



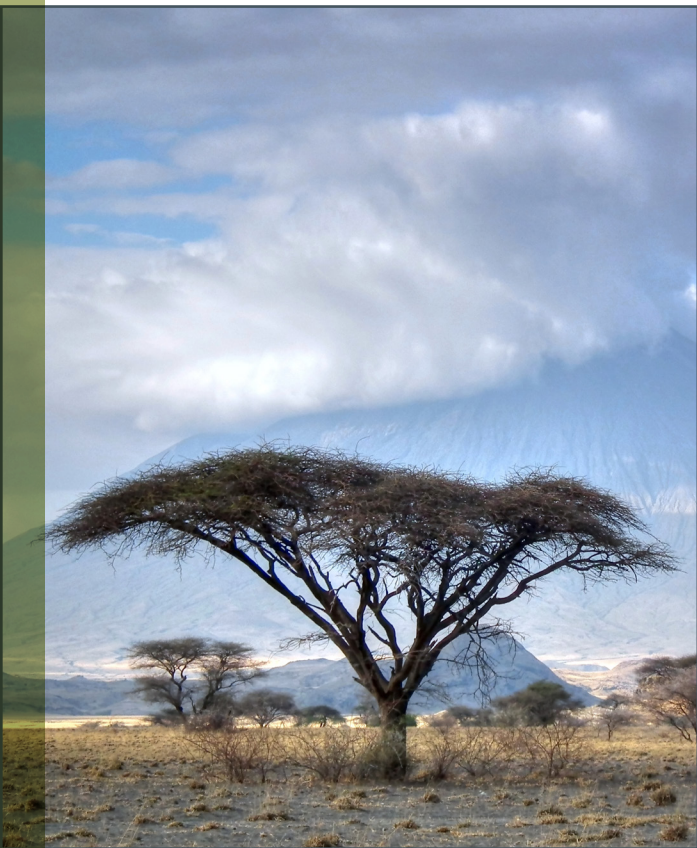
# *ESG in Private Equity*<sup>SM</sup> – 2015

*ESG Becoming Core to GP Investment Process*

*A Study by Malk Sustainability Partners*



**MALK**  
Sustainability Partners



## About MSP

**Malk Sustainability Partners** (MSP) is a boutique management consultancy that works exclusively with private equity firms and their portfolio companies to create and protect value through environmental, social, and governance (ESG) management. MSP advises over a dozen private equity firms representing more than \$90 billion in assets under management (AUM).

To learn more about how ESG management can enhance returns at your firm, please visit us online at:

[www.malksp.com](http://www.malksp.com)

## About ESG

**ESG** (environmental, social, and governance) is a broad term used by the investment community to describe a range of investment considerations related to environmental stewardship, social equity, and corporate governance with the goal of protecting and creating value. Common objectives of ESG management include energy savings, waste diversion, improved labor practices in the supply chain, employee health and safety, and ethical transactions.

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## Key Terminology

<b>DDQ:</b>	due diligence questionnaire
<b>EBITDA:</b>	earnings before interest, tax, depreciation, and amortization
<b>ESG:</b>	environmental, social, and governance
<b>HR:</b>	human resources
<b>IC:</b>	investment committee
<b>GPs:</b>	general partners
<b>LPs:</b>	limited partners
<b>NGO:</b>	non-governmental organization
<b>PCs:</b>	portfolio companies



# Introduction



“ESG risks and opportunities are getting more real every day.” –Survey participant.

This observation perfectly captures the evolving mindset between 2013 and 2015. Compared with two years ago, when we last published this study, every company today is more exposed to and more impacted by ESG issues - from apparel supply chain safety incidents to a growing water crisis to the carbon cap agreement to a more discerning consumer base. And based on the results of this year’s survey, the trend appears likely to continue.

As our *ESG in Private Equity*<sup>SM</sup> study found in past years, private equity firms have once again adapted to changes in the world of ESG. The state-of-the-market report you hold in your hands breaks ground in the ESG private equity space; we push beyond accepted answers to seek deeper insight about the state and future of ESG management. Using data from more than 70 firms, this report draws on primary and secondary research to examine trends in drivers and adoption of ESG management, how those trends reflect the broader market climate for private equity, and the practices that underpin GPs’ growing focus on ESG.

In our research, we uncovered a paradigm shift in ESG management. GPs’ consideration of ESG has moved beyond a perfunctory gesture to satisfy limited partners. No longer an “add-on” to the investment process, ESG management is now an integrated part of the investment process. GPs today increasingly recognize the material impact ESG can have on enhancing and protecting the value of portfolio companies and their firms. Of course, this doesn’t mean that today every firm fully exhibits this changed mindset; rather, it is evident that the typical firm views and responds to ESG very differently than in the early years of ESG management.

Within this new paradigm, we found a greater focus on risk mitigation as a driver of ESG management for GPs and greater attention to ESG generally, from LPs. To address and mitigate risk, GP participants are more consistently incorporating ESG into due diligence and ongoing board monitoring. We also found significant growth in the number and types of LPs that are requiring ESG performance of their fund managers; we see that increased focus on ESG in LP communication trends. LPs now routinely monitor GP performance through annual questionnaires, and LPs are initiating communication more frequently, especially through informal methods.

The *ESG in Private Equity*<sup>SM</sup> series would not be possible without the generous participation of many GPs, LPs, and other institutions, and this year is no exception. We offer them our sincere thanks.

**Andrew Malk**

*Managing Partner*

Malk Sustainability Partners

# Executive Summary

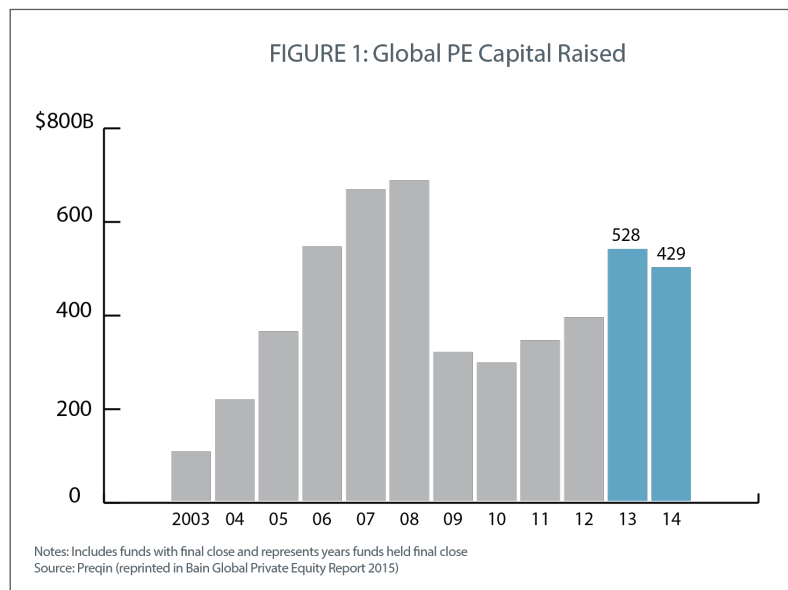
Area	Finding
<p><b>Today in Private Equity</b></p>	<ul style="list-style-type: none"> <li>• <b>Diligence more important since all deals are a “can’t miss.”</b> A vast increase in dry powder coupled with attractive debt opportunities and strong public equities markets has led to a surge in competition for private equity buyout deals. With that competition, firms are often paying a price premium to secure a deal, which means a portfolio company tanking hurts even more. To mitigate that risk, firms are stepping up all aspects of due diligence, including ESG due diligence.</li> </ul>
<p><b>ESG Paradigm Shift</b></p>	<ul style="list-style-type: none"> <li>• <b>Internal recognition of ESG value.</b> From <i>ESG in Private Equity</i><sup>SM</sup> – 2013 to today, we found that a majority of firms now recognize ESG risks and opportunities as material to a portfolio company’s value. While many firms still pursue ESG management in response to LP expectations, a growing number do so because they recognize the impact ESG can have on protecting and creating value.</li> </ul>
<p><b>ESG Risk</b></p>	<ul style="list-style-type: none"> <li>• <b>Risk is becoming a leading driver of ESG management.</b> Survey participants identified risk mitigation and its derivative, reputation preservation, as the top driver of ESG management. Increasing transparency around social and environmental issues, more stringent expectations from key customers, and the aforementioned buyout price premium all contribute to this trend.</li> <li>• <b>ESG risk mitigation begins in due diligence.</b> In response to the growing importance of ESG risk mitigation, a majority of firms surveyed include an ESG slide or summary in due diligence reviews of potential acquisitions. Additionally, 36% of firms surveyed include an ESG slide or summary in every review of potential acquisitions. These trends evidence the importance GPs give ESG issues, beginning in the due diligence process.</li> <li>• <b>Board ESG risk monitoring now common.</b> After diligence, a majority of firms also incorporate ESG risk monitoring into portfolio company board meetings. The incorporation into board meetings, a highly coveted time for GP-portfolio company interaction, demonstrates the impact that ESG can have on protecting and creating value. Furthermore, it shows the growing recognition among private equity firms of that impact.</li> </ul>
<p><b>LP Expectations</b></p>	<ul style="list-style-type: none"> <li>• <b>More and more LPs set ESG expectations.</b> In our survey of GPs and LPs, we found that a greater number and larger variety of LPs are increasing their ESG expectations of fund managers. While typically firms have found European LPs to be the main inquirers on ESG, that concern now extends to North American pension plans, LP consultants, foundations/endowments and many other types of investors. For certain LPs, ESG is now a key component of fund manager selection, with several GPs reporting that ESG formed a part of the “go/no-go” conversation.</li> <li>• <b>Increasing informal communication, too.</b> While these growing expectations have precipitated an increase in formal communication from LPs to GPs (DDQs, annual updates, etc.), they have also led to more informal communication. LPs use phone calls, emails, and even site visits as a method of checking up on whether GPs are fulfilling commitments.</li> <li>• <b>Focus on capacity, not specific issues.</b> In both the formal and informal communication between LPs and GPs on ESG, our survey participants overwhelmingly reported that LPs value GPs’ capacity to manage ESG; they don’t prescribe a method for managing specific issues.</li> </ul>

# Today in Private Equity

Since MSP published *ESG in Private Equity*<sup>SM</sup> – 2013, private equity has changed significantly. An improving macro-economy led to growth in asset value for companies purchased by private equity firms just before and during the 2008-09 recession. With that growth in hand, firms rushed to sell in the buoyant economy, and sell they did. 2013 and 2014 were two of the strongest years on record for sales of private equity-owned companies.

Investors, receiving the distributions from those vintage funds, struggled to continue meeting their target allocations to private equity. In part to compensate for large distributions, many of these investors began committing to new private equity funds, making this period the most generous fundraising market for private equity since before the recession.

The surge in fundraising, combined with cheap debt and a boom in the public equities markets, made for an equally competitive deal market. Fighting over attractive opportunities, private equity firms drove up the multiples on EBITDA for purchasing companies. From 2012 to 2014, average EBITDA purchase multiples grew from 6x to almost 8x (*Pitchbook 1Q 2015 Private Equity Deal Multiples and Trends*).



These macro dynamics in the private equity market hastened an evolution in the underlying firm-level modus operandi – active management to generate return. As the *2015 Bain and Company Global Private Equity Report* summarized: private equity firms “can no longer rely on beta<sup>1</sup> to do the heavy lifting.” In prior investment cycles, firms could find attractive companies at 5-7x EBITDA and leverage overall market and deal multiple growth to generate a strong return, exiting the company for 8-10x EBITDA. Today, with attractive companies selling at a minimum of 10x EBITDA, many firms find successful return due to beta boost alone elusive. “Instead of waiting for beta to do their work for them, [private equity firms] are stacking the odds in their own favor. Leading GPs are stepping up their due diligence to ensure that they

can identify the winning factors in a target company that can become the basis for a value-creation plan that can withstand any economic or market climate” (*Bain Global Private Equity Report 2015*, page 31).

“Instead of greasing the skids of global deal making, however, these vast sums of dry powder, supplemented by abundant cheap debt in the hands of eager PE buyers, pushed up prices in a capital-saturated market where attractive assets were in limited supply.” - *Bain Global Private Equity Report 2015*, page 12

<sup>1</sup> Beta boost refers to that return in the market that is passive, as opposed to alpha, which is return from active management. In private equity, beta return typically encompasses three factors – overall gross domestic product (GDP) growth, multiple increase, and leverage.

# ESG Implications of Current Private Equity Trends

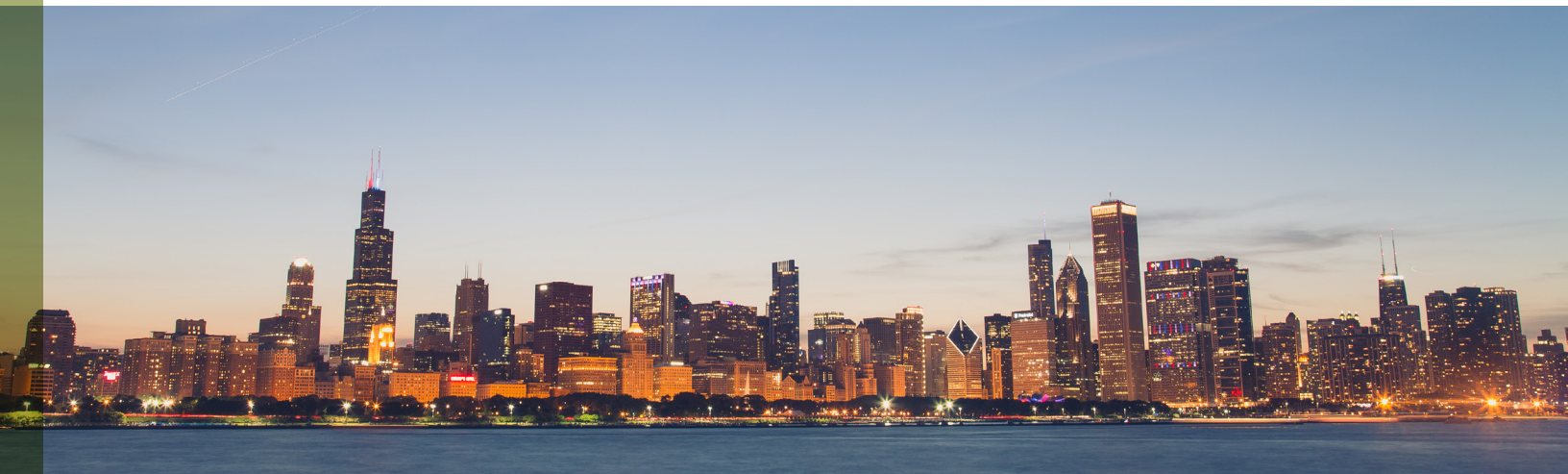
With the success of every deal increasingly important and hard-won, all aspects of due diligence have become more important, including ESG risks and opportunities

Buying companies at such price premiums, private equity firms have to be extremely confident about all aspects of a company's financials and operations. A missing or inaccurate assessment of any material area can diminish, if not tank, an investment – and now firms cannot rely on beta to make up the difference. To hedge against this risk, private equity firms are “applying rigorous due diligence to weigh industry opportunities and risks.” (*Bain and Company Global Private Equity Report 2014*, page 57) That includes an increased emphasis on the assessment of market growth, quality of management, existing liabilities, and operational efficiency.

Though one might expect firms to lessen their diligence in a tight buying market, as they become hungry for any company to purchase, the cost of failing to realize expected investment return is so high that firms overwhelmingly tend toward more rigorous diligence. Along with the more traditional aspects of due diligence, firms are increasingly pursuing diligence reviews of a company's ESG risks or opportunities. As discussed further in **Risk Becomes the Leading Driver of ESG Management**, identifying ESG risks is another opportunity for firms to ensure there are no negative surprises in ownership. Likewise, firms are more commonly identifying ESG opportunities to augment growth driven by active management.

More firms than ever before have now raised capital in an era of significant stakeholder ESG concern

The strong fundraising market of the past two years meant that many firms were out to market for the first time since 2009-2011. In their previous fundraises, it would have been significantly less likely for them to receive serious inquiries on ESG. In the past two years, though, a greater number and more varied types of investors sought to invest with firms that have strong ESG programs. Questions on ESG management are expected in a conversation with any European investor, US pension plan, LP consultant, and many other investors. Firms that never before received encouragement to adopt strong ESG programs faced significantly more inquiry on this point in the most recent two years of fundraising than in 2010-2012.





## Other Relevant ESG Trends

While part of the growing importance of ESG is due to changes in the private equity market over the last two years, broader trends have also made ESG more material to companies today.

### Journalists and NGOs are more often acting as watchdogs on social and environmental incidents

NGOs and journalists have long acted as corporate watchdogs on social and environmental incidents, publicizing issues detrimental to the communities or environment in which a company operates. In today's social and political climate, a company still has the autonomy to act at its own discretion in relation to ESG issues, but it is almost assured that those actions will become public if there is an incident. Transparency, as well as consequences, extend beyond a company's operations in both directions along the value chain – toward both suppliers and owners.<sup>2</sup>

This potential for unwanted publicity materializes as a significant risk for companies. Consumers are increasingly willing to avoid companies associated with negative ESG incidents. The risk of negative publicity extends beyond effect on consumers: public incidents can threaten a company's license to operate in the community, the ability to maintain ongoing approval within the local community and avoid government intervention in business (e.g. taxation and regulation that prevents the business from normal operations).<sup>3</sup>

### Enterprise customers are increasingly requiring sustainability performance from key suppliers

As explored in MSP's report, [ESG in Private Equity<sup>SM</sup>: Issue Focus - 2014](#), large enterprise customers are placing growing sustainability requirements on their suppliers. MSP investigated how that trend affects the GP-portfolio company relationship around ESG. These large enterprise customers, led by companies such as Walmart, Target, Apple, Unilever, and recently McDonalds, increasingly expect their key suppliers to go beyond regulatory compliance in terms of social and labor issues, environmental stewardship, and transparency. Large enterprise customers now demand demonstrated performance in these areas. As in the case of consumers, these large customers are showing a willingness to disassociate from companies that find their way into the headlines for an ESG transgression.

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2 Gani Aldashev, Michela Limardi and Thierry Verdier, 2013. "[Watchdogs of the Invisible Hand: NGO Monitoring, Corporate Social Responsibility, and Industry Equilibrium](#)" Working Papers 1404, University of Namur, Department of Economics. Retrieved from <https://ideas.repec.org/p/nam/wpaper/1404.html>

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3 In his Forbes article, [Three Ways to Secure Your Social License to Operate in 2013](#), Paul Klein discusses the increasing risk of losing a social license to operate, specifically for corporations in the resource extraction sector. Retrieved from <http://www.forbes.com/sites/csr/2012/12/28/three-ways-to-secure-your-social-license-to-operate-in-2013/>





# 1. ESG Paradigm Shift

When this report was last published, in 2013, the majority of GP participants considered ESG management to be outside their regular investing process. Management of ESG issues was driven primarily by a desire to satisfy LP expectations. As such, ESG management was not integrated into the investment process; it was instead conducted as a parallel process to ensure LP expectations were satisfied. Over the past two years, we've seen a shift generally in how and why GPs manage ESG concerns in their portfolios. While LPs' expectations for ESG performance are growing, and satisfying LP expectations is still a top driver for GPs' ESG management, GPs themselves recognize that ESG issues are material to the value of their portfolio companies. As a result, GPs are beginning to treat ESG as they would any other material dimension of a new investment and are integrating it into the standard investment process.

## Early ESG Management Emphasized LP Adherence

In its early years, ESG was generally treated as an addendum to the regular investing process. Notable LPs required GPs to consider ESG and confirm their compliance with affirmative responses to fairly basic DDO questions, so GPs tacked on "ESG compliance" to their investor relations operation. For example, as an initial step, many GPs were asked by their investors to develop an ESG policy. Many of those GPs complied, but they did so perfunctorily. While this approach satisfied the initial LP requirements, it did not position GPs to satisfy future LP expectations, nor did it reflect the material impact that managing ESG issues can have on protecting and creating value. In 2013, our research identified that leading firms were beginning "to address ESG concerns...as part of, rather than parallel to, the standard investment process." (*ESG in Private Equity*<sup>SM</sup> – 2013, page 19)

## 2013-2015, Evolution of GP ESG Management Drivers

In response to new LP expectations, many firms undertook the development of ESG policies and programs. This resulted in many firms' first exposure to ESG management. These new ESG programs raised awareness about risks and opportunities to which GPs had previously given less attention. GPs are realizing that ESG risks and opportunities are potentially material in their own right and therefore merit attention even outside of LP requirements. While material ESG risks have always been considered, recent trends in private equity and the world more broadly-increased transparency and headline risk, among others-have expanded the universe of what is deemed a material ESG issue.

This new perspective is not a complete departure for GPs. ESG-related risks and cost savings have always been a significant driver of GP ESG management; we saw that two years ago. What has changed is the degree to which GPs see that value. The majority of firms surveyed now view ESG risks as increasingly material. Responding to material ESG risks requires a different approach to ESG management than did checking boxes for LPs, and GPs have adapted accordingly.

**"They [deal teams] realize the value [of ESG] a lot more. It's not that they weren't doing it before, it's just that it wasn't as forefront." - Anonymous US Middle Market GP**

## How GPs are Now Integrating ESG management

We reported in *ESG in Private Equity*<sup>SM</sup> – 2013 that leading firms were beginning to integrate ESG into the investment process, not just to satisfy LP requirements but also to mitigate potential risk and capitalize upon potential material opportunities. Two years later, most of the GPs that participated in our survey are realizing that initial trend. For Apax Partners, ESG has “become part of the general process. It’s just part of how we operate,” said Ellen de Krijg, a member of Apax’s investor relations team.

Firm investment professionals now more readily acknowledge the importance of ESG, an important shift in firm culture. In discussion of ESG diligence, Jen Kwon, Principle of Investor Relations at The Gores Group said, “Our guys are very receptive to reviewing that aspect of a deal.” Kwon wasn’t alone; nearly every GP participant interviewed remarked that investment professionals at their firms support and accommodate incorporating ESG into the investment process.

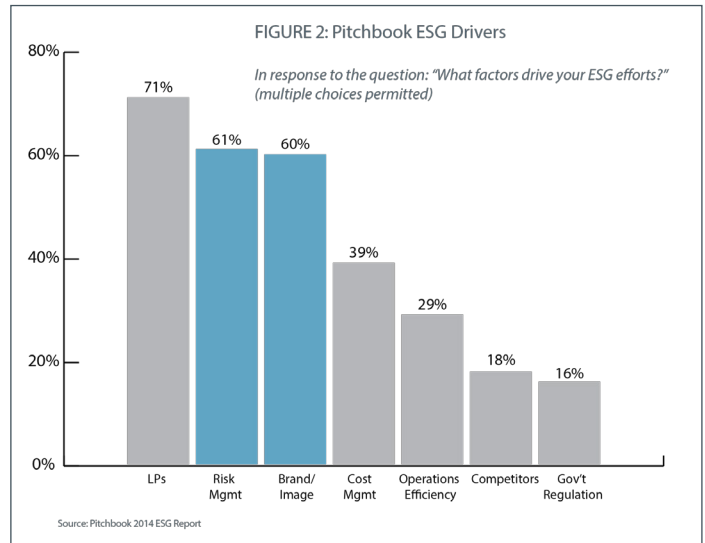
As ESG risks become more and more recognized for their materiality, their monitoring, management, and reporting are becoming integrated throughout the investment process. No firm surveyed has decreased its focus on ESG, and nearly every firm has made significant strides in integrating ESG management throughout its investment cycle. In previous years, ESG was not recognized as key to the value of a firm’s portfolio and as such its management was not intrinsically tied to the return on investment, but rather to the goal of satisfying LPs. Because the majority of GP participants are now considering ESG issues in the same way they consider market trends, competition, operational efficiency and other basic components of the investment process, they are now applying the same standard to ESG as they do to everything else: materiality.



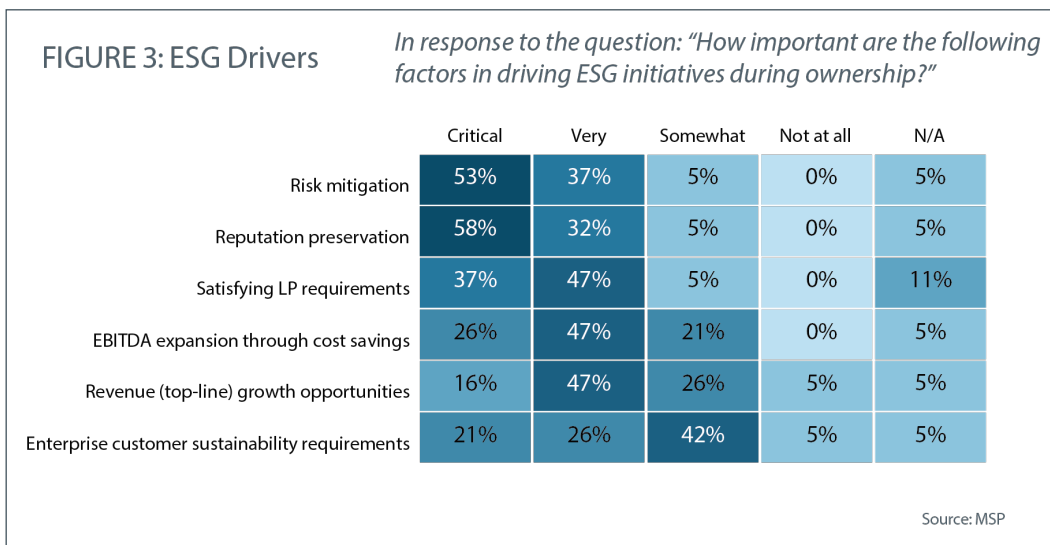
# 2. Risk Management is Becoming the Leading Driver of ESG Management

Of all ESG considerations, ESG risks are material for the greatest percentage of portfolio companies. Recent surveys show that ESG risks drive GPs to integrate ESG management more frequently than other potentially material ESG impacts to value such as cost savings and growth opportunities, though the latter two remain significant drivers. In Pitchbook's 2014 survey of 45 GPs, 61 percent cited risk management as a top factor driving ESG efforts, second only to LP expectations.

Our survey participants identified risk mitigation as the most important driver of their ESG management initiatives. Half of our participants highlighted risk mitigation as a critical factor driving ESG management in ownership and 54 percent reported that reputation preservation, a derivative benefit of risk mitigation, was critical. This compares to 23 percent of firms that cited EBITDA expansion through cost savings as critical, and 14 percent that reported revenue growth opportunities as critical. Because of their focus on risk, firms concentrate their ESG efforts in due diligence and board monitoring, where risk identification and mitigation efforts are the most efficient.



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# Why ESG Risks are More Material to Private Equity Firms Today

A vast majority of companies are exposed to some form of ESG risk, whether it is unethical labor and social practices in the supply chain, bribery of foreign officials, discriminatory employment, environmental liabilities, product hazards, data breaches, regulatory exposure, unsafe working conditions, or one of many others. When these risks materialize, their impact can be significant, and sometimes staggering.

## “We’re very sensitive to any potential headline risks” - Anonymous US Middle Market GP

Companies have always faced regulatory scrutiny, fines, and litigation over certain ESG management failings. But GPs today operate under the scrutiny of an ever-growing number of vigilant stakeholders – NGOs, journalists, governments, and a more aware public. They also recognize that in today’s media-saturated, environmentally and socially conscious world, stakeholder scrutiny will continue to intensify. If an ESG risk materializes, a brand is not only exposed to regulators or lawyers; the news reaches a company’s consumers, key customers, and the general public. On top of any litigation or fines, it’s the impact of this news that makes ESG risks material; a company’s brand reputation may be damaged, its social license to operate in the community revoked, and purchase orders with key customers canceled or delayed. Furthermore, it’s now common for any issue in a private equity-owned company to be tied back to the GP, tarnishing the GP’s reputation and damaging relationships with LPs. The broad range of threats that ESG risks pose to GPs have spurred firms to deepen their ESG management process in order to identify and mitigate those risks.

While the growing importance of ESG risk is only one of many factors considered in development of an ESG program, risk mitigation is viewed as having the largest possible financial impact. No private equity firm surveyed has purchased a company solely because they feel they can grow the company’s revenue or shrink its expenses through ESG initiatives, but every firm surveyed showed a willingness to walk away from a potential deal solely because of discomfort with the ESG risks.

## Achieving Cost Savings through Resource Efficiency

### A key opportunity in ESG integration

Twenty-six percent of firms highlighted EBITDA Expansion through cost savings as a critical factor driving ESG initiatives during ownership, while an additional 47 percent listed this driver as very important. With rising utility rates and increasing concerns around water tariffs and scarcity, a greater number of firms are finding that targeted initiatives to improve resource efficiency can have a material impact on a business. However, like all else in ESG management, resource efficiency is pursued when and how it is material to do so. For many firms, this means incorporating a resource efficiency review into diligence for asset-heavy companies where utility spend is a significant percentage of revenue. Increasingly, firms are finding resource efficiency can act as “another tool in the toolbox of active management.”

### ESG risk and cost savings at Ares Management

Caroline Zouloumian, Senior Vice President and Head of ESG, said, “We actively pursue and realize cost savings on ESG value-creation initiatives within the portfolio; however, we also recognize that, in certain instances, the capital or time and attention required may not rise to the level of trumping competing priorities, which can eclipse or delay a specific ESG value-creation proposal at a portfolio company regardless of anticipated savings or ROIs. Value creation is definitely a driver for ESG plans and policies, but the first order of business is risk management – identifying and addressing material ESG risks based on the company, its sector and geographical footprint.”



# How are Firms Pursuing Risk Mitigation?

## The majority of firms surveyed begin risk mitigation during due diligence

“By default, risk is the first screen that gets applied,” one industry leader told us. “The very first question is, ‘Does our firm want to be invested in this topic, issue, area.’ And that’s a risk question.” With this growing focus on risk, it’s not surprising that more GPs consider ESG issues in diligence than in any other area of the investment cycle (*Pitchbook 2015 Private Equity ESG Survey*). Intuitively, this makes sense:

**“Given our operational approach, we strive to identify ESG related risks from the onset as part of the overall risk mitigation in any given acquisition.” - US Middle Market GP**

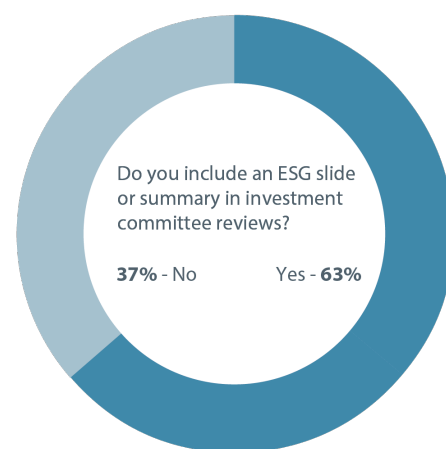
as ESG is integrated more seamlessly into the firm’s investment process, ESG consideration begins where the investment process begins – in due diligence. Nearly 100 percent of firms surveyed in Pitchbook’s 2015 report indicated that they consider ESG in diligence, compared to roughly 60 percent that consider ESG in the ownership period. Though ownership is an important stage of ESG management, diligence is where it is almost universally applicable.

For 76 percent of surveyed firms, the ESG due diligence review process culminates in the incorporation of an ESG slide or summary in investment committee reviews. Thirty-seven percent of participants reported that their firm includes an ESG slide or summary in every review, while 14 percent cited inclusion in greater than half of IC reviews, and 14 percent cited inclusion in less than half of IC reviews. We expected the number of firms including ESG slides to increase, but we were taken aback by how prevalent it’s already become, and by how many firms consider ESG core enough to include a slide or summary in every one of their IC reviews.

Though often just a small component of a much larger investment committee review process, the ESG summary is further evidence that ESG is moving into the mainstream investment cycle. Should the investment proceed to closure and the company be onboarded into the portfolio, the firm transitions into addressing those ESG risks that were identified in diligence. Where material, ESG is a legitimate investment consideration and is treated as such by both the deal team and the investment committee. “[ESG] forms part of our action plan with the company – we track the material issues with the portfolio company management teams to ensure they get addressed and ultimately closed out, just as we would do with any other aspect of due diligence,” said Adam Black, Principal, Head of Sustainability at Doughty Hanson.

**“We develop content for the Investment Committee materials and ESG is discussed on an as-needed basis in IC meetings. It’s integrated just like legal, HR, or more standard environmental diligence.”- US Middle Market GP**

**FIGURE 4: ESG IC Slide in Due Diligence**



**Among “Yes” respondents:**

22% - Yes, in less than 50% of reviews

22% - Yes, in greater than 50% of reviews

56% - Yes, in every review

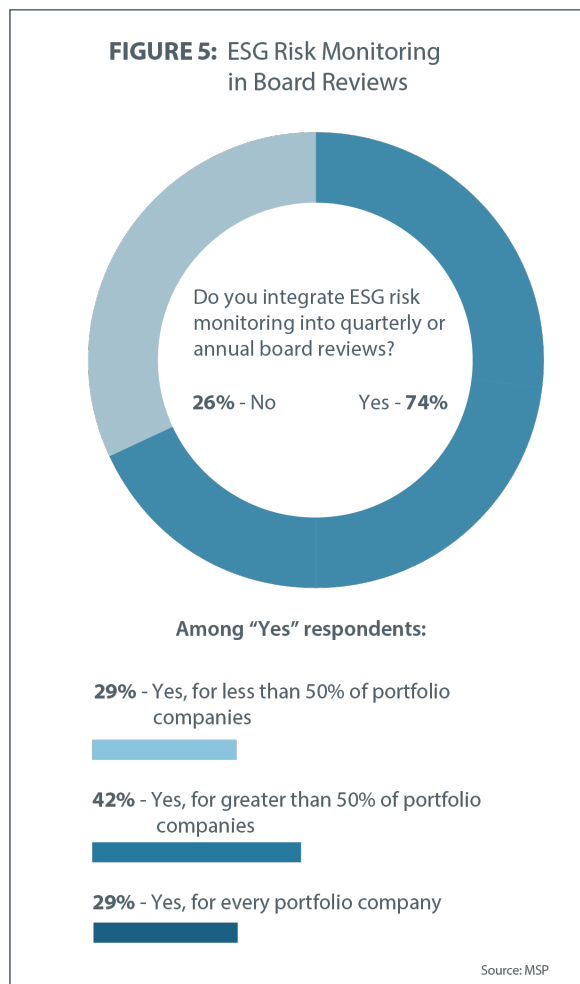
Source: MSP

## One firm's approach to ESG due diligence

For one middle-market buyout firm, ESG risk review proceeds much as it would for any other type of risk, but with specialized input from the firm's ESG professional. Every week the deal team and ESG professional sit down to review the pipeline of prospective deals. At that very early stage, before diligence, the team will discuss potential ESG issues from a high level perspective. For companies where ESG issues may be material, the ESG professional will write up a formal note to flag the most significant risks. Although finding a "showstopper" issue in ESG diligence will likely cause the firm to forego the investment altogether, it's worth noting that identifying a risk doesn't necessarily condemn a potential deal. For small risks, this GP will work with portfolio companies to make sure they can "clear the bar" in terms of acceptable risk level.

## After diligence, a majority of firms are integrating risk monitoring into portfolio company board reviews where material

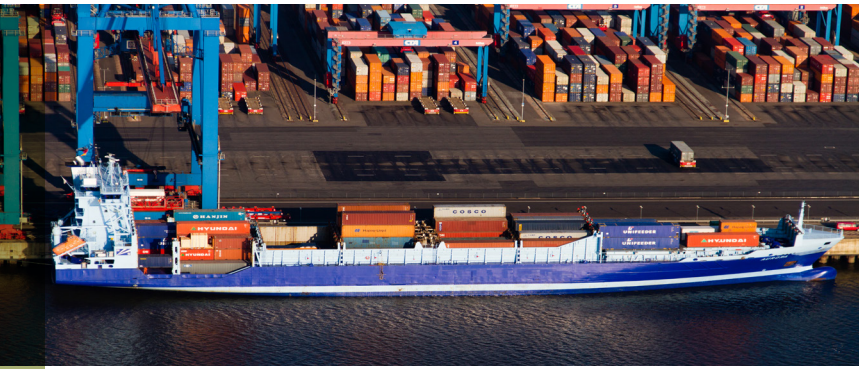
Surpassing our expectations, the large majority of GPs surveyed for this report include ESG risk monitoring updates in their quarterly or annual board meetings. Roughly 21 percent of firms report on ESG risks for every portfolio company, 32 percent report for a majority of portfolio companies, and another 21 percent report for a minority of companies.



Portfolio company board meetings are a precious opportunity for a private equity firm. No matter how operationally involved the GP is, the quarterly and annual meetings offer a rare opportunity to discuss big-picture issues and planning with the portfolio company management. The widespread integration of ESG risk monitoring into board meetings highlights the growing impact that ESG risks can have on a portfolio company's value (as well as the GP and portfolio company recognition of that risk to value). The fact that not all GPs do so for every portfolio company speaks to the variance in materiality of ESG issues across portfolio companies. "It is critical for this to gain the attention that it deserves," said Therése Lennehag, Head of Responsible Investment at EQT Partners AB on portfolio company ESG risk monitoring. "Within EQT, sustainability is viewed as a strategic question and it is expected to be part of portfolio companies' board agendas. The first time sustainability is discussed within the board after acquisition is an opportunity to go through: 'how does EQT view the world, what are EQT's expectations, what do we hope the company can achieve in this area.'" GPs rely on board meetings to communicate expectations and to ensure that portfolio company performance is up to par.

Though we already see substantial ESG risk review in portfolio company board meetings, as ESG risks continue to become more material for a greater percentage of companies, we can expect to see even more firms including ESG risks in every portfolio company review at the board level.

**"For companies where it is more applicable, we monitor for ESG issues at the board level. For [an apparel manufacturing portfolio company] we just had a board meeting last week and part of that was a section on CSR and ESG." – US Middle Market GP**



“After making a decision to invest, the same issues will be checked on a periodic basis during our hold to make sure the company is performing as we thought it would.” Don Anderson, Executive Director and Chief Sustainability Officer, Private Equity Group, The Blackstone Group

## Lack of Standard Practices, for Now

Within the framework of ESG management, we define standardization as applying processes consistently within every stage of the investment cycle. For diligence, that means applying the same review process consistently to every potential acquisition; within ownership that may mean applying the same process of ESG monitoring to every portfolio company.

“Wherever possible we haven’t created anything new necessarily, we’ve sought to embed ESG into existing fund and portfolio management processes, enabling the team to track and monitor risks and/or business opportunities.” – Adam Black, Doughty Hanson

In *ESG in Private Equity*<sup>SM</sup> - 2013, we noted a growing standardization of ESG management processes. To our surprise, we find that the opposite has unfolded. As discussed throughout this report, a vast majority of participants discussed over and over again the need to approach managing ESG where and how it is material to do so. The key to managing ESG is to “really make it practical. That’s the key,” said de Krijer. She added, “Don’t make it some overlay that’s going to drain away time and resources.” Making ESG management practical, to borrow de Krijer’s phrase, means moving away from a standardized approach. Instead, GPs are deciding whether and how to apply ESG management on a case-by-case, company-by-company basis.

In 2013 we saw an increased use of ESG due diligence checklists, which were relatively uniform and often only touched the surface of a very deep issue set. Today, we find that the majority of GPs are moving away from this approach, and toward a more in-depth review, but only for those companies where ESG risk is material to value. Using a standardized approach to ESG management may be efficient when a large proportion of the companies being reviewed face ESG issues that are material in similar ways. A fund that focuses 100 percent of its investments in upstream oil and gas companies will find it efficient to apply standardized ESG processes in diligence and ownership. However, in a fund that focuses 20 percent of its investments in each of the energy, software, healthcare, consumer goods, and food products sectors, applying those same processes consistently would be significantly less efficient. Most firms will not encounter enough ESG issues that are material in similar ways for a standardized approach to ESG management to be practical. Instead, GPs are finding that applying strategies company-by-company or vertical-by-vertical is both more efficient and more effective.

For firms with the strongest ESG programs, however, standardized ESG management practices are becoming more practical for two reasons. First, those firms have a lower materiality threshold. The largest and most developed private equity firms are under more scrutiny from the public (including being a public company, in many cases) and have made more advanced commitments to incorporating ESG. Take KRR, a firm that often serves as an example for ESG integration, as an example. KKR’s second ESG report, released in 2013, outlined several of the firm’s commitments and progress made on those commitments. In the report, KKR included ESG diligence reviews, ESG industry guides, ESG training, eco-efficiency, ESG reporting and many others. For firms such as KKR, ESG generally, as well as specific ESG issues, may be material for a greater percentage of their portfolio companies due to that public scrutiny and necessity of upholding commitments. Secondly, leading firms have greater capacity to manage ESG issues, reducing the cost of a standardized approach. Indeed for several of the largest firms, the investor relations and compliance teams outnumber an entire middle-market buyout firm.

# 3. LPs Continue to Increase ESG Expectations of Fund Managers

We observed two prominent trends in LP behavior with consistent directionality. First, the number and types of LPs setting ESG expectations continue to grow; and, the expectations themselves are higher. Second, LPs have increased their frequency of communication with GPs on ESG matters. This includes formal communication, such as DDQs, but more notably, we're seeing a rise in informal communication—email and phone calls. In both informal and formal means of communication, LPs are progressively focusing on a firm's capacity to manage ESG rather than specific ESG issues.



## More LPs and More Types of LPs are Setting ESG Expectations

Since publishing *ESG in Private Equity - 2013<sup>SM</sup>*, more investors and more types of investors are setting ESG expectations. According to a study by LGT Capital Partners and Mercer<sup>1</sup>, ESG is a factor in GP selection for almost 90 percent of LPs. For 63 percent of that subset, ESG factors in “significantly.” According to data from Pitchbook, in 2014, roughly 70 percent of LPs reported that their focus on ESG issues increased over the previous three years. This percentage is the highest since Pitchbook began recording data in 2012. A survey of GPs reveals the same trend. Over 80 percent of GPs—again, more than in either 2012 or 2013—report increased LP concern about ESG over the past three years.

According to data from Deutsche Bank, ESG is already important—and becoming more so—in almost every type of investor organization. It should come as no surprise that pension funds place a high importance on ESG. What may be surprising, however, is significant growth in ESG concern among all other asset owners. High net worth individuals demonstrate the greatest growth, with almost 60 percent reporting a rise in ESG importance. Furthermore, the majority of banks and endowments also classify ESG integration as important. Across all organization types, 20 percent on average perceive ESG as rising in importance.<sup>2</sup>

“For the last couple of years, we’ve been tracking the number of responsible investment / ESG specific requests for information (RFIs) that we receive and the annual growth number is quite astonishing. I can also see a trend towards more annual RFIs.” - Therése Lennehag, Head of Responsible Investment, EQT Partners AB

1 LGT Capital Partners and Mercer, 2015. “Global Insights on ESG in Alternative Investing.”

2 Deutsche Asset & Wealth Management, 2014. “The Alternative Perspective – 2014 Global Survey of Investors in Alternatives.” Retrieved from [http://realestate.deutscheawm.com/content/media/CC145947\\_Alternatives\\_Survey\\_2014\\_Results\\_FINAL\\_112514.pdf](http://realestate.deutscheawm.com/content/media/CC145947_Alternatives_Survey_2014_Results_FINAL_112514.pdf)



## ESG Beginning To Be a “Go/No-Go” Part of Fund Manager Selection

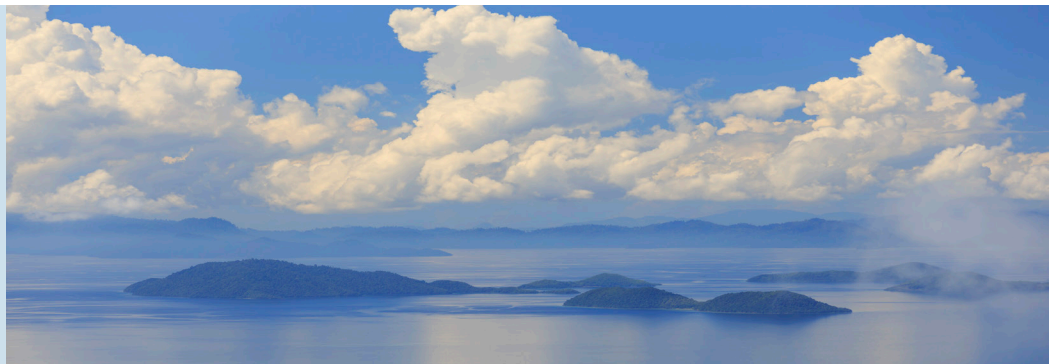
For certain LPs, having an ESG program is table stakes for investing with a GP. Such investors won't make a commitment to a firm based solely upon ESG performance, but without seeing evidence of a strong ESG program, more and more LPs won't place a commitment. The proportion of LPs who are willing to sacrifice fund performance for presence of an ESG program has risen substantially in the last three years, surpassing 30 percent in 2014 (*Pitchbook 2015 Private Equity ESG Survey*). Multiple survey participants, recalling meetings with LPs in their last fundraise, felt that investors viewed ESG as a critical component of fund manager selection. Those participants all reported successfully meeting the investors' expectations and securing fund placements, but viewed the incident as a sort of “wake-up call.” These firms expect this high level of scrutiny on ESG management to be the new normal in fundraising.

“We had a meeting recently with a potential new European investor, and one of the key items they wanted to discuss was ESG. It was great to be able to say that we are actively doing things now.” - US Middle Market GP

This trend is especially true for European LPs:

100 percent of European LP respondents indicated an increased focus on ESG in the last three years, according to 2014 Pitchbook data. For such LPs, “we're working on it,” is no longer an acceptable DDQ response. You now need to show results. And in light of the overall growth in LP attention to ESG, we can expect that ESG will become a deal breaker for a growing number of LPs.

“There's a lot of focus on how to make sure that GPs are actually following through on what they said they'd do.” - Maaïke van der Schoot, CSR Officer at AlInvest Partners



## Communication Has Increased Both Overall and Through Informal Means

Earlier in this report we discussed how many GPs were approaching ESG management on a case-by-case basis. The trend toward this style of management applies to LPs as well. Though DDQs remain the primary method for LPs to communicate expectations – more than 80 percent of GPs reported receiving an ESG-related question in a DDQ during their most recent fundraise – LPs have also substantially increased use of informal communication methods in order to determine a GP's capacity to manage ESG issues.

DDQs have become much more prevalent, and more important, but they don't serve as the only LP communication of ESG expectations. De Krijg said, "For a GP, a DDQ is really just an overlay on top of the work they're already doing. It allows them to summarize work they've already done."

In our survey, almost 60 percent of participants communicated capabilities and performance with LPs through non-traditional channels, such as email and ad hoc phone conversations, as LPs check on GP progress and clarify management expectations. The flexibility of informal communication allows LPs to more efficiently monitor the success of GPs' ESG management practices. Given these trends, GPs may expect to receive more communication requests from LPs in order to inquire more pointedly about the GPs' ability to "get the job done" on ESG issues.

**"I think there's definitely more of a push for the overall understanding of the ESG management system and processes of the fund." - US Middle Market GP**

## LPs Focus on GP Management Capacity

Looking back to 2013, we expected LPs' ESG expectations to become more issue-focused and prescriptive. LP requirements were becoming more stringent and sophisticated, and DDQs were beginning to rise in prevalence. Logic dictated that as more LPs set more expectations, those expectations would become more specific. However, although

**"From our point of view, each and every portfolio company has its own specific ESG topics that can be material and we believe that the GP should ensure that company management properly addresses those material ESG issues and opportunities." – Maaïke van der Schoot, CSR Officer, AlInvest Partners**

LPs' level of concern is growing, reflected in part by their now-widespread use of DDQs, they're not becoming more prescriptive. Instead, LPs are focused on a GP's management capacity; as a result they're communicating with GPs more frequently and in new ways. This reflects their overall approach to managing GPs. LPs understand that GPs are the ones with the investing expertise. What we've found through numerous interviews is that this pragmatic ethos applies to ESG, too. As Elizabeth Seeger, Director, Public Policy and Affairs at KRR said, "For the most part they want to know that we're thinking about these things. Additional dialogue helps them better determine the level of integration and thoughtful management that exists."

The growing number of informal inquiries and growing focus on capacity reflects a transition in LP goals for GPs. LPs in private equity today value ESG because it represents long-term sustainability in a company; managing ESG concerns is necessary to satisfy LPs' fiduciary duty to mitigate risks. LPs want to know that GPs are managing ESG effectively, not that they can check a series of boxes. To address that changed focus, LPs are focusing on a GP's management capacity in both formal and informal communication.

**"It's not, 'You have to do X Y or Z;' it's more 'You guys recognize that we're very interested in ESG: make sure you're doing something about it.' " – US Middle Market GP**



# Outlook



Every year we like to conclude this report by looking ahead and sharing trends we see on the horizon.

**LPs will increasingly consider a GP's ESG management capabilities in the 'go/no-go' stage of fund manager selection.** LPs' expanding expectations have already begun to manifest where they're most impactful to GPs: during fund manager selection. Based on our conversations this year, we have every reason to believe this trend will accelerate.

**ESG risks and opportunities will become material in due diligence and ongoing monitoring for more and more companies.** The growing importance of ESG risks and opportunities to a company's value will spur GPs to review ESG risks and opportunities for a larger percentage of their portfolio. Participants in this year's study repeatedly cited the need to review ESG where material; as ESG issues are recognized as material for more companies, GPs will continue to broaden the range of companies for which they monitor and manage ESG concerns.

**ESG management will increasingly be seen as an opportunity to innovate against competitors both at the firm and portfolio company levels.** Leading firms are on the frontier of viewing ESG as an opportunity for innovation and competitive differentiation. Over the next several years, we predict that this trend will progress as firms and companies alike see the benefits of incorporating ESG as a differentiator.

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