relations	Risk management
	Marketing communications	Separation of chairman and CEO
	Product mis-selling	Stakeholder dialogue
	Product safety and liability	Succession planning
	Supply chain management	Whistleblower schemes

* including policies to mitigate climate change and the impacts of climate change
** including training and education
*** including freedom of association and collective bargaining, child labour, forced labour, occupational health and safety, living wage
**** including fines and other sanctions

APPENDIX D – OVERVIEW OF INTERVIEWS

Spring Associates conducted interviews with 47 GPs and 4 LPs as research for this guide. The majority of these interviewees are PRI signatories. The interview selection process was led by Spring Associates with oversight and input from the PRI GP Guide Working Group.

The following describes how the GPs and LPs interviewed for this guide were selected.

- Using Thomson Reuters data, Spring Associates mapped the current global PE industry by geography, PE strategy (e.g. buy-out, venture capital, and real-estate) and aggregate fund size.
- Spring Associates selected a target list of interviewees distributed by region, investment strategy and size.
- This list was submitted to the PRI GP Guide Working Group for approval. Working group members also suggested organisations to be interviewed. These organisations were not necessarily signatories to the PRI but had demonstrated that they are integrating ESG considerations into their investment practices.

ORGANISATION	LOCATION OF INTERVIEW
3i Group	UK
Actis	UK
Adams Street Partners	USA
AlpInvest Partners B.V.	Netherlands
Altor	Sweden
Apax Partners MidMarket	France
APG Asset Management	Netherlands
Arcano Asset Management	Spain
Ardian	France
Auda International L.P.	Germany
bcIMC	Canada
Berkeley Energy	Singapore
Blue Wolf Capital Partners	USA
Bridges Ventures	UK
Canada Pension Plan Investment Board	UK
CapMan Plc	Russia
Carlyle Group	USA
CDC Group	UK
Commonfund	USA
CVC Capital Partners	UK
Direct Capital	New Zealand
Doughty Hanson	UK
Egeria	Netherlands
EQT	Sweden
Eurazeo	France
First Reserve	USA

ORGANISATION	LOCATION OF INTERVIEW
FMO	Netherlands
Generation Investment Management LLP	UK
Global Environment Fund	USA
Hamilton Lane	USA
Headland Capital Partners Limited	Hong Kong
IDFC Alternatives	India
Idinvest Partners	France
Investec Asset Management	South Africa
Ironbridge Capital	Australia
Kendall Court	Singapore
Kohlberg Kravis Roberts & Co. L.P.	USA
Lunar Capital	China
NewQuest Capital Partners	Hong Kong
North Sky Capital	USA
Oak Hill Capital Partners	USA
PAI Partners	France
Pantheon	UK
Permira	UK
PGGM	Netherlands
Rabobank	Netherlands
SEB	Sweden
Stafford Private Equity (formerly Quay Partners)	Australia
TPG Capital	USA
VantagePoint Capital Partners	USA
Vietnam Holding Ltd	Switzerland/ Vietnam

PREPARATION OF THIS DOCUMENT

The PRI engaged Spring Associates to conduct the research and develop the content for this Guide. The document was co-written by Spring Associates and the PRI Secretariat with input from the PRI GP Guide Working Group. The PRI Secretariat would like to thank all contributors for their significant input into this document including:

PRI GP GUIDE WORKING GROUP

- Chair: Haran Narulla, Blue Wolf Capital Partners
- Sara Robinson, Adams Street Partners
- Marta Jankovic, APG Asset Management
- Candice Brenet, Ardian
- Michelle Kathryn Essomé and Dara Owoyemi, AVCA
- Lauren Caplan, Commonfund
- Chloë Sanders, CVC Capital Partners
- Jennifer Choi, EMPEA
- Therése Lennehag, EQT
- Yannick Grandjean, Eurazeo
- Caitlyn MacDonald and Kimberlie Saint Louis, First Reserve
- Peter Tynan, Global Environment Fund
- Ana Lei Ortiz, Hamilton Lane
- Joanne Saleeba, HESTA Super Fund
- Andrew Malk and Topaz Simply, Malk Sustainability Partners
- Darren Massara, NewQuest Capital Partners
- Blaise Duault, PAI Partners
- Dushy Sivanithy, Pantheon
- Tim van der Weide, PGGM
- Silva Deželan, Rabobank

AUTHORS

Maarten Biermans, Ebel Kemeling and Willem van Lanschot, Spring Associates
Fong Yee Chan and Natasha Buckley, PRI
Edited by Akif Chaudhry and Brett Phillips, PRI
Designed by Alessandro Boaretto, PRI

CONTACT PRI

implementation.support@unpri.org
www.unpri.org

CONTACT SPRING ASSOCIATES

ebel.kemeling@spring-associates.com
maarten.biermans@spring-associates.com
www.spring-associates.com

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP Finance Initiative
Changing finance, financing change

UN Global Compact

Launched in 2000, the United Nations Global Compact is a both a policy platform and a practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with 10 universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

United Nations Global Compact