Responsible Investment

A guide for private equity & venture capital firms

Updated version including a supplement on Evaluating ESG Issues at the Pre-Investment Stage

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Private equity firms are seeking to improve their ability to manage the risks and opportunities arising from environment, social and governance issues. This document provides some guidance on current best practice.

Preface

Private equity and venture capital have been widely recognised as a force for good. By aligning the interests of owners and managers, and bringing strategic expertise to grow companies, the private equity business model adds intrinsic value and helps to build better companies. It does this by driving both financial and operational performance, including the managing of environmental, social and governance issues (ESG).

Private equity has always promoted financial performance in parallel with ESG compliance. It is only in recent years, however, that the ESG focus has moved from basic compliance to a more ambitious benchmark – the pursuit of strategic value through actively managing ESG issues.

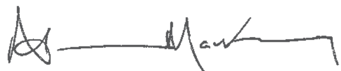
In parallel with this more ambitious approach there has been an increasing expectation from major private equity investors – such as pension funds – for private equity firms to demonstrate and report non-financial (ESG) performance in the widest possible context. This is universally called "the Responsible Investment (RI) approach".

Within global private equity and venture capital the BVCA has been at the forefront of the Responsible Investment approach, first publishing a Responsible Investment Guide in 2009. Over the last two years steady progress has been made. This 2011 edition aims to build on that progress.

An effective RI approach demands a focus on ESG issues throughout all phases of every investment, from pre-investment diligence, through active ownership, up to the time of exit. In this new edition of the BVCA Responsible Investment Guide we introduce a supplement addressing in more detail the first of those phases – Evaluating ESG Issues at the Pre-Investment Phase. Whilst the Guide refers to 'PE' throughout, we have used this to describe both PE and VC houses.

We would like to thank all the individuals and organisations below, from within and around private equity and venture capital, who have contributed to the preparation of this Guide – it is intended as a practical and pragmatic guide to adopting the responsible investment approach.

Mark Florman
Chief Executive
BVCA



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Introduction

Evidence is mounting that private equity and venture capital firms (PE) view responsible investment (RI) as increasingly important. This publication is intended to increase General Partners' (GPs') awareness of the RI factors to consider when determining strategy and policy, and throughout the investment life cycle.

According to a recent UN Principles for Responsible Investment (UNPRI) publication, an audience survey at the October 2009 Private Equity International CFO / COO Conference in London showed that "71% of the Limited Partner (LP) and GP attendees agreed that environmental, social and governance (ESG) issues could influence the realisation process."[1] Further evidence of rising recognition is seen in a survey conducted by the British Private Equity & Venture Capital Association in August 2011, which revealed that 63% of respondents thought that active management of sustainability issues made a company more attractive to investors.[2]

Yet just a few years ago, ESG issues did not typically feature as business priorities for PE Houses. So what has changed?

Development of the ESG agenda

Financial firms originally viewed ESG issues purely from the perspective of reputational risk. Today, they increasingly recognise their effect on business and financial risk, as well as the opportunities for investment, new business and market access. Additionally, stakeholder expectations regarding good practice in RI are rising fast, with financial services firms increasingly held accountable for their business practices.

Investors are becoming more socially and environmentally aware. They are avoiding or selling investments seen to be materially harmful or likely to suffer negative commercial or reputational impact. The recent economic crisis has exposed certain ethical concerns in the financial services sector and dramatically lowered public and stakeholder trust. Restoring that trust has become a key priority and RI presents an important way of beginning to address that need.

The banking sub-sector is, arguably, the most advanced in considering ESG issues within its business operations. Banks began integrating ESG into risk management and exploring opportunities related to ESG themes over a decade ago, and the practice is now firmly embedded among the majority of banks in industrialised economies. Investment is akin to lending from the ESG viewpoint and PE firms can use banks' experiences to shorten their own learning curves.

Development of responsible investment in the PE sector

Outside banking, until recently only specialist financial services firms such as Generation Investment Management, Climate Change Capital and Earth Capital Partners have focused specifically on ESG issues. Asset managers investing in publicly listed companies pioneered the practice, concentrating on the regulatory and reputational risks arising from poor ESG management in portfolio companies.

Traditionally, privately-held companies and their investors faced less scrutiny than their publicly-listed counterparts. However, investor and market expectations, regulatory requirements and business risks and opportunities have evolved rapidly in recent years. Managers of privately-held investments are, therefore, also integrating ESG considerations into their businesses.

PE houses have started focusing on the impact of environmental issues such as climate change, on business and investment risk. Within the corporate world as a whole, there are well-known examples of ESG issues impacting both companies and their investors. Climate change is the current hot topic but others that have been significant include: labour issues in the supply chain, health and safety (e.g. BP), or corruption (e.g. Siemens).

PE firms are becoming increasingly active in the renewable energy and clean technology markets. A growing number of GPs see investment potential in environmentally sound technologies and energies. For example, Kohlberg Kravis Roberts' 'Green Portfolio Program' now makes up over 20%

1 http://www.unpri.org/files/ILPA_RI%20article_Winter%20Newsletter_Dec09.pdf

2 The BVCA 2011 Sustainability Survey

CASE STUDY
DOUGHTY HANSON

Balta Group

Doughty Hanson believes that by engaging in the broad set of environmental, social and governance (ESG) issues it can improve the financial performance of portfolio companies, reduce investors' exposure to reputational risk and make portfolio companies more attractive to potential acquirers.

The PE firm works across the full spectrum of ESG engagement, ranging from environmental efficiencies, through to long-term business process management.

Activities at Balta Group, a leading European manufacturer of wall-to-wall carpets and rugs, are representative of Doughty Hanson's approach to responsible investing. They include:

- Addressing energy efficiency (resulting in cost savings of €400,000 to €570,000 a year per plant and reduced energy demand of some 12% per plant);
- Using onsite solar power (resulting in some €500,000 annual income and some 2,000 tonnes annual carbon savings);
- Tackling waste minimisation (resulting in a reduction of over 300 tonnes of solid waste in 2009 versus 2008);
- Enhancing recognised standards of good management practice (resulting in better governance and risk management);
- Providing training and improving safety culture (resulting in improved performance and reduced lost time);
- Addressing supply chain and product range sustainability, such as the use of timber from certified sustainable sources (resulting in enhanced credentials and exceeding customer expectations).

"Doughty Hanson was an early advocate of responsible investing within the private equity asset class and continues to champion its potential for value creation. The work we are doing alongside our management teams is now yielding tangible results across many of our portfolio companies."

Nigel Doughty
Co-Founder, Doughty Hanson

of its total global portfolio.[3] The sector increasingly views RI as, potentially, a means to differentiate portfolio companies, balancing risks and creating new business opportunities. While approaches to RI may differ across the sector, dependent on the size and strategy of the PE House, the importance of the agenda applies across the entire spectrum of GPs, from small venture capital managers through to large PE Houses.

The UN-backed Principles of Responsible Investment (PRI) form PE's primary framework for RI, providing a voluntary and aspirational structure for the incorporation of ESG considerations into investment decisions. Today, 110 PE fund managers and fund of fund managers are signatories to the UNPRI, up from 38 since 2009. This includes leading PE houses such as Actis, BC Partners, Cinven, Doughty Hanson, Ironbridge, First Reserve and Kohlberg Kravis Roberts. As an increasingly high profile initiative, a key milestone for the PE sector was the creation in September 2008 of the UN PRI Steering Committee on Private Equity.

Recent developments show how RI is gaining in importance. The US Private Equity Growth Capital Council (formally the Private Equity Council), which represents 36 of the largest houses worldwide, published a set of Responsible Investment Guidelines in 2009 and PE associations representing the US, UK, Australia, France, Brazil and Europe have established permanent working groups.

The UN PRI has also published a guide which is aimed at supporting LPs in their RI decision-making, much of which is focused on their relationship with GPs.

Many PE houses already consider certain ESG issues during pre-acquisition due diligence, particularly focusing on compliance and potential ESG-related liabilities. However, most lack a structured and strategic approach under an over-arching sustainability strategy, linked to the firm's business strategy.

Drivers for action on the ESG agenda are examined in the box, but two dominate all others:

1. The growing interest and pressure from investors, and
2. Regulatory developments – especially the UK's CRC Energy Efficiency Scheme legislation (formerly known as the Carbon Reduction Commitment), which confers financial and reputational risk on PE firms, treating them as holding companies.

An example of multiple drivers is seen in the growing response to climate change. Investments can be impacted by both actual climate change and the policy responses to it such as carbon caps. Energy-intensive industries are particularly affected. Public policy, which is increasingly encouraging new technological developments, can stimulate business opportunities and investments. There is growing market demand for technologies that address climate change.

Strategic management

Most GPs have some element of ESG consideration in their investments, but much of the time this is executed in an ad hoc manner. Taking a more strategic approach can ensure that opportunities are maximised. GPs should stop to consider:

- Why am I devoting resource to these activities?
- How do I want my efforts to be perceived by stakeholders?
- What progress do I want to have achieved in three-to-five years?

A defined strategy can significantly support ESG-related decision-making during the investment life cycle, but can also give support during fundraising activities by providing a framework for meaningful responses to LP enquiries, and by helping to demonstrate a proven RI track record.

When planning their RI strategies, PE firms should consider the following success factors:

Ambition – A firm should have a bespoke ambition and vision, which guides its approach and risk appetite. Having defined the desired outcome, a firm can plan the progressive actions and structures needed to achieve this. There is no single right answer, scenario or means of implementation. Each firm should decide its own path based on its level of ambition, which may change over time as the RI programme becomes more fully integrated. RI should also be aligned with the firm's overall business strategy and risk management procedures.

3 Creating Sustainable Value: KKR's 2010 ESG Report http://www.kkr.com/ar/downloads/kkr_ESGreport.pdf

Drivers of responsible investment

Regulatory – Public policy and regulation around ESG issues is growing in both industrialised and emerging markets. In the United Kingdom, the CRC Energy Efficiency Scheme holds PE houses liable for the carbon emissions of the UK companies over which they have management and financial control.

Investor demand – At a time of growing PE transparency, an increasing number of influential investors want to see evidence that their PE managers are taking ESG considerations into account in their investment analysis and ownership practices. The emergence of the UN Principles of Responsible Investment, adopted by over 520 asset managers, has also encouraged investors to seek reassurance. Observance of ESG issues gives access to a wider pool of investor capital.

Risk management – ESG issues in portfolio companies can expose PE houses to reputational, financial and regulatory risk.

Business opportunities – The demand for green/clean technologies and energies has driven innovation and entrepreneurship among businesses, spawning significant PE investment opportunities.

Value-add – Integrating responsible investment practices into the investment cycle can enhance portfolio companies' cost efficiency and profitability. Effective management of ESG issues can reduce operating and regulatory compliance costs. It can also improve access to new markets and customers, as well as stimulating product innovation. Ultimately it can improve the saleability and value of portfolio assets on exit.

Suitability to stakeholders – A firm interested in developing an RI approach to its investment strategy should consider matching this not only to its own values and principles but also to those of its key stakeholders, particularly investors and its diverse portfolio companies. Some investors may, for example, require certain sectors or activities to be excluded – such as alcohol, tobacco, defence industries etc.

Leadership – Identifying a firm's future ambition requires the commitment of senior management and boards – this is critical to the success of any RI strategy. Articulated from the top, RI strategy should be intrinsically linked to the firm's overall objectives. This allows a consistent message to be conveyed throughout the firm and to be reflected over time in its overall business strategies.

Defining a policy or policies – Having established a broad strategy, PE firms should consider defining and communicating not only principles of investment (for example the UN PRI), but also a more specific ESG policy, or series of polices covering different aspects of the agenda, such as climate change, bribery and corruption etc. Careful consideration should be given to whether policies will cover only investments or the management firm as well, with many stakeholders expecting the latter.

Defining a governance framework – Implementation of an RI approach requires effective governance to outline ownership of the strategy and ESG policies, as well as to define who is responsible for RI management activities within the investment cycle. Governance should extend to portfolio companies, with primary ESG contacts being established, and reporting arrangements being agreed in advance (e.g. by integrating ESG metrics/KPIs into Board reports or balanced scorecards).

Internal engagement – Successfully integrating RI into the business strategy and daily operations of a PE firm requires internal buy-in, as well as the enhanced awareness of employees and management about the issues and their relevance. Firms that succeed in developing and executing an effective approach to RI have staff who are trained and fully committed, regarding this as an integral component of their daily roles and responsibilities.

Integration into core business – Procedures should be set out, outlining how a firm plans to integrate RI into its strategic approach to investment. They should show how the firm's overall RI ambition will be integrated into the existing investment cycle, from investment screening to portfolio management and, finally, exit. The ultimate goal is to integrate RI into the firm's investment cycle, making it central to the firm's investment approach.

Measurement – Firms need to measure progress to understand how they are enhancing value, satisfying stakeholders and growing businesses in key sustainability areas. Measurement is also critical at the strategy level, to evaluate the firm's progress in meeting objectives. This enables the firm to assess whether it needs to correct its course or to adjust its ambition and goals.

Reporting – In an era of increasing transparency and accountability for the PE sector, consideration should be given, from the outset of designing an RI programme, to the nature of information that should be divulged to stakeholders, when and in what format (for example, online, in annual reports etc). Only by considering desired reporting outputs from the beginning, can necessary inputs (data, performance metrics, case studies etc) be collected over time.

"Making all of this work in practice is about the right attitude and the right plumbing. Plumbing good corporate responsibility (CR) into every stage of the process from investment papers, due diligence, portfolio management. If our teams have the right attitude, they will spot issues, enlist support and deal with them.

Getting due diligence right is key but businesses change and the CR agenda changes so we need to ensure we are alive to these changes. These days, it is commercially imperative for a business to address issues relating to corporate social responsibility. When it comes to exit, what sensible buyer will buy if there are CR issues? In my view good CR is simply good business. It reduces risk and enhances value."

Patrick Dunne
Group Communications Director, 3i

CASE STUDY
3i

As a public and international company, 3i has long been committed to putting its core values into effect by investing responsibly and encouraging responsible business conduct among its portfolio companies. In 2011, building on previous policy commitments in the area of corporate responsibility, we developed a specific Responsible Investment Policy. The purpose was to set out our approach to the effective identification and management of environmental, social, business integrity and corporate governance issues (together, "ESG" issues).

3i's new Responsible Investment Policy makes explicit commitments under each ESG heading, for all new private equity and infrastructure investments. In particular, minimum standards of ESG performance (based on the IFC Performance Standards and associated Guidelines and the eight core ILO Conventions) are specified which new investee companies will, in appropriate circumstances, be required to work towards achieving during 3i's period of ownership. The Policy also identifies a number of sectors in which 3i will not invest, and in addition, lists several more sectors where referral to the Chief Investment Officer is required before proceeding.

Implementation of the Responsible Investment Policy will be aided by the use of new tools and resources accessible to all investment professionals worldwide, and will build on updated ESG investment procedures and guidance notes originally launched in 2008. The supporting tools will aid investment professionals to assess the target company's commitment, capacity and track record in managing ESG issues and are aimed at identifying the need for, and scope of, any specialist external due diligence. Where commissioned, external specialists will be required to assess the target company's current ESG performance against our minimum standards, and to make recommendations for ESG performance improvement during our period of ownership.

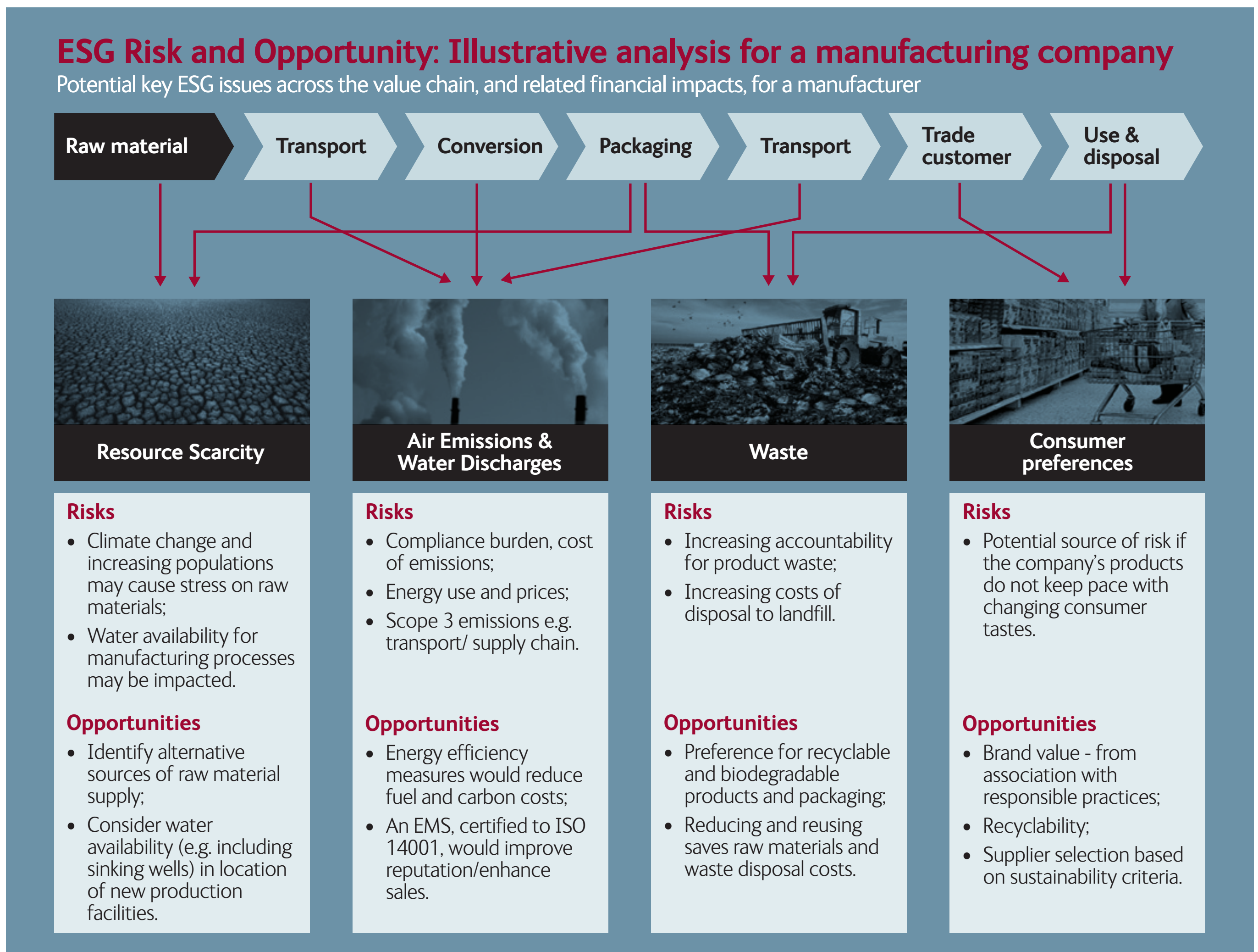
Recognising the challenges inherent in assessing the portfolio against the revised / new RI policies, the RI Steering Group (of senior investment executives mandated with embedding the policies across the investment business) requested that an independent review of the portfolio be conducted to identify risks and opportunities and to set a baseline to assess / benchmark future ESG performance. Encouragingly, of the 27 companies that were reviewed, some 20 companies have identified opportunities to further improve ESG issue management as part of their value creation strategies.

Key factors to consider throughout the investment cycle

Pre-investment

Decisions made during the pre-investment stage can be critical to influencing a GP's ESG impacts. Where GP strategies exist on ESG, key pre-investment evaluation of a target investment should assess whether the proposed transaction would, in principle, create synergies, conflicts or opportunities in relation to these defined protocols. The evaluation could include overall sector profiling (i.e. is this an area in which the fund should consider investing based on known or likely social, environmental, ethical and/or governance issues?) or a screening of publicly-available information on the target, perhaps using a checklist. This checklist could systematically assess key risks and opportunities which could be relevant to the GP. Further details on the practicalities of ESG screening pre-investment can be found in the supplement, starting on page 16.

Traditionally, this pre-investment screening has been limited to environmental, health and safety issues related to operations at specific company sites. It has focused on legal compliance and the potential for liabilities related to contamination clean-ups. Given the increasing impact – even at a company level – of global "mega-trends" such as climate change, water resource constraints, demographic change and population growth, this is unlikely to be sufficient going forward. Rather, a "value chain" approach is recommended, with careful consideration being given to all ESG impacts at each stage of the chain. An example of this thinking – for a manufacturing operation – is provided below:



Key considerations at the pre-investment stage could include:

- Are there any inherent significant ESG concerns or opportunities associated with this sector or geographic area of operations?
- Where sector issues are pertinent, does the target's ESG policy adequately address the relevant themes?
- Where sector-specific ESG issues arise, could there be a short-term impact on the business model?
- Does the target appear to foster transparency in its activities, for example does it have a publicly-available ESG or "Corporate Social Responsibility" policy?
- Does the target have a reputation for strong or poor marketplace performance in relation to ESG issues?

Known poor ESG performance of a particular target does not necessarily prevent investment if the potential for substantial improvement can be demonstrated. On the contrary, this may represent a significant opportunity to add value by reducing costs, identifying new business areas, improving staff loyalty, improving reputation and ultimately boosting marketability. However, carefully scoped due diligence may be necessary to ensure that legacy ESG issues are fully understood, so that material risks can be anticipated and allowed for within the business model.

Whatever the proposed investment, consideration should be given to effective ESG due diligence during acquisition. The overall aim of due diligence is to understand the target's ESG performance in greater detail, including associated risks and opportunities that could impact either the overall business case or the business value. While some issues can be unique to a particular sector or even a business, many core principles will apply across sectors and investment opportunities. In addition, the weighting of each issue will depend not only on the target's location and activities, but also on the GP's defined RI principles and strategy.

GPs should ensure that the due diligence scope identifies ESG risks and opportunities as effectively as possible. The scope will vary depending on the nature, location and activities of a business e.g. businesses with significant operations in some developing countries may present more ESG risks / opportunities for performance improvement than those with operations in developed countries, and hence due diligence scope may need to be broader and deeper. Some issues to consider when defining the scope are included in the table on page 9. Where internal resources or expertise do not adequately cover ESG issues and/or the particular sector under consideration, external consultancy support may be advisable. The BVCA has developed an approved panel of appropriately qualified consultants for this purpose.

CASE STUDY

Bridges Ventures

The Office Group

Bridges Ventures manages funds using its commercial expertise to deliver both financial returns and social and environmental benefits. Its Venture Funds are themed, focusing on businesses in regeneration areas and in the sectors of environment, health and education/training.

Bridges Ventures has a responsible investment policy, available through its website and incorporates ESG issues throughout its investment process:

- Selection: Positive and negative screening and social and environmental issues covered in investment committee papers and Term Sheets
- Engagement: working with portfolio companies through the Bridges IMPACT scorecard to identify ESG opportunities that can also benefit the business
- IMPACT reporting to investors

Portfolio company example: Bridges Ventures was a founder investor in The Office Group, which provides flexible office space to small and medium sized businesses. It acquires freehold buildings, mainly in inner city regeneration areas of London and undertakes significant redevelopment work to convert the buildings into distinctive, attractive space for SME's, thereby stimulating the local economy.

The Office aims to combine a friendly community feel with a real commitment to sustainable working environments, including green roofs, recyclable materials, rainwater harvesting, low energy lighting and solar water heating. It works closely with local charity Global Generation, taking local children and students and educating them on the environment and business.

The focus on regeneration areas and environmental sustainability appear to have delivered strong commercial advantages. Client surveys have consistently shown that the environmental credentials and the value for money proposition of The Office are in their top 4 reasons for choosing to locate there. The Office has continued to run well ahead of plan and maintain full occupancy despite the economic downturn.

Due diligence should consider both current and reasonably foreseeable ESG issues, so providing maximum visibility of the risks and opportunities. The scope should cover not only legal compliance but also non-regulatory issues. This could include recognised reporting standards like the Global Reporting Initiative,[4] sector-specific concerns (e.g. carbon foot-printing for the food sector or social capital for the service sector), and/or investment community agreements (e.g. the UN PRI and the Equator Principles[5]).

GPs should try to allow sufficient time and access for ESG due diligence wherever possible, as this will maximise the opportunity for a comprehensive asset assessment. They should encourage both positive and negative due diligence reporting, which provides as holistic a picture of the asset as possible. Additionally, ensuring that reports cover both the inherent business risks and existing mitigation strategies allows a full evaluation of effective management procedures.

If possible, one team member should have responsibility for the ESG due diligence workstream. This person should ideally have a detailed understanding of the identified issues and liaise with external advisors in good time (so avoiding any last minute "surprises").

KEY MESSAGES

- Develop high-level understanding of the sector and/or target's existing ESG performance to help guide preliminary business modelling
- Assess whether the ESG profile has conflicts or synergies with the GP's ESG policy and strategy
- Where underperformance is identified, consider well-scoped due diligence to establish key risks at investment outset
- Use high-level risk and opportunity screening to effectively scope due diligence
- Engage expert support early
- Encourage balanced reporting
- Obtain regular feedback from advisors
- Make time to understand the implications of findings and their associated mitigation

Immediately post-investment

On balance, ESG issues are rarely so material that they prevent an investment progressing, but their significance could merit inclusion within key items within the post-acquisition performance improvement plans to form a start point from which an ESG strategy can evolve.

Whatever the identified issues, due diligence provides the information for a baseline from which future strategies should evolve. Correspondingly, revisiting recommendations made in the relevant due diligence report(s) is urged as part of the post-acquisition performance plan. The required actions are likely to vary, depending on the business's known or suspected issues.

As a start, GPs should consider disclosure of the due diligence reports to relevant personnel within the portfolio business to aid their understanding of issues, allowing them to put in place the management strategies to tackle these issues. All too often, these reports never reach the target and, therefore, do not achieve their maximum impact.

Any urgent actions should be identified, especially regarding major actual or potential non-compliance with regulations, and where possible rectified as part of the 100-day plan. This could also include the collation of additional data sources to close out significant outstanding issues, which was not possible during the timescale of due diligence. Other less urgent issues can be addressed during the post-investment stage. The specific required actions are likely to vary, depending on the business's known or suspected issues.

Personnel should be selected within the GP organisation who will take responsibility for managing these issues moving forward. Where internal expertise is insufficient, this may merit the support of expert consultants.

4 www.globalreporting.org.
5 www.equator-principles.com.

CASE STUDY
CLIMATE CHANGE CAPITAL

Creating Wealth Worth Having®

Climate Change Capital (CCC) manages its Climate Change Property Fund with the philosophy that buildings which meet the highest sustainability criteria are likely financially to outperform older, obsolete buildings at risk of falling in value over time. In particular, CCC considers that carbon-efficient buildings will become a key part of institutional investors' portfolios in future.

CCC's management strategy is to improve property values through low-carbon retrofits that increase energy and carbon efficiency. Identifying opportunities to improve a buildings' performance starts during due diligence, with analysis designed to assess the current and potential future building performance, as well as the cost of upgrading. CCC then discusses mutually beneficial options with tenants, being prepared to fund a portion of retrofit costs itself. Options focus on improving both the building's fit-out and its use by tenants. These initiatives can yield material carbon savings and significantly reduce operating costs.

Building fit-out – A recent refurbishment of a six-storey city-centre retail and office building has significantly improved lighting, plant and air conditioning equipment with an estimated payback of five years. The refurbishment has improved the building's performance and occupant satisfaction. Improvements should translate directly into value gains through lease and tenancy negotiations.

Building use – A city-centre office building refurbished in 2003 to meet the BRE Environmental Assessment Method (BREEAM) Excellent standard still had energy usage figures three times higher than the benchmark value. Investigations identified several reasons, including incorrect meter calibration and an additional feed from a neighbouring property. Resolving these issues alone won the building's tenant a rebate exceeding £250,000. Examining settings on other plant—including hot water heaters and air handling units— is anticipated to deliver the tenant further year-on-year savings at minimal capital investment.

GP ESG policies, procedures and strategies should be communicated to key personnel within the portfolio business in a manner which will engender understanding and appreciation.

Personnel should also be selected within the portfolio business to take part in the ESG initiative. Appropriate mechanisms should be established, although ideally these should be within existing company structures, roles and responsibilities.

KEY MESSAGES

- Revisit ESG due diligence reports as part of the post-acquisition performance improvement plan
- Cover off any outstanding issues
- Correct or mitigate any major regulatory non-compliance representing a significant immediate business risk
- Where possible, begin to develop the structure which will support development of future ESG initiatives

Post-investment stage

As significant shareholders, and custodians of LP capital, GPs have a responsibility to encourage the companies in which they invest to adopt and pursue responsible business practices. Moreover, they have a clear financial interest in so doing: overseeing the management of ESG issues during the ownership period of an investment has the potential to protect or significantly enhance profitability, and value/saleability on exit.

Managing residual risk in the portfolio – Where acquisition ESG due diligence has been limited in its scope (perhaps due to time constraints or access issues), firms may not have sufficient insight into the ESG risks and opportunities in their current portfolios.

To remedy this, GPs may wish to consider the following initiatives:

High level review – A supplementary review of the portfolio through a survey, interview or audit – in particular if undertaken annually – can be a useful tool to determine:

- How ESG issues relate to each company
- Management attitudes and actions taken to date on ESG issues
- Areas of unmanaged risk
- Areas of unrealised opportunity

"Deep dives" – Following an initial portfolio review, or where detailed ESG due diligence has identified issues which should be tackled outside the 100-day plan, GPs can focus resources on those companies and supply chains with the most unprotected and unrealised value. This may take the form of:

- Site audits
- Implementation of risk management procedures
- Training company staff
- Market analysis

"The business case for environmental management has never been stronger. The Green Portfolio highlights that environmental performance and business performance can go hand-in-hand. We are very excited about the momentum to date and the fact that we have taken this effort global in such a short period of time."

Henry Kravis
Co-founder of KKR

CASE STUDY
KKR

Green Portfolio Program

In May 2008, KKR and the non-profit organization Environmental Defense Fund (EDF) announced the "Green Portfolio" partnership to measure and improve the environmental performance of companies within KKR's portfolio. The partnership builds on the successful collaboration in the 2007 acquisition of TXU Corporation, now EFH.

Since that time, KKR has committed itself to developing a set of analytic tools by which companies can assess and track improvements on a series of environmental metrics. These tools enable managers to cost-effectively improve efficiency, reduce waste and address environmental impacts, such as greenhouse gas emissions, the use of priority chemicals, waste generation or water consumption.

How It Works: The GPP applies KKR's approach of assessing, measuring, and optimizing performance to help its portfolio companies manage their environmental impacts while also improving their business.

KKR's team of operations experts — KKR Capstone — partners with KKR's portfolio companies to help make this program work. KKR has also built a number of resources for the GPP participants, including a portal that will help the companies collect data and report performances against their goals, and a database of best practices for improving performance.

Portfolio Company Involvement: Promoting practices that are more sustainable for the environment and provide cost savings has been widely accepted among many of KKR's portfolio companies. Participation in the program is voluntary, but provides company management teams access to a community of practice around shared issues and challenges. Currently, more than twenty percent of KKR's private equity portfolio companies participate in the program, with several more companies expected to join the venture in 2011 and 2012.

Results: In June 2010, KKR and EDF announced program results from the first eight companies to enroll. These companies avoided \$160 million in operating costs, 345,000 metric tons of CO_2 emissions, 1.2 million tons of waste and 8,500 tons of paper.

An ongoing system for engaging portfolio companies

To mitigate risk and maximise opportunity, GPs must maintain awareness of trends in consumer and investor preferences, regulation, technology and physical changes. This awareness will help them to manage procedures for ensuring portfolio companies are engaging on ESG to protect and create value.

1. Motivate – ESG action can be integrated into each year of the investment period. At a minimum, where effective control is held, GPs should consider requiring that portfolio companies adhere to the GP's own ESG principles and values. The way such principles are actually implemented will, of course, need to be tailored to the needs of each company.

2. Support – GPs can support their portfolio companies to drive value from ESG issues. For "hands—on" GPs, this could be through designating a central ESG resource in their value enhancement teams. For "hands-off" GPs, this could be through providing access to experts, or facilitating knowledge sharing and good practice across the portfolio.

3. Monitor – GP partners who sit on company Boards will likely be the leads for engaging each portfolio company and monitoring progress. To do this effectively they need to be trained to be aware of the potential risks, opportunities and actions. They will also need to ensure that ESG metrics/KPIs are built into existing Board reporting processes – e.g. via a balanced scorecard approach – to facilitate upward reporting to the GP.

4. Report – Through the Board, portfolio companies should report progress on ESG initiatives at least annually. This could include actions undertaken and their results; for example, investments made in energy efficiency or costs saved, plus plans for the next set of actions. Reporting should consider the following:

Internal: ESG information should primarily be used to monitor and to continuously improve ESG performance. However, portfolio company management teams should also be encouraged to inform their employees of the actions taken on ESG issues. As well as raising the awareness of issues with staff, highlighting positive action on ESG issues can help to increase employee motivation, productivity, recruitment and retention.

Investors: GPs must demonstrate to investors that their money is being invested responsibly and in line with, or exceeding, their investment policy standards. However, policies and claims of good practice must be backed up by robust processes, systems and evidence.

Wider stakeholders: There are various other stakeholders who will have an interest in the ESG performance of portfolio companies and the GP. These may include consumers, government, regulators and Non-Governmental-Organisations. GPs should, therefore, consider the extent to which they are willing and able to report publicly on ESG issues. As well as external reporting, GPs and portfolio companies should maintain, and can benefit, from ongoing dialogue with these stakeholders.

KEY MESSAGES

- Oversee management of ESG issues
- Develop full insight into ESG risks and opportunities in the portfolio companies
- Create an ongoing system for managing and reporting on ESG risks and opportunities in portfolio companies

CASE STUDY

Earth Capital Partners

Earth Capital Partners (ECP), a General Partner chaired by Stanley Fink, former CEO of Man Group plc, specializes in managing infrastructure funds specialising in renewable energy, sustainable agriculture and forestry. ECP has integrated environment, social and governance (ESG) fully into its transaction evaluation, portfolio management and reporting processes, using a proprietary tool, the Earth Dividend™. The Earth Dividend™ has been developed following a detailed benchmarking of international best practice approaches to the assessment, reporting and assurance of ESG issues and performance. It provides an annual measure of the sustainable development impact (positive and negative) of ECP fund investments across 30 ESG indicators.

The 30 indicators are grouped into five categories, comprising Natural Resource Consumption; Ecosystem Services; Pollution Control; Social and Economic Contribution; and Society and Governance. Each category has six ESG impact 'tests', which determine whether the asset is having a positive, neutral or negative impact for a particular ESG issue, such as climate change, employee welfare or corporate governance standards. The 'tests' apply to the asset's operation, its supply chain and the asset's product/output.

Each asset agrees an annual Earth Dividend™ performance improvement plan with ECP. This focuses on ESG indicators where improvement should also enhance the commercial rate of return of the asset. The Earth Dividend™ is audited by an external assurance provider, and is then subject to review by the ECP sustainability council.

"Sustainable development – meeting the needs of today without jeopardising the ability of future generations to meet their needs' – is at the heart of ECP's model, reinforced by our commitment to generating a dual return from our investment products – first the financial return and second the Earth Dividend™ ESG return."

Stanley Fink
Chairman Earth Capital Partners LLP

Exit

The strategy on disposal will be determined in part by the GP's chosen method of exit. For example, the level of data presented by the GP is likely to be more robust and detailed when selling through an IPO than via a trade exit.

The GP should consider an early portfolio review so that any major ESG concerns can be identified prior to divestment, giving sufficient time for action to be taken to correct or mitigate problems. Holistic preparatory work, irrespective of the specific exit strategy, may help to maximise portfolio value. This may be particularly valuable for investments that have been held for a long time and where initial acquisition due diligence may not have matched current best practice. In such circumstances, a detailed audit or review may be necessary. However, where adequate ongoing portfolio engagement and ESG reporting has been encouraged, this may merely require collation of existing data in an appropriate format.

The original acquisition due diligence report can serve as a baseline against which improvements (or otherwise) in ESG performance and, therefore, overall business value can be effectively assessed. On exit, a high-level review may be pertinent to identify "lessons learnt", both positive and negative.

A GP should assess the benefit of using data rooms to provide additional information to potential bidders, so providing a holistic perspective on the business's ESG performance over the investment period.

Where an IPO is proposed, the ESG aspects of the "equity story" should be told to best effect in order to engage prospective shareholders from all backgrounds and to maximise value.

The GP must prepare for any "awkward" topics which may be raised in relation to ESG performance, and agree internally what responses will be made.

KEY MESSAGES

- Prepare to tackle ESG issues early, particularly where acquisition due diligence may not have identified all key issues
- Consider the benefits of proactive ESG vendor due diligence, data rooms or similar in maximising asset value
- Try to identify lessons learned, based on asset ESG performance on acquisition and on exit.

Summary of Key ESG Risks and Opportunities

Economic performance	Environmental performance
Direct value generated and distributed – how does the target contribute to the local or national economy? Implications of **climate change** – what could the longer term considerations be for the target in a carbon- constrained world? Does this potentially undermine the current business model? **Pensions** Defined benefit plan obligations – does the target have defined benefit plans for its employees? Are these in line with recognised best practice for the sector, and what percentage of the workforce is covered? **Government assistance** – does the target receive government incentives or similar? **Wages** relative to local norm –how well is the workforce remunerated relative to accepted (including legal) local standards? **Local spending** on supplies – how much of the target's supplies are sourced from the local market place? i.e. how much of the economic benefit generated by the target remains in the local community? **Local labour** supply – how much of the target's labour force comes from the local area and, therefore, what percentage of the local population benefits from the target's activities? This is also a social performance factor. **Infrastructure investment** & service provision for public benefit – how much financial benefit does the target recycle to the local community to improve welfare, services and infrastructure? This could include pro bono support.	**Material usage & recycling** – what is the indirect impact of raw material manufacture required for the target? How much of this material comes from recycled or sustainable sources? **Energy usage, energy savings and energy saving initiatives** – what is the direct contribution to carbon emissions from the target's activities? Will this represent a significant constraint in a carbon-constrained world? **Water usage and sources** – what is the direct impact on water resources of the target's activities? Will the business still be viable in a water-constrained world? **Biodiversity** – how does the target's activity impact on global and local flora and fauna? **Emissions, effluents and wastes from both normal and abnormal (e.g. accident) conditions** – what are the outputs of the target's activities, and how can these be mitigated or minimised? **Mitigation of product and services impacts** – does the target (need to) take action to minimise the total environmental impact of its product? Could stakeholder perception of these impacts reduce the target's viability in the longer term? **Compliance with environmental laws** – is the target in material compliance with relevant local, national and international environmental laws? Could non-compliance represent a significant risk of prosecution and/or business interruption? Impacts of **transportation of goods, raw materials and labour force** – what is the carbon footprint associated with logistics, business travel and commuting? **Environmental protection, expenditure and investment** – has the target allowed sufficient provisions within the business model for current and future required environmental expenditure? Are provisions associated with legal compliance or a move towards best practice?

Summary of Key ESG Risks and Opportunities (continued)

Social performance	Supply chain management / producer responsibility
Workforce profile and turnover (by number, region, contract, benefits etc) – are statistics suggestive of a balanced work force with equal opportunities? Is employee retention supporting or hindering the business? **Collective bargaining** agreements – percentage of workforce covered. **Notice periods** for operational changes – are contractual and operational changes notifiable within reasonable periods? **Health and safety compliance and performance** – is the target at risk of fines, penalties or regulatory intervention? Does the target take appropriate steps to protect the health and safety of its employees? **Training** provided, including performance and development reviews – is employee development encouraged to ensure that human capital is directly contributing to the business with maximum impact? Does this effectively contribute to staff retention and motivation? **Diversity** of staff and equal opportunities (pay relative to gender, age and ethnic origin) – is this in line with recognised best practice? **Human rights** conformance and awareness – does the target ensure that human rights of its employees are considered and protected? **Non-discrimination** – is there sufficient evidence that employees are treated fairly and equally? Is there any litigation underway or pending which could have a significant adverse impact on the target (financial or otherwise)? **Freedom of association** and collective bargaining – does the target meet legal requirements or best practice? **Child labour** rates, and measures to combat this. Forced and compulsory labour rates, and measures to combat this – does the target meet legal requirements or best practice in this area? Is there a risk of reputational damage or litigation which could impact the target? **Security practices** – are personnel in high risk areas provided with sufficient security and protection? Are security personnel sufficiently trained in understanding human rights of employees or others? **Indigenous rights**, based on number of violations and actions taken – is the target considerate of indigenous rights? Is there a risk of reputational damage associated with previous or current activities? Could there be significant market opportunities to improve this reputation? **Community** programmes to manage business impacts on the local population – are mechanisms in place to minimise impacts on the local community or to create positive effects? **Corruption**-related incidents, anti-corruption policies and actions taken – does the target take a firm stance on anti-corruption, and have there been any incidents which could result in penalties or negative publicity? **Public policy** positions, e.g. lobbying and political donations – could any of these public positions result in positive or negative reputational impact? **Anti-competitive behaviour** – is there a risk of penalties, legal intervention or reputational damage? **Overall business compliance with relevant laws and regulations** – are there risks associated with fines or regulatory intervention? Has the target allowed sufficient contingency within the business model for reasonably foreseeable legal requirements?	Investments with **human rights** screening/clauses – have agreements been made to ensure legal liability through the supply chain is minimised in key areas? **Suppliers undergoing screening for environmental and social performance** (see individual sections) – does the target take actions to encourage improved ESG performance, and does it monitor actual performance? **Customer health and safety across product lifecycles** – are there issues associated with products and services which could impact the end user, and result in negative publicity? Product and service **labelling** - does this conform with legal requirements or seek to meet best practice standards? **Marketing communications** relative to laws, standards and voluntary codes of practice – do these meet relevant standards or have there been any breaches which could represent a material risk? Has marketing improved product image among stakeholders? **Complaints data** regarding breaches of customer privacy – has there been any significant evidence of such breaches?

Bold – likely core considerations for any transaction.

Additional Source of Information

Global Reporting Initiative (GRI)
(www.globalreporting.org)
An international, multi-stakeholder effort to create a common framework for voluntary reporting of a company's global economic, environmental, and social practices.

Institutional Investors Group on Climate Change (IIGCC); A Guide on Climate Change for Private Equity Investors
(http://www.iigcc.org/__data/assets/pdf_file/0017/269/IIGCCGuideonClimateChangefor PrivateEquityInvestors.pdf)

Organisation for Economic Co-operation and Development (OECD)

- OECD Guidelines for Multinational Enterprises (www.oecd.org/daf/investment/guidelines)
- OECD Anti-Bribery Convention (www.oecd.org/daf/nocorruption/convention)
- OECD Principles of Corporate Governance (www.oecd.org/daf/corporateaffairs/principles/text)

UN Global Compact (http://www.unglobalcompact.org/)
The UN Global Compact's ten principles in the areas of human rights, labour, the environment and anti-corruption are derived from:

- The Universal Declaration of Human Rights (http://www.un.org/Overview/rights.html)
- The International Labour Organization's Declaration on Fundamental Principles and Rights at Work (http://www.ilo.org/public/english/standards/decl/declaration/text/)
- The Rio Declaration on Environment and Development (http://www.un.org/esa/dsd/agenda21/res_agenda21_00.shtml)
- The United Nations Convention Against Corruption (http://www.unodc.org/unodc/en/treaties/CAC/index.html)

UN Principles of Responsible Investment:

- UNPRI; Responsible Investment in Private Equity; A Guide for Limited Partners (http://www.unpri.org/files/PE%20LP%20Guide%20FINAL.pdf)
- UNPRI; Responsible Investment in Private Equity; Case Studies (http://www.unpri.org/files/PrivateEquityCS151209H.pdf)

Supplement to

Responsible Investment

A guide for private equity & venture capital firms

Applying a Responsible Investment Approach at the Pre-Investment Stage

Introduction

This Supplement is designed to augment the Guide by providing practical guidelines – based on the experience of our members – on how to implement an effective Responsible Investment (RI) programme. The aim is that this Supplement will provide guidelines for each part of the private equity investment cycle. It will build over time to become a comprehensive source of reference material and good RI practice. Hence, the first topic dealt with here is the "Pre-Investment Stage", referred to on page 7 of the Guide.

RI values and principles

As explained on page 6 of the Guide, it is fundamental for PE and VC firms (PE) to first set out clear responsible investment (RI) values and principles, which will inform their investment strategy and which will allow assessment of any given potential investment against these principles.

Responsible Investment Policy

Setting out the RI values and principles is best achieved by drawing up an RI Policy, with separate environment, social and governance (ESG) sections. The Policy should, as a minimum, include:

- A commitment to **compliance with all relevant legislation**;
- A commitment to "**continuous improvement**" in ESG performance;
- Any **excluded activities or sectors**.

  Some investors specify sectors in which funds cannot be invested, or the PE House makes a policy decision to avoid certain sectors e.g. gambling and adult entertainment sectors.

  In addition to these excluded sectors, some leading PE Houses are now specifying "referral sectors" as well – i.e. sectors which give rise to concern on environmental, social or ethical grounds, but which may not be specifically excluded provided there is further review and justification; and
- The **ESG standards** which the PE House will apply in judging potential investments.

  For some, this will simply be "legal compliance" even in developing countries, where national regulations are neither as stringent nor as well-enforced as in developed countries. However some stakeholders may prefer to see a commitment to consistently high ESG standards across the PE House's investments – for example, a commitment to work towards alignment with the IFC Performance Standards and related Sectoral Guidelines.

  Note that setting such standards does not necessarily imply the need to comply with them from the outset: compliance may be expressed to be "aspirational" – i.e. a commitment to achieve specified standards during the period of the PE House's ownership of the portfolio company.

Reference material: The IFC Performance Standards and related Sectoral Guidelines are used by the IFC to define clients' roles and responsibilities with respect to ESG issues in their projects. They have also been adopted by leading PE Houses for the assessment of target companies (see: www.ifc.org/ifcext/sustainability.nsf/Content/PerformanceStandards).

Approach to responsible investment

During the investment process, the PE House will need to make decisions about how to evaluate ESG risks and opportunities. This approach will depend on:

- The PE House's level of RI ambition and maturity of RI approach (see options in the diagram below);
- The PE House's RI Policy commitments – e.g. the standards set for ESG performance and/or the existence of any sectoral "exclusions";
- The materiality of the ESG risks and opportunities in terms of the magnitude of their expected effect on the financial 'bottom-line' as well as on other stakeholders including employees, customers, and the environment and society at large.
- The PE House's strategy for building ESG expertise, in terms of the balance between internal or external evaluators. If an internal strategy is preferred, then staff need to be equipped with tools to aid ESG issue evaluation and be trained for the role;
- The PE House's views of the ESG risks and opportunities which are inherent to the sectors and geographies involved in the potential investment. To take a simple example, an investment in a chemicals manufacturing company based in a developing country would be expected to have higher inherent ESG risks and opportunities than a consultancy services company based in a developed country, and hence require more extensive ESG risks and opportunities evaluation.

  Note that it is important to consider "top tier" suppliers' countries of operation when considering inherent geographic ESG risk – see the "value chain" comments in the Top-level Screening section below; and
- The timing of the evaluation and the level of ESG information available. ESG evaluations could begin as soon as the investment opportunity is identified, with the depth of the evaluation being dependent on the amount of information available. However, many PE Houses understandably only commission external due diligence assistance at the "exclusivity" stage.

Setting the PE House Position on ESG Values and Principles

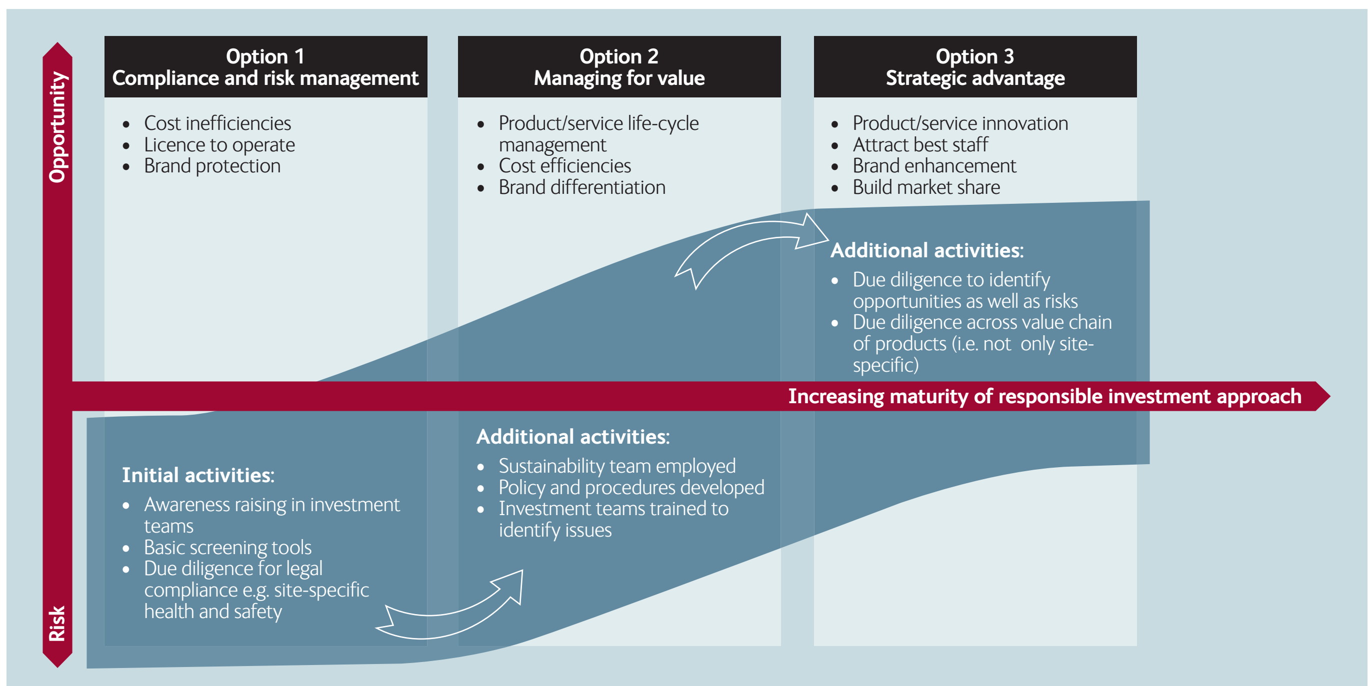


Fig 1: This diagram illustrates the choices to be proactively made with respect to a PE House's desired market positioning on RI and the respective extent of ESG management / due diligence required.

A 3-step pre-investment process

Note on decision-making

In this section, we describe ESG activities in the pre-investment process, however please note that ESG issues evaluation should be considered at all decision points, particularly where inherent environmental or social risks are high. In this way, the need for external specialist support can be identified at an early stage and funds can be authorised to meet the cost. To facilitate this process, leading PE Houses now include sections for ESG evaluations at each stage of their process documentation, and require the ESG issues evaluation to be recorded alongside other material issues.

Once the ESG evaluation is complete, and fully understood by the investment team, it needs to be considered in the context of the overall investment. ESG issues should certainly feature in the post-acquisition improvement planning process. All too often, such issues are ignored at this important stage, as "more pressing issues" consume management attention. However, this is exactly the right time to view company improvement plans through a "sustainability lens", to overlay consideration of ESG issues as part of all planned work streams.

Ideally, early agreement should be reached with the management team, not only on the actions required to improve ESG performance, but also on the starting point or "baseline" and the metrics by which progress will be judged. Only then can the PE House be sure that sound foundations are being laid to improve ESG performance over their hold period, such that value can be maximised on exit.

ESG Evaluation Process

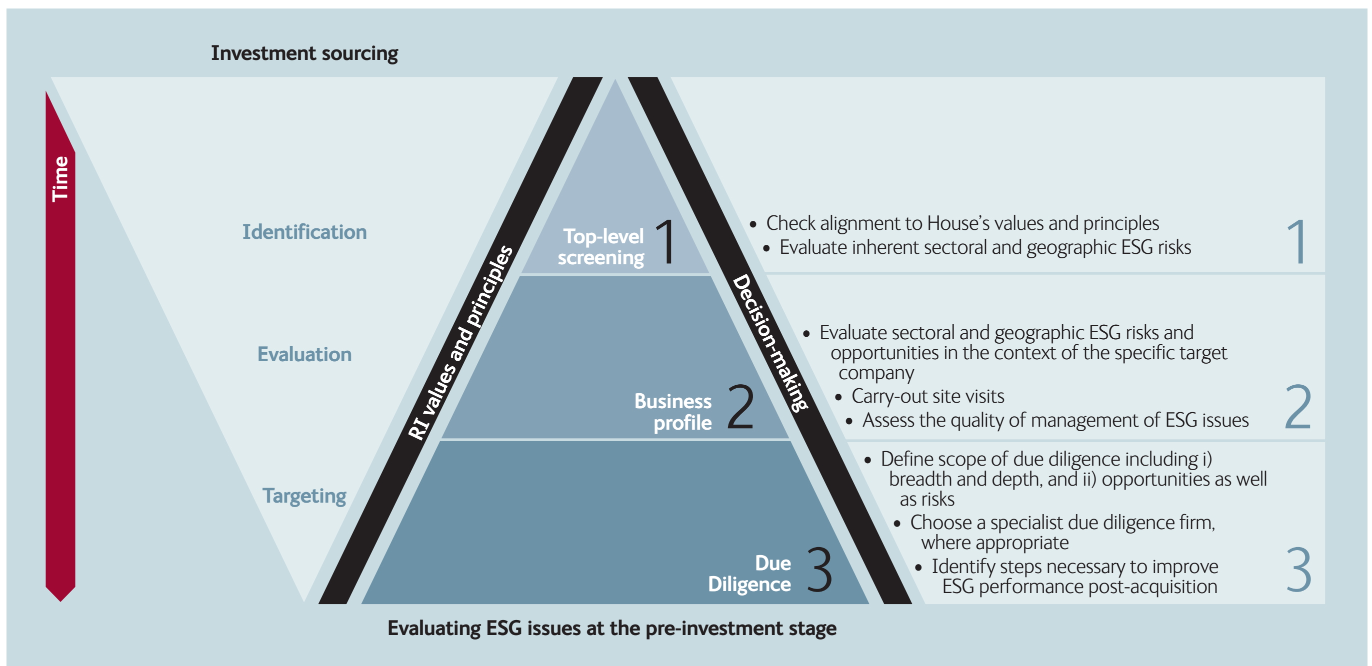


Fig. 2: As the investment sourcing process focuses down onto fewer investment targets, the corresponding evaluation of ESG issues needs to become more thorough. The PE House's RI values and principles must be considered at all stages of the ESG issue evaluation. The results of the evaluation should be fed into the decision-making process all stages.

1. Top-level screening

At this initial stage, when very little company-specific ESG information is available, the ESG assessment approach needs to be light touch.

Simple checks should be undertaken to ensure alignment to the PE House's values and principles. This prevents time/expense being put into evaluating a potential acquisition which simply cannot proceed on ESG grounds. An example might be an investment in a sector which is specifically excluded by the RI Policy. PE Houses should ensure that their RI Policies are well-communicated and available internally, preferably on-line and embedded into investment memorandum templates, to facilitate such checks.

Inherent sectoral and geographic ESG risks should be evaluated at this early stage. Many PE Houses rely either on checklists or ESG sector briefing notes to guide investment professionals on the level of inherent risks by sector or geography. Internal investment procedures are often then aligned to these pre-set inherent risk levels – e.g. for investment opportunities in a "low" inherent ESG risk sector, internal policy may be to take no further ESG evaluation action (on what are likely to prove to be immaterial issues). Conversely, a "medium" or "high" inherent ESG risk rating may dictate the need for further investigation at a later stage.

It is important to consider ESG risks and opportunities in the light of the target company's entire "value chain". That is, the target company may operate at a relatively benign part of the chain from an ESG perspective – e.g. a packaging company in the example used on page 7 of the Guide – but may still be exposed to higher risks in the upstream or downstream parts of the same chain. Where supply chains are based in developing countries, inherent ESG risks are likely to be higher.

Where top-level screening checks indicate that further consideration of ESG issues is warranted, there are again two main options: either continue evaluating the target company internally, or commission external ESG due diligence (see due diligence section below).

Reference material: A number of "tools" of the type alluded to above – e.g. checklists and briefing notes – are now being developed to help investment professionals with these considerations, some of which have been made publically available. Examples include the IFC's Private Equity Toolkit (see: www.ifc.org/ifcext/climatechange.nsf/Content/SustainableInvesting), and CDC's "ESG Toolkit for Fund managers" (see: www.cdcgroup.com/CDC-Publications.aspx). Whilst these can be very useful, care should be taken to ensure the approach adopted is properly tailored for the PE House's particular business (e.g. in terms of sectoral coverage and alignment with internal process) and is simple and practical to adopt.

2. Business Profiling

Internal evaluation may take the form of "business profiling" – i.e. considering the inherent sectoral and geographic ESG risks in the context of the specific target company. Are the company's actual activities typical of the sector, or are there activities which raise or lower the inherent ESG risk level accorded? For example, a company may have been accorded a "high" level of inherent ESG risk at the top-level screening stage because of a belief that the company is involved in manufacturing. However, on closer examination, the activity may actually be found to be assembling components – a lower order of inherent risk.

Site visits may be required at this stage to gain a full understanding of the business. ESG expertise is not essential to make such a visit worthwhile. Much can be gleaned by asking simple questions, for example:

- what raw materials are used and what wastes are produced? And are these hazardous?
- are environmental permits or licences required to operate?
- is the workforce based in developing countries, large, non-unionised or involves a significant element of temporary or migrant labour (all of which raise concerns over labour standards)?
- are material contracts negotiated with public officials?
- is there currently any consideration of ESG issues in the company's supply chain?

Reference material: A comprehensive site visit environmental risk checklist is publically available from the European Bank for Reconstruction and Development at www.ebrd.com/pages/about/princples/sustainability/resources/financial.shtml to assist in getting the most from a site visit.

Having established exactly what the company's operations involve, and having identified the ESG aspects of those operations (a process which may be deemed to require external specialist support), the next consideration should be to evaluate the quality of management of ESG issues. After all, PE Houses are in the business of accepting known risks in the anticipation of a return, and ESG issues should be treated no differently: if ESG risks are being managed well, then the overall risk profile may be considered acceptable.

Three facets of ESG management should be evaluated:

i. **Commitment**: are senior management committed to a sustainability agenda? How is this evidenced? What is the "tone from the top"? Many companies have statements of Values or Principles, or specific policies covering "Business Conduct" and/or "Corporate Responsibility" which will help to answer these questions.

ii. **Capacity**: are specific human resources allocated to managing ESG issues – e.g. a sustainability director, a corporate responsibility team, or an environment, health and safety manager? If so, are these specialists well trained to perform their roles?

iii. **Track record**: what does available information reveal about the target company's track record in managing ESG issues (e.g. from an internet search or from discussions with customers)? Is this consistent with what management have disclosed? Sometimes, NGO campaigns against the target company, community unrest, or pending environmental prosecutions are revealed which cast the company in quite a different light.

3. Due Diligence

External support will be required where either a decision has been taken to sub-contract consideration of ESG issues from the outset, or where internal ESG evaluation has concluded that certain aspects of the target company's business would benefit from further specialist evaluation.

The **choice of specialist firm to employ is an important one**, and should depend not only on the nature of expertise required (environmental, health and safety, supply chain expertise etc), but also on the scale and reach of the consultancy's office network and the "fit" with the target company's geographic operations. Some PE Houses are now establishing "panels" of preferred ESG due diligence suppliers so that help is available at short notice when needed.

Reference material: As noted on page 8 of the Guide, the BVCA has developed a directory of qualified consultants who may be able to assist.

Traditionally, ESG due diligence has focused on environmental, health and safety liabilities – typically at a site level. Contamination liabilities, asbestos risks and environmental regulatory compliance are all examples of issues which have been at the centre of specialist investigations in the past – mainly to check whether there are any financial implications which may impact investment economics.

This type of due diligence still has its place. However, the **scope of ESG due diligence is now beginning to change** – in two key respects:

i. **Breadth and depth**: ESG due diligence should consider the target company's whole value chain (please see page 7 of the Guide), as, for example, broader environmental issues – such as climate change or water scarcity – might have an impact on the quality, availability or price of raw materials in the future.

ii. **Opportunities as well as risks**: due diligence should also include consideration of the upsides so as to evaluate the potential for, among others:

- **New markets or income streams**: development of products designed to respond to climate change (e.g. renewable energy, clean tech products) or to changing consumer tastes. Examples of the latter include consumer labels such as Fair Trade or organic products, or sustainably managed timber or fish resources;
- **Eco-efficiencies**: simply "doing more with less" makes clear business sense by saving money from using less energy or raw materials, whilst benefiting the environment; and
- "**Industrial ecology**": one company's waste product can be another company's raw material. By identifying the potential synergies, the first company can save on waste disposal costs, whilst the other has a source of cheaper raw material – whilst both companies benefit the environment and can gain brand value or reputation enhancement by communicating their approach.

External ESG due diligence, covering both opportunities and risks, should be commissioned prior to the investment being made. However, unless there are known ESG problems which need to be investigated fully (when an early external appointment would be appropriate), external **ESG consultants should generally be commissioned at the "exclusivity" stage** of the investment, when incurring such expenditure can be justified in the context of the likelihood of completing the transaction.

In this exclusivity "window", much can be achieved by consultants accessing data rooms for information and by discussing ESG issues with the target company's management. That is, **it is often not necessary to undertake exhaustive enquiries**, incurring high costs and tying up valuable investment team and target company's management's time, **to arrive at valid and valuable conclusions** about the target company's ESG risk/opportunity profile.

Crucially, a good ESG due diligence report should clearly articulate not only the risks and opportunities in both qualitative and quantitative terms, but also **identify the steps necessary to be taken to improve ESG performance post-acquisition**. Only then can ESG action plans be properly integrated into the company-wide work streams that are created as part of the post investment ownership process.

KEY MESSAGES

- The approach at the pre-investment stage should be aligned to the value and principles of the PE House.
- Evaluation of ESG risks and opportunities needs to start pre-investment so that:
  - Compliance with a RI Policy can be checked; and
  - Any actions arising from the evaluation can be integrated with the strategic and operational post-acquisition performance improvement plans.
- The 3-step process of i) top-level screening, ii) business profiling and iii) due diligence may provide a suitable framework to evaluate ESG issues at the pre-investment stage.

The British Private Equity and Venture Capital Association (BVCA)

The BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. Our members come from venture capital, through mid-market, to private equity/large buy-out houses from all over Britain.

Our voice is one of authority when speaking for, or negotiating on behalf of, the UK industry. Our aim is to aid understanding, clarity and transparency around the activities of our members, promoting our industry to entrepreneurs and investors—as well as Government, trade unions, the media and the general public.

We provide a growing list of services and best practice standards for our members across a spectrum of activities covering a network of interconnected committees, which focus on segment-led, legal, technical, regulatory, investor-led and service-led needs. We also provide networking opportunities, training courses, research, publications, public affairs and communications on behalf of the industry.

With a membership of over 500 firms, we represent the vast majority of all UK-based private equity and venture capital firms and their advisors. The benefits of becoming a member—whether full or associate—are wide-ranging and only briefly described above.

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