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ESG in Private Equity

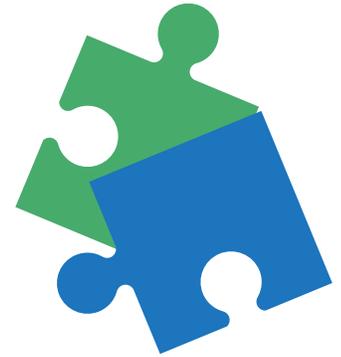


Thought leadership on the best ways to add environmental, social, and governance value to your investment program

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How to Add ESG to a Private Equity Program



Two veterans of private equity value creation and risk management explain the steps GPs can take to focus more on environmental, social, and governance impacts



Paula Bosco
CEO & Co-founder
Activus Risk Management

The institutional investment market is demanding greater transparency into the environmental, social, and governance (ESG) impacts of its managers, including private equity managers. However, many GPs have yet to launch formal ESG programs due to misperceptions and fear of the unknown. Privcap recently spoke with two veterans of the private equity operations function to learn about what some concrete steps are to getting started with ESG.

Privcap: ESG has been part of the private equity market for a number of years now, and yet there are many participants out there who believe that adopting ESG means sacrificing returns. Is that true?

Paula Bosco, Activus Risk Management: Especially in Europe, ESG has been around long enough for us to see returns from those players who integrate ESG into their platforms, and there is real value. Plus, there's a lot of academic and investor-based research out there that actually shows that you don't have to give up those investment returns for ESG.



Anthony DeCandido
Partner
RSM US LLP

Anthony DeCandido, RSM: You have to understand that the basis of private equity is that managers are in the business of driving returns. That's never going to change. But GPs have to consider driving profiles of return and the social responsibility that comes with that role. You also need to consider where you are in your lifecycle. For example, if you're a new general partner and your interests are fundraising, ESG may be an opportunity for you to showcase your values and your missions. If you're a more seasoned manager and you have a track record that follows you, this may be an opportunity to align your investor base a little bit more with your missions and your values.

So ESG doesn't diminish returns. But why should a GP consider adopting these principles?

DeCandido: A GP needs to understand that there's a changing demographic in the general workforce in the United States. Millennials have now taken over as the primary workforce. They are now set to inherit \$30 trillion of assets over the next decade or

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so, so the general partners are going to be working with allocators who are from the millennial population. Millennials have different interests and tend to favor mission-based strategies. These are individuals who are more interested in why they're doing something than what they're doing. Many allocators today are already in putting ESG on their checklists. General partners need to understand that this is an opportunity for them, too, to maintain relevancy in the changing market environment.

Bosco: What's more, if you're a GP and are looking to attract state and local pension fund money, or capital from sovereign wealth funds, they are squarely looking to see what you're doing in the ESG space. Now, you take a look at some of these DDQs and RFPs—whereas 10 years ago there might have been three or four questions on ESG, now we're seeing four or five pages dedicated to ESG, especially in the context of risk management.

Although there are now laws everywhere mandating ESG, are there important rules and regulations that are pushing its adoption by managers?

Bosco: Major institutional investors like CalPERS and CalSTRS have mandates around climate risk disclosures. To the extent that you're operating in California or invested in companies that are operating in that state, there are some disclosure requirements around that. It shows that the state is willing to get involved in this issue, and we think that many of the other state pension funds will follow. In addition, there was a rulemaking proposal from the SEC in 2017 which would have required sustainability reporting among issuers. That would be in line with the Europe-based Sustainable Stock Exchanges Initiative, which requires issues to report on what they're doing from an ESG perspective or explain why you're not required to do so.

What would you recommend to a small or medium-sized private equity firm about the best way to launch an ESG program?

DeCandido: For starters, I would suggest to a general partner to create a vision statement. Define the purpose of this effort as it relates to driving returns. You would also benefit from developing some level of governance controls. You may want to pull together a sustainability committee. This would be no different than a board of directors or a committee in a public scenario.

Bosco: Have the firm assess any of its legal or regulatory obligations. You need to be looking at your investor-specific issues. Anything that's part of a side letter or part of a commitment that you have made to an institutional investor, you want to get that on the books.

Frameworks for ESG

There are a number of standards available for adoption by GPs

United Nations Principles for Responsible Investment (UNPRI): An independent entity working to understand the investment implications of ESG factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. "To be a member of the UNPRI, you have to commit to making sure that you are doing all the things that you say you're doing and then report on that," says Bosco. "Asset owners are really looking for that."

Sustainability Accounting Standards Board (SASB): An independent nonprofit standard-setting organization that develops and maintains robust reporting standards that enable businesses around the world to identify, manage, and communicate financially material sustainability information to their investors. SASB standards are evidence-based, developed with broad market participation, and are designed to be cost-effective for companies and decision-useful for investors. "The spirit of this framework is that's intended to drive superior results all by way of measurements of these ESG and priorities," says DeCandido. "There's a codification about 77 different goals."



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–Anthony DeCandido, RSM US LLP

DeCandido: Getting started with ESG is less an expense for the general partners than it is a time allotment. You have a very lean group that’s devoted to driving an investment strategy. Now you have to redeploy some time to ESG, and there’s a lot of questions as to who’s the right person to do that.

What kind of help would a third party, like RSM or Activus, be able to offer a GP?

DeCandido: The calls that we’ve been getting from our clients are around things like helping to prepare a sustainability report. Some are lengthy reports that detail all the ESG measurements for each portfolio company. More commonly, I’m seeing managers request a performance assessment from an independent party like us that can help validate some of the numbers, but then also give some comparability and benchmarking across other organizations.

Bosco: The main concern around ESG is that a lot of the information is self-reported and not verified, and so we provide verification services.

Final question: Using a baseball analogy, what inning is the private equity market in by way of fully adopting ESG?

DeCandido: I would say that we’re probably somewhere in the fourth or fifth inning. There’s been a lot of progress that’s been made. There’s more to come.

Bosco: I agree. I think we’re probably in the fifth or sixth innings. I think ESG has moved away from just the fundraising strategy to more of a long-term approach to investing, and that is a good thing. No matter where you are in the value chain, if you’re an asset owner, an asset manager, one of the target portfolio companies, a regulator, people are realizing that ESG brings value to every part of that process.

The Challenge of ESG Data-Gathering



The data captured in an environmental, social, and governance program can be vast and voluminous. How should GPs approach this task and who on the team should lead it?

With all the kinds of information that could be gathered as part of an ESG program, how can GPs know what information to prioritize?

DeCandido: It’s no different than any other challenge that GPs have in their organization. They need to fully understand who their stakeholders are and what their desires are.

Bosco: Institutional investors are pretty clear about what they want from you in terms of ESG. There’s not a lot of hiding the ball.

But isn’t there ESG information that is too difficult for some GPs to gather?

DeCandido: I will say that often in early meetings with GP clients, they will say they don’t quite know whether they have the infrastructure, time, or the sophistication on this topic to be able to direct this strategic imperative.

Bosco: I think GPs sometimes forget the fact that there is wiggle room in negotiating with LPs about ESG reporting. To the extent that they are collecting a certain type of information and an investor asks for information that’s similar but not exactly what they do, there’s nothing wrong with calling that investor and just saying, “Look, this is what we’re currently doing. Will this suffice for your purpose?” Nine out of 10 times, it will.

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In your experience, are there any fields of information that GPs most often resist?

DeCandido: In my experience, GPs don't always volunteer their gender composition or their board's gender composition. We see a lot of asset managers who fall into this “stale pale male” syndrome—basically managers who fit a Caucasian background, an Ivy League background, and they don't always have much ethnic or gender diversity. The data we see is that only 6 percent today's of asset managers at leadership levels are women. That's a little bit daunting, and there's a lot of work to be done.

How about on the environmental side?

Bosco: That is something that is a lot of work, but the reality is, most times portfolio companies that are taking in capital from private equity have done this kind of background work because they know it will be expected of them at some point. So yes, carbon footprint reporting, for example, is definitely one of the more complex issues. Water scarcity seems to be an issue as well. It is hard to wrap your head around how much water your portfolio companies are using, what are the metrics they're using, etc.

Who at the firm should be in charge of ESG data-gathering?

DeCandido: At many of our clients, the individuals who will be fulfilling that responsibility do not yet know that because of the leanness of their organization. We've seen all types of arrangements. We've seen CFOs take the role. But at some point in the process, the analysts will have to be involved.

Bosco: The analysts and the deal team members are closest to the portfolio companies. They should gather that information and be responsible for getting that from the portfolio companies. Then we'll recommend that the investor relations person be responsible for taking in that data, compiling it. You want to be the first one to know about that. Typically, the investor relations entity will own



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ESG until the firm becomes of a size or has the desire to hire a dedicated ESG person.

Are some managers afraid that in reporting their ESG information, they'll be exposed as not doing a very good job on these fronts?

Bosco: You can't measure what you don't know. The first step in the process is asking the question. If you get information back that's not consistent with what you thought it was or is not consistent with what your values are as a fund or a GP, then you have an opportunity to fix it.

DeCandido: Transparency is going to overcome the shortcomings that might be revealed in ESG measurements you're not proud of. It's an indication that the GP has a level of self-awareness to say, “Hey, look, we're acknowledging this, and we're acting to change it.” I think that's a positive. ■