ESG in Private Equity[SM] - 2013

Perspectives and best practices for managing environmental, social, and governance issues

A Study by Malk Sustainability Partners

MALK
Sustainability Partners

About MSP

Malk Sustainability Partners (MSP) is a specialty management consultancy that guides investors and businesses in developing profitable corporate sustainability strategies. MSP advises private equity firms to reduce exposure to environmental, social, and governance (ESG) risks, cut operating expenses in portfolio companies, and respond to investors' increasing expectations around ESG management. MSP's deep expertise and seasoned technical team position us as a trusted advisor to numerous investment institutions, providing them with the tools to reach ESG success.

For more information to understand how ESG management can enhance returns at your firm, please visit us online at:

www.malksp.com

Acknowledgments

MSP would like to thank all of the private equity professionals who generously participated in interviews with our team. We would also like to thank and acknowledge the Environmental Defense Fund for its continued support and review of this study.

Table of Contents

Introduction

ESG management is growing up. Over the past year, more private equity firms have initiated ESG efforts and programs. Those with programs are pushing further. As a relatively young concept in private equity, ESG management is catching on as an important area to align general partner (GP) performance with limited partner (LP) interests. This year we witnessed the release of the ESG Disclosure Framework, which provides guidance to GPs and LPs about how to communicate ESG information. In an increasingly competitive investing and fundraising environment, GPs are developing ESG management capability as an additional tactic in the active value creation toolbox. In addition, the application of ESG management to private equity investing is becoming more targeted and clearly correlated to generating value. Initially understood as a crude instrument to apply broadly across investing activities to capture fleeting value creation opportunities, the industry has begun to conceive of ESG management as a means to determine material issues and then guide their management. For this reason, ESG management programs cannot be designed as a 'one size fits all' solution. Rather, materiality is defined for each firm by the sector, location, and size of companies in which it invests.

MSP's *ESG in Private Equity*℠ - 2013 survey found that LP ESG interests are being driven more than ever by the desire to enhance risk management and protect reputations, translating into greater expectations for action and disclosure from GPs. In a practical alignment of interests, GPs are answering this call, and adopters are rapidly beginning to uncover added value from ESG management. Our interviews found growing attention to ESG issues, as reflected by increased levels of commitment to program development and management. The private equity sector is at a frontier, where middle market firms are now following the larger early adopters in developing their capabilities to manage ESG issues.

The *ESG in Private Equity*℠ - 2013 survey would not be possible without the gracious participation of so many LP and GP institutions. The insights they shared during our interviews allow MSP to regularly report on the state of the market and best management practices for the benefit of the larger investment community and its stakeholders.

Andrew Malk
Managing Partner
Malk Sustainability Partners

Background

MSP's *ESG in Private Equity*SM - 2013 strives to be an authoritative source of current market intelligence on the adoption of ESG management as well as a concrete guide on best practice. Through extensive telephone interviews with senior professionals at participant firms, we gather information from a set of consistent questions as well as address new topics to expand our knowledge base.

*ESG in Private Equity*SM - 2012: A Retrospective

During March and April 2012, we interviewed 19 private equity institutions, including GPs and LPs headquartered in the U.S., Europe, and Australia to produce a study capturing the state of the market and highlighting best management practices for ESG. Our research was released in September 2012, in our inaugural study, *ESG in Private Equity*SM - 2012, in collaboration with the Environmental Defense Fund (EDF).

Last year, interviews were structured around three primary topics: awareness and importance of ESG, current and anticipated management capabilities, and potential drivers of ESG. Our 2012 findings demonstrated increasing consideration of ESG issues and highlighted the tools and best management practices being employed. Using our 2012 research as a foundation, our team constructed the 2013 survey to uncover a broader and deeper understanding of how private equity firms allocate ESG management responsibilities to achieve effective program integration.

*ESG in Private Equity*SM - 2013

Participants

MSP conducted interviews with investment, investor relations, and ESG professionals at 19 private equity GPs and 12 LPs with capital allocated to private equity. To provide holistic state of the market information, our survey includes GPs and LPs that vary in geographical focus, investment strategy, and asset size.

GP and LP participants were located in the U.S., Europe, and the Middle East. The GP sample includes firms with assets under management ranging from less than $1 billion to $170 billion that specialize in buyout, growth capital, distressed, and diversified strategies. The LP sample includes university, municipal, state, and national pension funds as well as fund of fund investors.

A full list of the 2013 participant firms can be found in **Appendix A**.

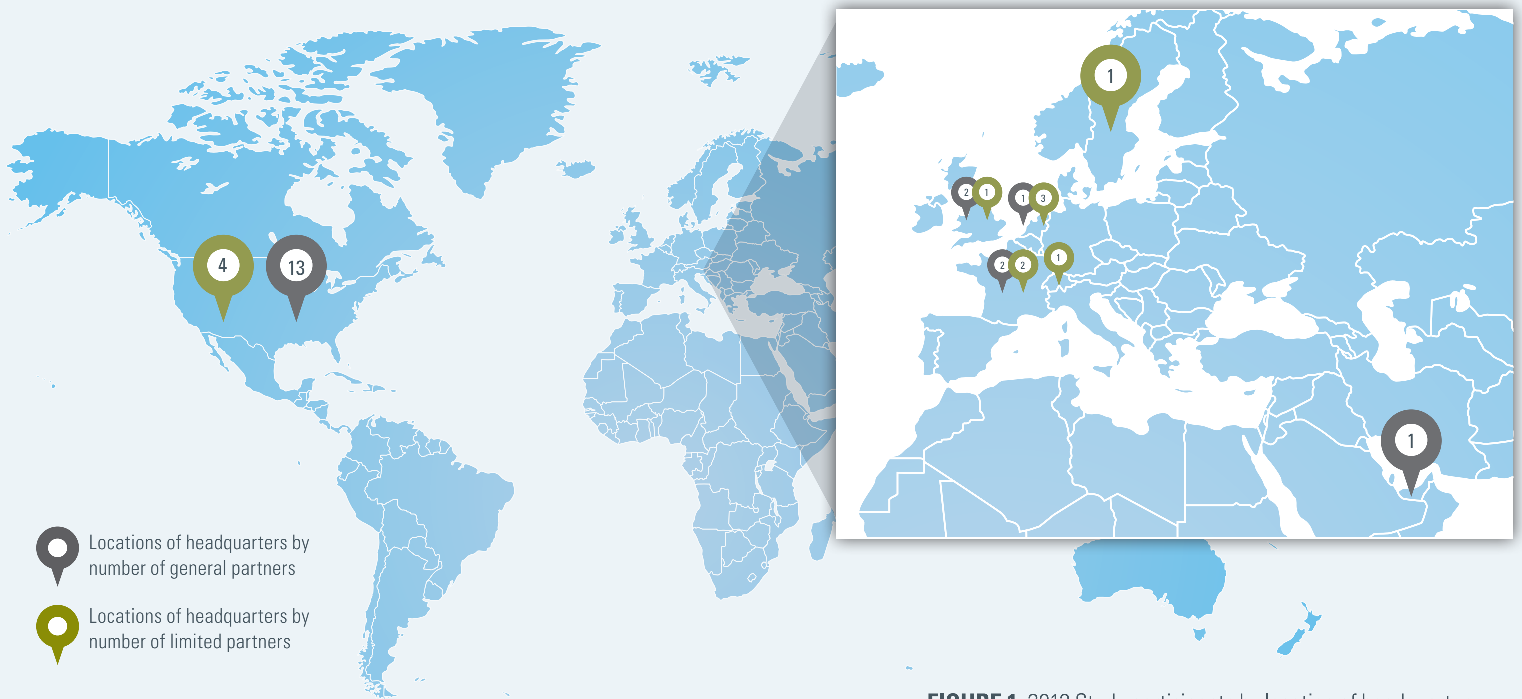


FIGURE 1: 2013 Study participants by location of headquarters

Structure

Information from conversations with participants was organized into three sections presenting observations on the current state of the market and commentary about best management practices:

1. Factors Propelling Adoption of ESG Management
2. Trends in ESG Commitment
3. Structuring ESG Capabilities for Effective Action

Interviews revealed that our 2012 categorization of GP best management practices remain current and accurate, as most participants fell into one of three categories: Emerging, Developing, and Leading.[1] For each category, the matrix on the following page displays typical behaviors in the areas of leadership, people, diligence, operations, metrics, and communication.

1 By extending this year's sample well beyond early adopters to include a broader segment of the market, we surveyed firms that had not yet reached our Emerging category – this caused a slight decrease in some year-to-year averages.

	Leadership	People	Diligence	Operations	Metrics	Communication
LEADING	» Develop fund specific approaches » Develop ESG criteria for each stage of the investment cycle	» Involve investment professionals and investment committee » Empower ESG team to partner with portfolio companies » Engage stakeholders and NGOs	» Create geography and sector specific ESG policies » Integrate ESG opportunities into 100 day plans » Create investment committee ESG guidelines	» Create an ESG community and platform to share best practices and resources among portfolio companies	» Leverage industry forums and case studies to showcase accomplishments » Measure impact of social and governance initiatives on investments	» Participate in collaborative research and tool development
+ DEVELOPING	» Express senior management support of ESG initiatives » Become a UN PRI Signatory » Adopt internal ESG management policy and metrics	» Engage consultants/ advisors to develop fund level ESG management platform » Hire in-house ESG professionals	» Standardize procedure for integrating ESG into due diligence » Involve ESG team in due diligence	» Measure results and share lessons learned across the portfolio	» Establish value-oriented ESG goals » Benchmark ESG metrics across portfolio	» Integrate ESG program and accomplishments into fundraising materials » Develop corporate citizenship reports
+ EMERGING	» Leverage US PEGCC GRI	» Engage consultants/ advisors for specific ESG related projects	» Adopt sector specific ESG due diligence criteria » Conduct legal compliance and contamination diligence	» Partner with individual companies to identify opportunities for operational improvements	» Adopt standards and processes for measuring ESG metrics » Identify relevant ESG metrics	» Develop ESG case studies » Participate in industry forums

FIGURE 2: 2012 GP best management practices

Executive Summary

Our Approach

During the second quarter of 2013, MSP interviewed 31 GPs and LPs in the private equity sector. Conversations explored the evolution of the sector's efforts to manage ESG issues over the past year by examining drivers and levels of commitment, modes of communication, and organizational structures of effective management programs.

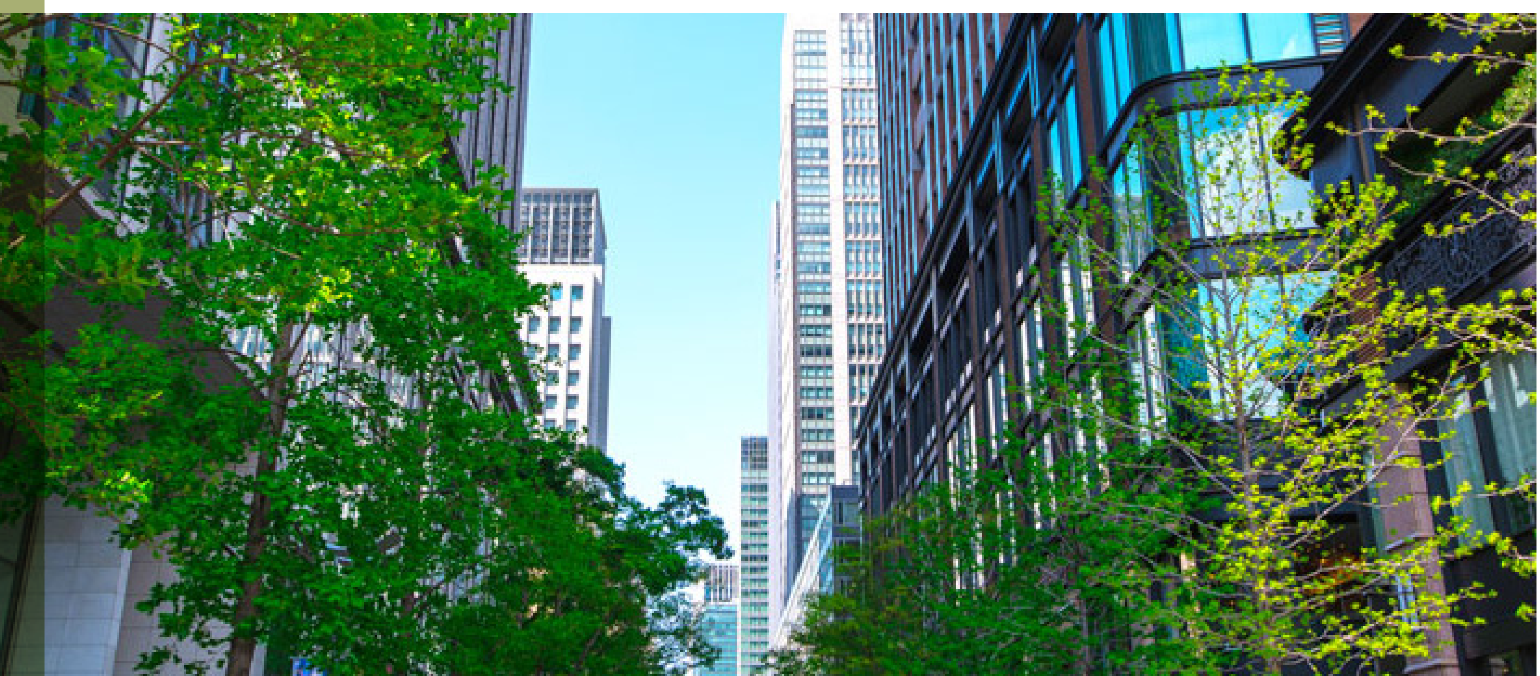
Our Findings

Discussions revealed the following themes about the state of ESG in private equity in 2013:

- **Despite almost doubling the sample size from 2012, *ESG in Private Equity*SM - 2013 uncovered significant evidence of continued growth in ESG management from both LPs and GPs.** A majority of LP and GP respondents stated that their commitment to ESG had increased over the previous 12 months, supported by dozens of examples of evolutionary steps taken in their ESG policies, management practices, and personnel decisions.
- **GP action is still largely spurred by LP attention to ESG management practices and customized to portfolio company operations.** GPs often view ESG management as a way to further align interests across funds' investors, and more are actively creating value by optimizing application of risk mitigation and efficiency tactics to portfolio companies. Both the LP and GP communities more fully recognize the importance of ESG management to achieving the best risk-adjusted returns.
- **Risk mitigation is increasingly systematized, with GPs reviewing investments during diligence and ownership.** It is becoming quite common to submit an ESG memo to the investment committee or include an ESG slide in the investment deck identifying labor and environmental practices that have potential to influence companies' performance.
- **GP disclosure to LPs is advancing beyond describing management processes to explaining process implementation.** LP expectation for GP disclosure is evolving from simply responding to due diligence questionnaires (DDQs) to discussing DDQ answers and addressing periodic LP inquiries.
- **Leading GPs integrate programs by building firm-wide awareness and decentralizing responsibility.** No longer strictly the domain of investor relations and general counsel, integrated ESG programs increasingly rely on investment and operating professionals to execute ESG efforts at portfolio companies, ESG professionals to advance and transmit program content, and investor relations professionals to communicate with LPs.

2013 Survey Results

- 58% of LP participants have increased their commitment to ESG management in the previous 12 months. 42% indicated that their commitment remained stable, many of whom explained this is because their long-standing commitment has already generated effective programs.
- Risk management and reputation (75%) drive LP participants' adoption of ESG management.
- 75% of participating LPs inquire about GP ESG management during fund manager selection.
- 75% of LP participants prefer or require ESG disclosure from managers in the forms of incident alerts and descriptions of management processes, while 33% favor disclosure of process implementation in case studies and annual reports.
- 74% of GP participants have increased their ESG commitment in the previous 12 months, with 26% indicating no change in commitment level.
- GP participants reported LP expectations (84%) and cost savings (68%) drive ESG adoption.
- 84% of GP participants have discussed the need for an ESG policy with senior management and 63% have developed a process to manage ESG. 37% described ESG management programs that integrate responsibilities across functional roles.



1. Factors Propelling Adoption of ESG Management

LP Drivers

Risk Management and Reputation are Primary LP ESG Drivers

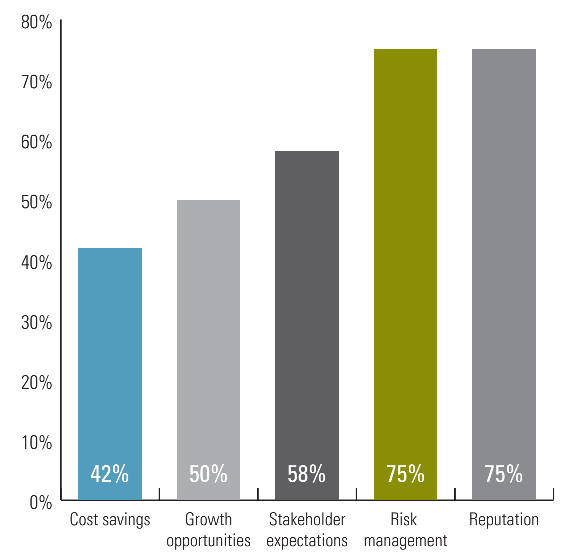
Since LP expectations were identified as the number one driver of GP action, we begin with an assessment of factors LPs reported as motivating their consideration of ESG in private equity investment.

Risk management and reputation are the two primary drivers. While the two are logically connected, as poor risk management can lead to reputational harm, LPs highlighted that an ESG lens expands the breadth of risks considered, which helps preserve a positive reputation. Throughout the study we call out how this LP emphasis on risk management and reputation manifests in LPs' ESG commitment and communication with GPs, for example showing a preference for ESG incident alerts as one of two favored forms of GP communication.

LPs also communicated the importance of GPs pursuing ESG-related cost savings and growth opportunities; however, they clarified these more as added benefits than direct drivers of their ESG focus. LPs explained that ESG-related value creation opportunities are GP responsibilities and ways for GPs to distinguish their management capabilities and performance.

> "We want to be sure these issues are being managed because if an issue does arise it can impact both reputations and returns. For pension funds, the end goal is to ensure that these issues are managed so that we can make appropriate returns."
>
> - David Russell, *Universities Superannuation Scheme*

FIGURE 3: Drivers of ESG adoption at LP participants



Fiduciary Role Favors Manager Selection on the Basis of Risk Management and Capital Allocation

Many LPs specified that their risk-oriented perspective on ESG aligns with their general approach to institutional investment in private equity. That is, LPs consider it their fiduciary responsibility to maximize rates of return. When investing in private equity, they primarily select GPs on the basis of historic fund returns. However, in an increasingly competitive fundraising environment, LPs have begun to expand operational diligence to more fully consider GP processes to manage risk and create value.[i] Similarly, as general partners, fund managers assume the responsibility of determining optimal allocation of capital to maximize returns while managing risks capable of diminishing them. This natural division of fiduciary responsibility in private equity partnerships underlies LPs' distinction between the importance of GPs pursuing ESG-related opportunities to create value as a form of best practice and the fact that ESG-related risk management is what really drives LP attention today.

"When a business case shows that implementation costs of ESG initiatives are too high, fine, but without a business case you cannot claim for certain that ESG falls outside of your fiduciary responsibility."

- Tim van der Weide, *PGGM*

LP Stakeholders Have Varying Influence

Stakeholders of our LP participants include pensioners, university students, high-net-worth individuals, and, in some cases, other investment institutions. Stakeholder expectations were another driver cited by a majority (58%) of LP participants. The most commonly communicated stakeholder view on ESG is that it is an effective way to accomplish good corporate citizenship in private equity investment. Confirming that stakeholders' ESG views are a significant driver for LPs, we sought to better understand whether this is consistent with a well-documented bifurcation in the level of ESG attention between U.S. and European LPs. Indeed, we found that European stakeholders communicate concern more frequently through organic mechanisms: typically emails, NGO-led online surveys, and board meeting participation. Communication of this form and frequency was referenced as a factor that accelerates LP board-level attention to ESG concerns.

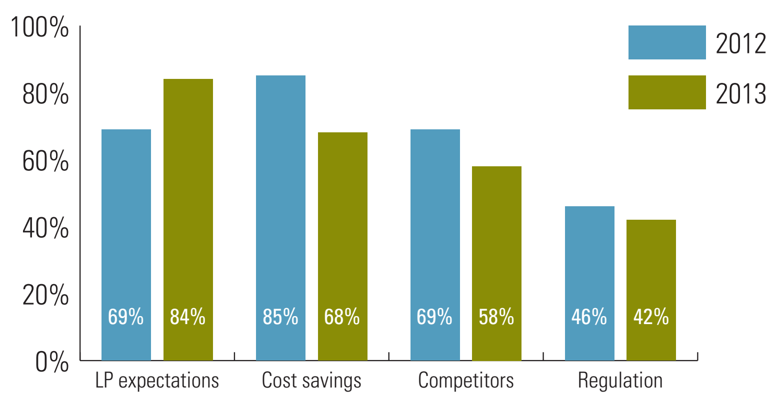
"For our stakeholders, it is really about good corporate citizenship and investors being able to look at stakeholders and say they are good corporate citizens."

- Richard Clarke-Jervoise, *Quartilium*

GP Drivers

LP Expectations Are Paramount

FIGURE 4: Drivers of ESG adoption at GP participants



Across the spectrum of firm size and level of ESG management, aligning GP management practices to LP interest is the leading driver of action. This is the most notable change from 2012 to 2013, as the most commonly cited driver switched from cost savings to LP expectations. This may be indicative of the fact that LP attention to ESG performance is becoming more evident to GPs as well as more important in the context of a competitive fundraising environment with an increasing inventory of assets to sell.[ii]

"ESG is an important element of our investment strategy and it is likely that our LPs will reinforce this agenda."

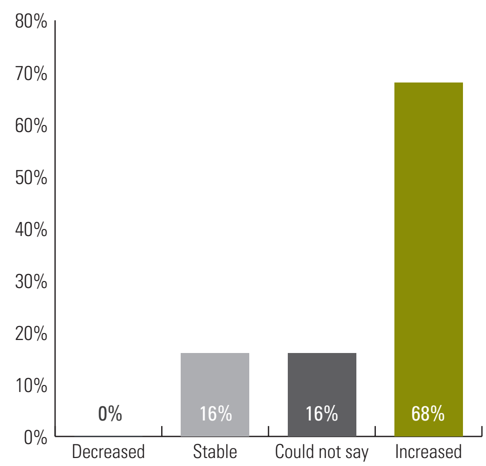
- J. Taylor Crandall, *Oak Hill Capital Partners*

GPs Report Increased LP Attention to ESG in the Previous 12 Months

Consistent with LP expectations cited as driving adoption by the greatest proportion of the GP subsample, 68% of GPs reported LP attention to the issue has increased over the previous 12 months.[2] The remaining 32% of participants were split evenly between not being able to speak to LP attention, either because of lack of access due to their functional role or fundraising activity, and reporting attention levels had remained stable.

The 2013 findings are consistent with 2012 responses. Last year, 77% of the GP participants expected investor focus on ESG to increase in the following 3 to 5 years. Considering the 2013 question was asked to a broader sample set in a narrower time frame, this consistency in year-over-year responses strongly suggests that GPs experience LP attention to ESG issues growing and will continue to do so.

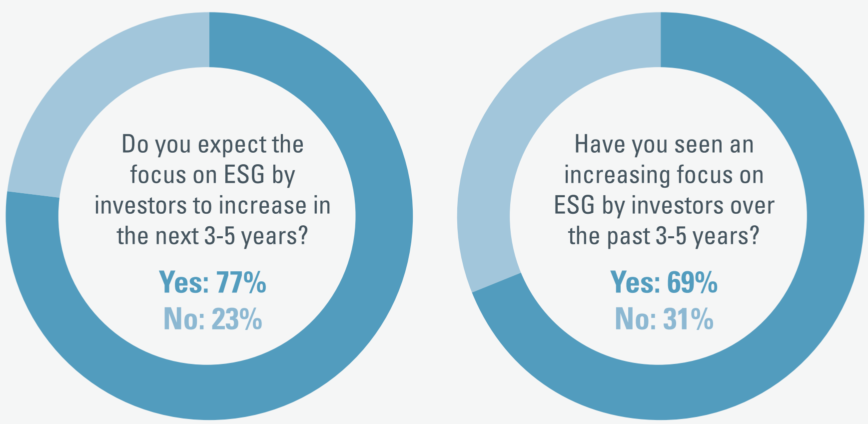
FIGURE 5: 2013 GP perception of LP attention to ESG management during previous 12 months



"Expanded risk management for brand and reputation is a big LP consideration."

-Bryan Corbett, *The Carlyle Group*

FIGURE 6: 2012 GP expectation and perception of increasing investor focus on ESG



Regulation Continues to Be Only a Modest Driver

While the proportion of GPs driven by regulation remained similar between 2012 and 2013, our team noted an expansion in the types of firms that reported it as material. In 2012, primarily European firms reported carbon and anti-bribery regulations as driving ESG management. However, in 2013 an increased number of U.S. firms reported regulation as a driver. This was often described as increased exposure to changes in the regulatory environment and contextualized as a result of policy makers paying more attention to private equity, for instance, requiring many firms to register with the SEC under the Dodd-Frank Act.[iii] Many firms' recently escalated sense of exposure to potential regulation seems to be extending the impact of regulation as a driver to U.S. firms, while remaining pertinent in Europe.

2 Given that risk mitigation is the primary factor driving LP adoption of ESG management and that LP expectations overtook cost savings as the primary GP driver, it is likely that risk mitigation is a material driver of GP adoption of ESG management as well. Risk mitigation was not explicitly offered as a choice when asking about GP drivers for year-to-year consistency.

2. Trends in ESG Commitment

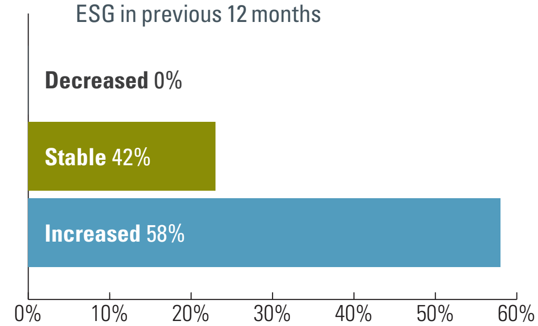
LP Commitment to ESG

LPs are Directing More Attention to ESG Management in Private Equity

Overall, we found that LP personnel responsible for capital allocated to private equity pay attention to ESG issues. While the LP sample skewed toward larger and European LPs, all but one LP reported that ESG is discussed in their investment committees and they had contemplated joining UN Principles for Responsible Investment (PRI). Unlike the GP subsample, the majority of LPs that considered joining PRI progressed to become signatories.

58% of our 2013 LP participants reported an increase in their commitment to ESG management in the previous 12 months. When asked why, institutions with nascent efforts referenced refocusing on ESG during the recovery from the 2008 financial crisis, while advanced institutions cited efforts to further systematize ESG management in private equity investment processes and set internal examples. Participants that reported stable levels of commitment over this period included both institutions lacking ESG commitments and institutions with long standing commitments and highly functional programs. The latter type explained their programs' efficacy represents successful integration of ESG into standard operation, and thus required no further levels of commitment.

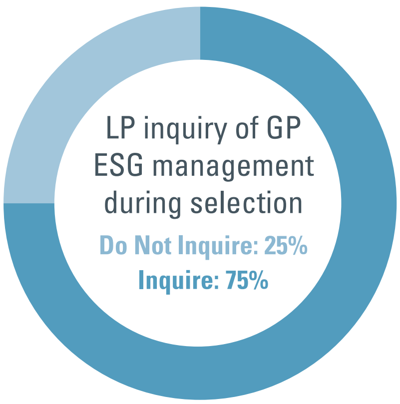
FIGURE 7: Change in LP commitment to ESG in previous 12 months



"In the future more and more GPs will integrate ESG, some to a greater extent than others; however, institutional investors will continue to ask about ESG."

-Christina Kusoffsky Hillesöy, *AP3*

FIGURE 8: LP inquiry of GP ESG management during selection



Fund Manager Selection Includes Deeper ESG Inquiry

Our interviews identified that LPs evaluate ESG management during fund manager selection. The 75% of LP participants that reported they inquire about GP ESG management explained the inquiry is addressed alongside other issues of concern in the GP selection process; that is, by including ESG considerations in their DDQs. In addition, a large portion of these participants reported further investigative best practices, including following up on flagged issues with direct discussions and prescribing conditions in which managers must communicate material events and progress. Those most advanced LPs reported having moved from including ESG concerns in side letters to addressing the issue in their limited partnership agreements.

CalSTRS 21 Risk Factors:

An example of an advanced U.S. institutional investor, CalSTRS employs its 21 Risk Factors to systematize ESG consideration with investment managers as part of investment analysis and decision making. Institutional policy states all investments are to be assessed using the factors, which include issues such as air quality, climate change mitigation, and workers' rights and safety.

CalSTRS outlines that it is within its fiduciary responsibility to consider these factors, but CalSTRS does not select or reject investments solely based on adherence to the risk factors.

Source: CalSTRS. Green Initiative Task Force. 2012 Annual Report.

ESG Sections in DDQs Are Increasing Focus on GP Management Processes

Many participants that inquire about ESG management described increased engagement with GPs, such as efforts either to include an ESG section in the DDQ for the first time or to expand it. Most explained past inquiries infrequently required input from GPs' investment and operating professionals during follow up, but emphasized their recently expanded ESG sections delve deeper into management process and will likely require such perspective in future follow up. Likewise, some LPs that continue to develop their ESG processes reported contacting fund managers with whom they are already invested to emphasize that ESG DDQs in future placements will be more substantial and influential to fundraising.

> "The issue is not investments without risk; most investments have risks. We are interested in the mechanisms by which GPs manage and communicate any risks."
>
> - David Russell, *Universities Superannuation Scheme*

In the selection process and application of best practices described above, advanced institutions seek to speak with GP personnel responsible for ESG at specific stages of the investment cycle, often engaging beyond investor relations professionals to dedicated ESG, investment, and operating professionals. These LPs articulated that their interest in discussing ESG management with individuals involved in investment-level implementation stems from wanting to understand how managers determine materiality of issues and to ensure that process aligns with their own goals to manage risk.

In general, LPs reported that their inquiries focus on management processes rather than specific ESG issues to avoid limiting the breadth of fund managers' investment opportunities. To be clear, LPs' risk management oriented approach establishes areas for GPs to manage ESG-related risks while avoiding outright exclusions whenever possible. Many LPs, particularly U.S. ones, explained that exclusion policies create areas of ambiguity because their use in unforeseen investment circumstances can generate liabilities that undermine both parties' fiduciary responsibilities. For this reason, LPs rely on assessing GP management capabilities to understand and remained informed of risk mitigation efforts.

> "AXA believes there is great value added by investment professionals managing ESG during due diligence because they know their investments best."
>
> -Laure d'Azémar, *AXA Private Equity*

Environmental, Social, and Governance Disclosure Framework for Private Equity

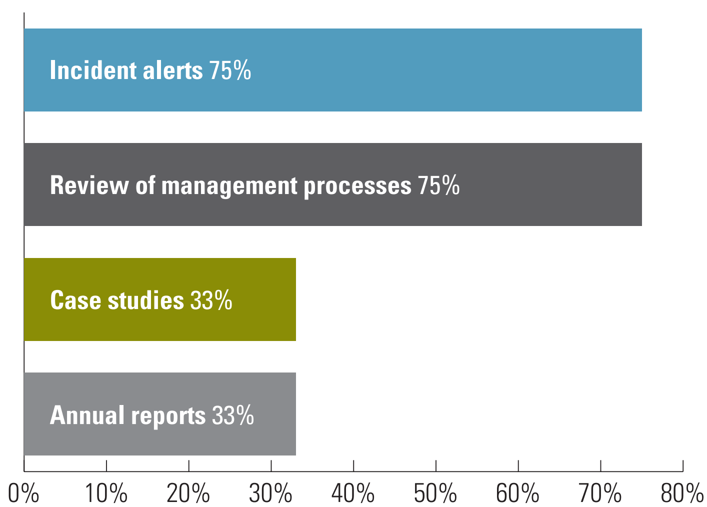
Prior to the release of the ESG Disclosure Framework (the Framework) in March 2013, the private equity sector suffered from a lack of consensus on how GPs and LPs should communicate ESG information. As the product of a collaborative effort by more than 40 LPs, 20 private equity associations, and a number of GPs from around the world, the Framework is designed to facilitate informed discussion between LPs and GPs. By offering example questions and associated forms of GP communication designed to address eight explicit objectives, the Framework serves as a document to guide, not prescribe, an effective form of ESG disclosure in private equity. Ultimately, as the Framework directs, effective and relevant ESG disclosure must be defined through discussion between GPs and LPs in the context of specific funds.

LPs Expect More ESG Disclosure

As the ESG Disclosure Framework highlights, disclosure can include documentation of ESG commitment from previous funds, case studies on efforts to manage ESG-related risks and opportunities, and, in select instances, even annual reports that roll up ESG efforts at the portfolio level.[iv] Our survey's inquiry into the type of ESG-related information LPs prefer GPs to disclose showed that 75% of LP participants are interested in management processes and incident alerts.

The most advanced LPs require regular reporting about substantive achievements in their GPs' programs. While not wanting to be inundated with unnecessary GP ESG reporting, such LPs are requiring annual or even semi-annual ESG updates that review GPs' implementation of and changes to their management processes, engagement at the portfolio company level, and efforts to share best practices across portfolios. These updates are in addition to standard protocol to communicate ESG-related incidents.

FIGURE 9: Forms of ESG disclosure LPs prefer from GPs



"One element of LP expectations is knowing the GP's ESG approach and how it changes during the life of a fund. Another element is what is going on at the portfolio-company level, such as reporting ESG metrics normalized to monetary metrics. Finally, LPs want to be aware of possible media incidents. From a portfolio management perspective we want to know the overall ESG risks and value creation we are facing."

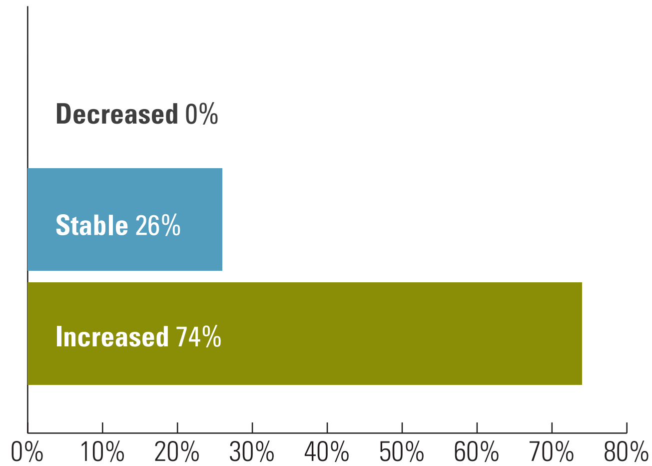
- Tim van der Weide, *PGGM*

GP Commitment to ESG

GPs' Commitment to ESG Management Increases Over the Past Year

Looking at the past year, 74% of participating firms reported having increased their levels of commitment to managing ESG. It is important to note that, similar to LP participants, a majority of firms that reported stable levels of commitment were those that already have Leading management processes. Their explanation highlighted how an early focus and appropriately designed program alleviated the need for added subsequent commitment. Such testimony should allay the fear that developing an ESG management program will continually add operating costs to firms. Participants described the process of developing an ESG program as similar to most investments: getting to an effectively integrated ESG management program requires initial dedication of time and capital, but pays off as the program identifies opportunities to harvest value and mitigate risk while its marginal cost stabilizes.

FIGURE 10: Change in GP commitment to ESG in previous 12 months



"Our commitment is still gradually evolving. There's always been a very strong commitment and it continues to grow stronger and stronger. It is more evolution rather than revolution."

- Mark Goldsmith, *Actis*

Industry Update: New PRI requirements for ESG reporting

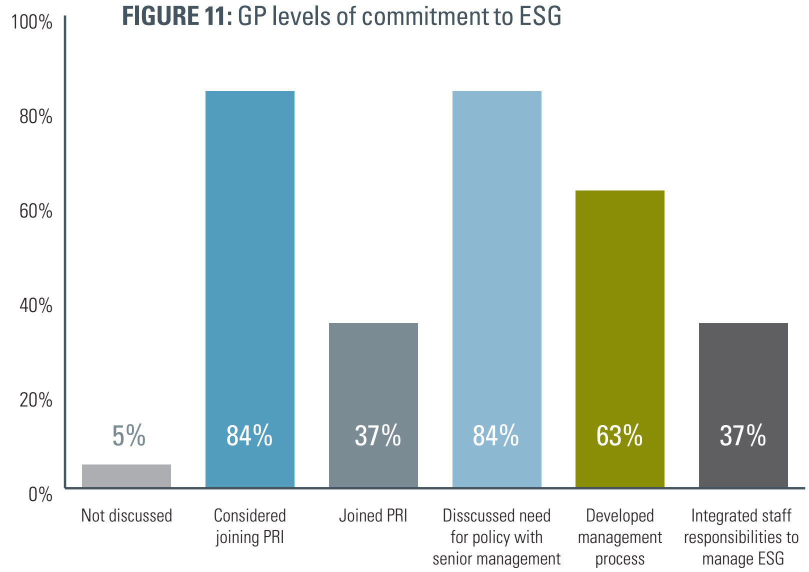
In May 2013, PRI released an overview of its **updated reporting requirements**, for which the final framework will be released October 2013. As asset managers and owners continue to ratify the principles, 184 new institutions did in 2012, PRI seeks to increase the accountability of its signatories and transparency of their responsible investment practices. To achieve this, it has developed web-based assessment tools. With fewer mandatory indicators, the updated tools provide detailed guidance to facilitate internal review. All signatories are required to report using the updated requirements; however, new signatories will continue to be given a one year grace period.

GPs Report Commitment to ESG Management Begins with Industry Organizations and Management Discussions

Our investigation of participants' levels of commitment focused on their decisions to join industry organizations, discussion of need for an ESG policy with senior leadership, development of management processes, and integration of process-responsibilities in roles across the investment cycle. The results of our 2013 survey uncovered further evidence that private equity fund managers are increasing their consideration of ESG issues.

All but one of our GP participants indicated that the topic has been discussed within the firm. Likewise, 84% reported having considered joining PRI. However, only 37% have so far decided to make the commitment and become a signatory. The fact that the same 84% of participants who had discussed the need for an ESG policy with senior management have also considered becoming PRI signatories demonstrates how emerging industry standards are often the starting point of ESG discussions with management.

FIGURE 11: GP levels of commitment to ESG



"The best advice is to just get started and look for early wins in your portfolio…Do not feel like you need to go zero to 60 right away."

- Ed Norton, *TPG Capital*

Leading GPs Integrate Responsibilities

63% of participants reported having gone beyond discussing and adopting policies to developing ESG management processes. These processes include allocation of duties to manage ESG-related risks and opportunities. However, Developing firms do not necessarily integrate them across the investment cycle by assigning ESG considerations to firm roles involved in specific phases of the investment cycle. Only 37% of our participants had achieved this Leading level of performance in their ESG management.

Our discussions with Leading firms revealed that the balance between ESG cost and benefit is struck when firm professionals have an understanding of ESG that enables them to consider ESG as a natural part of their job function. This expands the breadth and depth at which ESG is considered in the investment cycle and maximizes opportunity to create value while minimizing added cost.

This point was often mentioned by participants with investment strategies focused on emerging markets. They explained the diverse yet significant set of risks inherent to the strategy sparked early attention to the value an ESG lens brings in the form of expanded risk mitigation.

Firms with established programs as well as those at the outset of their development efforts confirm that constructing an integrated process that effectively addresses ESG concerns doesn't happen overnight or with a fixed endpoint. As ESG issues become more material to investment returns, responsibilities must be continually tuned within specific organizational structures to systematically address an expanded suite of issues.

> "By implementing ESG gradually, investment teams incorporated ESG into regular practice and have truly embraced the potential value it can create through identification and management of opportunities and risks."
>
> - Anonymous, *European Middle Market GP*

EDF's ESG Management Tool

Released December 2012, EDF's **ESG Management Tool** is designed to define the practices necessary to build a successful program and a framework to assess, analyze, and improve ESG management at private equity firms of all sizes. By evaluating performance across 22 best practice areas, including commitment and leadership from the top, access to ESG resources and expertise, integration of ESG management into the investment process and portfolio company operations, and measuring and reporting results, the Tool helps users identify areas to improve and goals to reach.

3. Structuring ESG Capabilities for Effective Action

Integrated Programs Decentralize Responsibilities

When Built Into the Standard Investment Process, ESG Management Harnesses Greater Value

As mentioned previously, less committed GP participants cited the belief that ESG management creates unnecessary added cost for the firm as the obstacle to developing ESG management capabilities. As the cost, and effectiveness, of any management program is largely dictated by the complexity of issues at hand and how associated responsibilities are allocated to personnel, our team investigated how firms allocate consideration for ESG management across functional roles and phases of the investment cycle.

"Our perspective is that integration means ESG factors are embedded in the analysis of investment managers and are not just a responsibility of the responsible investment team."

- Tim van der Weide, *PGGM*

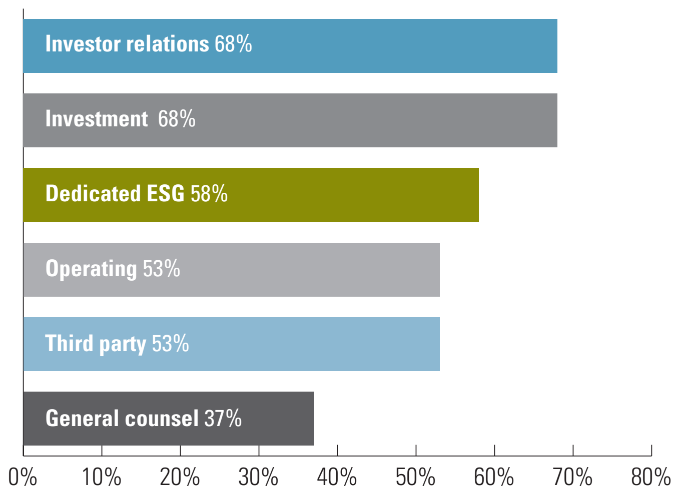
In general, we found that Leading participants are developing integrated programs by decentralizing ESG-related considerations to functional roles focused on specific phases of the investment cycle. This trend reflects firms' growth in commitment to address ESG concerns and realization of the need for them to be considered as part of, rather than parallel to, the standard investment process. While this integration process takes careful planning, participants reported that it sharpens the approach to ESG management by creating a targeted communication loop that identifies and addresses material issues.

"Being an embedded specialist within the team enables us to start thinking about ESG issues early on. It also helps in better understanding the ESG issues a company faces. For instance, the issues associated with what goes into making their products. This is important when seeking to understand whether there is anything inherent about the business that might restrict growth in some way during our holding period."

- Adam Black, *Doughty Hanson*

Decentralization of ESG Accountability Facilitates Program Integration

FIGURE 12: GP professionals participating in ESG management



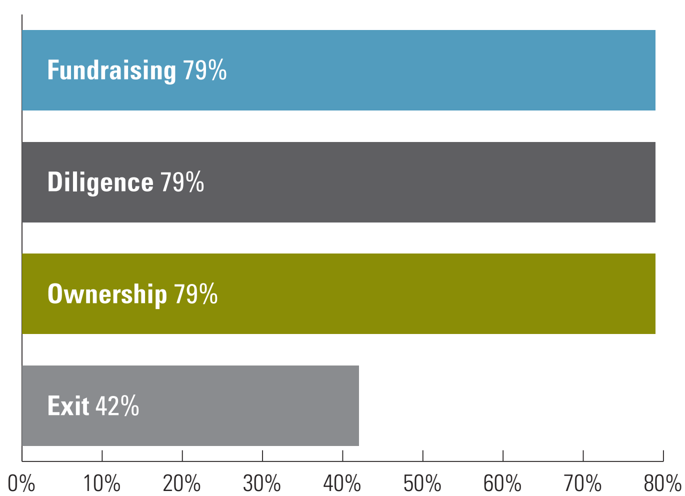
ESG management is being decentralized as it follows a path of deeper integration into firm operations. Once the domain of investor relations professionals and the general counsel, a majority of participants indicate that accountability for ESG considerations resides across multiple functional roles as well as third parties.

As ESG responsibilities are being integrated across the firm we found that Leading ESG programs typically align consideration for ESG issues to investment phase-specific tasks standard in each role. At a high level, this often breaks down to investor relations professionals receiving inbound LP ESG inquiries and tailoring outbound responses based on up to date progress; ESG professionals and/or third party experts designing programs, keeping internal knowledge bases current, and educating the firm; investment and operating professionals identifying material issues and implementing management tactics at the portfolio company level often with the guidance of consultants; and general counsel overseeing governance and compliance issues.

ESG Consideration Across Phases of the GP Investment Cycle

GP and LP Attention Focus Heavily on the Diligence and Ownership Phases

FIGURE 13: GP consideration of ESG in phases of the investment cycle



Perhaps because of LPs' role in catalyzing GP action, there was tremendous similarity between LP responses to the question "during which stage of the investment cycle do you seek managers to consider ESG" and GP responses to the question "during which stage of the investment cycle do you consider ESG." Both GPs and LPs reported their attention to ESG management concentrates on GP diligence and ownership and is most frequently communicated during fundraising. This consistency was, in part, attributed to the fact that procedures during these phases are more standardized than the exit phase. These phases provide a better opportunity to systematize ESG management processes, identify material issues, determine salient application of initiatives, and create value.

Still Inadequate Data to Quantify Value ESG Adds to Exit

While the few participants that focused exclusively on emerging markets attributed exit premiums to portfolio company ESG performance, our other participants said it is too early to understand the quantitative value ESG adds to exit. This being said, many of the latter reported portfolio companies' ESG performance is material to exit valuations by increasing probability of completing deals and limiting points of potential negotiation counterparties can leverage. These reports align with certain findings from the PRI's *Trade Buyer Survey Results*, which addressed the value of ESG management to the transaction phase in greater detail.[v] According to research led by Harvard University Prof. Robert Eccles, public companies that were early adopters of sustainability management noticeably outperformed their peers, in both stock and accounting valuations, during the past two decades.[vi] For the private equity sector's long-term investment in ESG, our team recognizes the importance of quantifying its value to the exit phase and believes that more exit data will yield these measurements in the future.

> "Oftentimes, acquirers pay a premium for portfolio companies with strong ESG standards in place."
>
> \- Geetha Tharmaratnam, *The Abraaj Group*

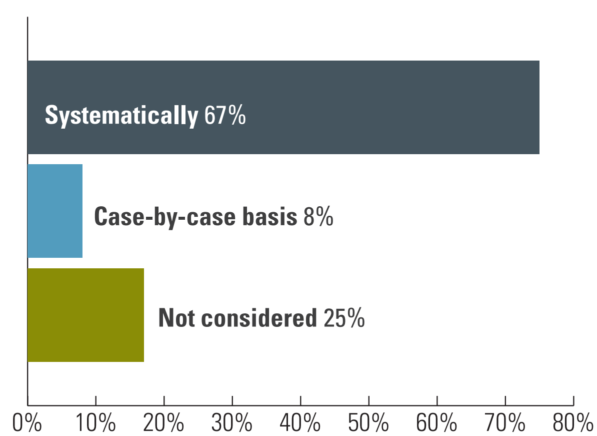
> "Diversey, a provider of cleaning and hygiene solutions for commercial customers, developed cleaning solutions that helped their customers improve environmental performance. The company's leadership in sustainability was not only a source of great pride among its employees and an important factor in its favorable positioning with customers, but was also cited by Sealed Air as a benefit of the transaction when it acquired Diversey from CD&R."
>
> \- Dan Jacobs, Clayton, *Dubilier, & Rice*

GP Fundraising: LP Fund Due Diligence

The Majority of LP Participants Who Apply ESG Considerations Apply Them Systematically During Fund Selection

Our team investigated the fundraising phase of the GP investment cycle, or fund manager due diligence from the LP perspective, with specific focus on how LPs apply ESG criteria and how GPs respond. Specifically, we assessed the proportion of LPs that consider ESG issues systematically versus a case-by-case basis during due diligence. Systematic was defined as diligence evaluations that are deployed and reviewed consistently in all private equity fund placements. Survey results indicate 67% of LP participants employ systematic consideration of ESG during fund manager selection. As discussed previously, these LPs typically assess GP management processes by requesting ESG DDQs and following up on responses in need of clarification.

FIGURE 14: LP consideration of managers' ESG processes during selection



"I believe ESG is a two part process: fund manager due diligence and engagement post investment. While we have not made many new fund investments recently, we continue to engage in dialogue around ESG with firms we have already invested in."

- Christina Kusoffsky Hillesöy, *AP3*

As more advanced LPs reported requesting communication from GP staff directly involved in relevant phases of the investment process, professionals in ESG, investment, and operations will play greater roles in achieving investment-level ESG performance important to successful fundraising efforts. Not surprisingly, our GP participants cited investor relations and ESG professionals as most frequently responsible for gathering and communicating ESG-related information requested by LPs during fundraising. ESG professionals help to close the loop between the communication and implementation of management processes. While at present, this fundraising disclosure can be accomplished by these functions alone, consider that much of the actual content communicated is driven by efforts of investment and operating professionals.

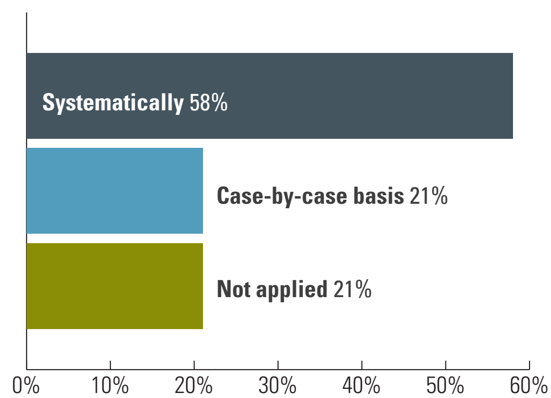
GP Investment Due Diligence

Majority of GPs Apply ESG Considerations Systematically During Diligence

Our survey investigated GPs' ESG management during diligence by inquiring whether firms apply management processes systematically or on case-by-case bases. We defined systematic as diligence processes that preliminarily review all investments to determine whether material ESG issues exist, versus ad hoc review processes triggered by criteria, such as sector or geography. Because GP due diligence is largely focused on determining the issues that would trigger walking away from a deal or materially impact deal valuation, participants emphasized the importance of balancing breadth of considerations with available time and resources.

The 58% of our GP participants that described systematic ESG diligence processes communicated a more sophisticated and effective balancing effort – one that applies ESG criteria at high levels across all investments to identify material issues, considers investment-specific criteria to qualify materiality, and investigates issues requiring more scrutiny. Likewise, those that had effectively educated investment professionals explained that it was easier to strike this balance because the breadth of ESG attention is greatly expanded across firm function. This enables ESG professionals to oversee management processes and only get involved with ESG issues investment professionals qualify as material.

FIGURE 15: GP application of ESG management during investment diligence



"We assess whether there are ESG issues to consider in every private equity investment. In some cases the decision is that there are no material ESG issues, but every company is reviewed."

- Elizabeth Seeger, *KKR*

ESG Professionals Design Programs to Facilitate Efficient, Firm-Wide Communication

We have seen a year-over-year increase in the number of firms deploying more sophisticated ESG programs and tools, further customized to sectors and investment strategies. These include issue spotter lists, like opportunity checklists and risk areas. Early U.S. examples of significant ESG initiatives documented in last year's study include Carlyle's Eco-Valu Screen, KKR's Green Portfolio Program, and similar firm-wide approaches at TPG and Blackstone.[3]

Our 2013 survey revealed that a broader group of firms, primarily in the range of $2 billion to $10 billion in AUM, have begun to adopt similar approaches. As program integration is intended to expand the number of firm roles involved in ESG management, the tools serve to guide material ESG information up the communication ladder by condensing it into forms typically reviewed by senior management. This was reflected by the greater portion of 2013 participants that include ESG considerations in materials for senior management decision-making, like investment committee memorandums and slides in investment review presentations. ESG professionals, particularly in larger firms, oversee management programs by quality controlling utilization of tools and directing information across investment platforms and up the management hierarchy.

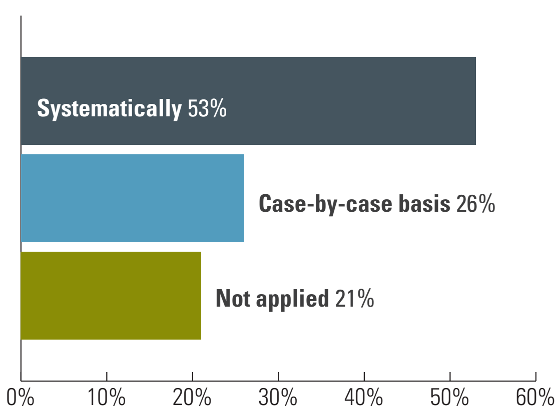
Case-by-Case Consideration Triggered by Criteria

The 21% of GP participants that consider ESG issues on a case-by-case basis explained they only review the topic if investments trigger criteria. While this approach appears to prioritize materiality, participants reported it spurring deeper investigation of issues that could have quickly been determined immaterial if initially qualified by investment-specific criteria. The case-by-case approach often arose from a dedicated ESG or investor relations professional being the single role responsible for ESG. Likewise, the majority of this 21% of GP participants reported that investor relations professionals are responsible for ESG consideration, often due to LP expectations driving firm adoption. Ultimately, case-by-case consideration does not fully leverage the benefit of an integrated approach to diligence risk identification and can be more time consuming.

GP Ownership

Systematic Consideration of ESG Drives Opportunity Identification

FIGURE 16: GP application of ESG management during ownership



In an effort to better understand how GPs manage ESG during the ownership stage of their investment cycle, we again posed the question of whether management processes consider ESG issues systematically or on case-by-case bases. In this case, we defined systematic processes as efforts that consider managing ESG issues during ownership of all investments, rather than when triggered by specific criteria. 53% of GPs described management processes that took a systematic approach to managing ESG during ownership. This approach ensures significant opportunities are not overlooked and helps to drive synergies by leveraging best management practices applicable to multiple companies across the portfolio.

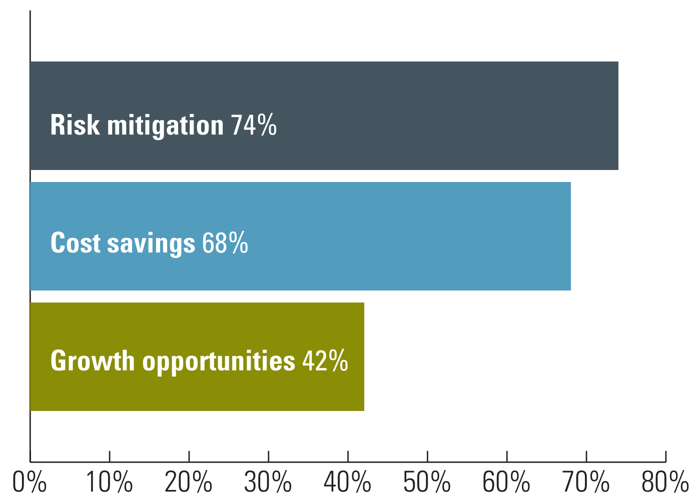
Interestingly, a significant proportion of the 26% of participants that consider ESG issues on a case-by-case basis cited variability in ESG materiality across investments as a factor limiting further program development, while

3 Carlyle's annual report highlights $7M in savings from the Eco-Valu Screen.

participants with systematic programs highlighted their approach as an effective way to determine material issues. Participants of the latter type explained this distinction arises because more professionals gain familiarity with the issue set and thus can more readily identify related value creation opportunities. This sentiment was even stronger among participants with integrated programs that had allocated responsibilities across the firm. They referenced ESG, investment, and operating professionals as most commonly responsible for determining the materiality of ESG issues and implementing value creation initiatives during ownership.

During Ownership, GPs Still Focus on Managing Risk and Seeking Cost Savings Opportunities

FIGURE 17: Facets of ESG GPs manage



Leading GP participants explained that dedicated ESG professionals design portfolio company-level initiatives that investment and operating professionals implement. Additionally, Leading firms utilize ESG professionals to identify opportunities to emulate best in class ESG practices in other areas of the portfolio. While 74% of GP participants reported managing the risk mitigation facet of ESG during ownership, in part to respond to LP expectations, a significant proportion reported managing the cost saving (68%) and growth opportunity (42%) facets of ESG as well. Conversations revealed these types of initiatives are undertaken by a smaller proportion of GP participants because their associated drivers are less direct.

Recall that LPs deemed cost-saving initiatives as a GP responsibility and a proxy for firms' ability to improve operations. At an implementation level, this translates to the need for GP investment and operating professionals to evaluate cost saving and growth initiatives as optimal allocations of capital, relative to alternative options to create value. While this determination is based on initiatives' implication to valuation, implementation thresholds greatly depend on the nature of GP relations with portfolio company management. More operationally involved GPs reported designing, assessing feasibility of, and implementing facility-level ESG initiatives. However, GPs that take a more hands off approach often suggest resource categories and third parties to help focus portfolio company attention on resource efficiency.

"I view the hierarchy of ESG adoption as regulation and compliance is the foundation; every company has to make sure they get that right. Then companies advance into the cost savings model to identify low hanging fruit. From there they move to find ways to create additional value, through green products, growing market share, driving revenue, and brand reputation."

- Beth Lowery, *TPG Capital*

Resource Efficiency Initiatives Afford Opportunity to Address Growing ESG Concerns of Enterprise Customers

In circumstances where resource efficiency initiatives can be connected to portfolio companies' sales, there is potential to drive greater returns by translating resource efficiency into broader product marketability, better brand reputation, stronger customer relationships, and ultimately greater market share. To achieve this, managers must facilitate cross-functional communication at portfolio companies.

Don Anderson, Chief Sustainability Officer at Blackstone, emphasized the ability to maximize potential benefits by connecting facility, engineering, and marketing personnel at portfolio companies. He stressed that often, there is a dearth of dialogue between these departments, limiting the opportunity for successful resource efficiency initiatives to impact perceived value. By translating resource efficiency achievements to marketing department vernacular, ESG professionals can help leverage opportunities to reinforce, if not increase, sales to customers concerned about ESG.

Our survey assessed the degree to which GPs have experienced instances where enterprise customer requirements forced ESG considerations up the supply chain and affected their portfolio companies. Roughly half of participants had experienced such a situation, and many Developing managers of portfolios weighted heavily with telecom and consumer products companies expressed concern about requirements increasing in the near future. As Head of Sustainability for a Leading GP, Adam Black of Doughty Hanson took a more optimistic perspective in commenting that enterprise customer requirements complement efforts to manage ESG in private equity by adding to the business case and creating an opportunity for portfolio companies to work closely with customers.

"A one size fits all shotgun approach to ESG does not create value; however, a more tailored and customized approach to each company can drive real value."

- Bryan Corbett, *The Carlyle Group*

Looking Ahead

A 2013 study by Bain found that GPs investing successfully in today's difficult fundraising environment utilize active value creation tactics to generate superior returns because current private equity investments receive less benefit from GDP growth, expanding multiples, and leverage than investments in the past.[vii] When combining this finding with BDO's assessment that median holding periods have increased by more than 50% since 2007, to 5.3 years, the need for GPs to have ESG programs that effectively mitigate risk and increase returns becomes clear.[viii] In addition, evolving LP expectations will only serve to heighten GP attention to these issues. As more GPs shift from asking "do we have to address this now" to "how do we create value from ESG management," our team foresees the following trends in the coming years:

- **LP attention to GPs' ESG management will continue to increase because of growing stakeholder interest in responsible investment.** Stakeholder divestment campaigns demonstrate keener understanding of the impact capital flows have on people and the environment. This trend will place increasing pressure on LPs to account for the overall impact of their investments.
- **ESG management will mature through integration of responsibilities across the firm and investment cycle.** GPs that realize the greatest value from ESG management will be those that integrate program accountability after educating firm professionals about how ESG pertains to traditional responsibilities in the investment cycle.
- **ESG management programs that systematically assess opportunities will outperform ad hoc assessments by replicating best practices across the portfolio.** While resource efficiency initiatives must be tailored to specific operations, they apply to basic processes and activities common to many companies and industries. By assessing application of these initiatives across all investments, common opportunities to implement best practices across companies will drive greater returns from each initiative.
- **ESG management at the portfolio-company level will be increasingly used to grow the top line as well as the bottom line.** Efforts to market resource efficiency improvements will help strengthen customer relations and sustainability-driven innovation will open up revenue streams from new markets.

MSP Project Team

Andrew Malk
andrew@malksp.com

Michael Shoemaker
mshoemaker@malksp.com

Topaz Simply
topaz@malksp.com

Laurèn DeMates
ldemates@malksp.com

Appendix A: Study Participants

General Partners	Limited Partners
Anonymous General Partner	Anonymous Limited Partner
Anonymous General Partner	Anonymous Limited Partner
Anonymous General Partner	APG Asset Management
Anonymous General Partner	AXA Private Equity
Anonymous General Partner	California Public Employees' Retirement System (CalPERS)
Anonymous General Partner	PGGM
Anonymous General Partner	Quartilium
Anonymous General Partner	RobecoSAM AG
The Abraaj Group	San Diego City Employees' Retirement System (SDCERS)
Actis	TorreyCove Capital Partners
Arlington Capital Partners	Tredje AP-fonden (AP3)
The Blackstone Group	Universities Superannuation Scheme (USS)
The Carlyle Group	
Clayton, Dubilier, & Rice	
Doughty Hanson & Co.	
The Gores Group	
KKR & Co.	
Oak Hill Capital Partners	
TPG Capital	

Endnotes

i Bain and Company. 'Global Private Equity Report 2013'.

ii Bain and Company. 'Global Private Equity Report 2013.'

iii Davis Polk 'Private Equity Newsletter' 16 September, 2010 and Morrison | Foerster 'Investment Adviser Registration for Private Equity Fund Managers' 2012.

iv ESG Disclosure Framework. 25 March, 2013. <http://www.unpri.org/viewer/?file=wp-content/uploads/13161_ESG_Disclosure_Document_v6.pdf>

v UNPRI and PwC. 'The Integration of Environmental, Social, and Governance Issues in Mergers and Acquisitions Transactions: Trade Buyer Survey Results.' January 2013.

vi Eccles, Robert G., Ioannou, Ioannis, Serafeim 'The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance.' HBS. 25 November, 2011.

vii Bain and Company. 'Global Private Equity Report 2013.'

viii BDO. '4th Annual Private Equity Study.' Spring, 2013.