

Responsible *Investment*

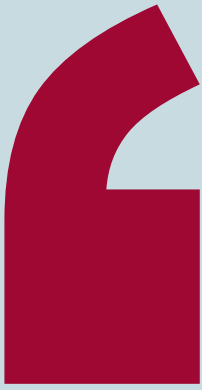
A guide for private equity
& venture capital firms

Authored by

PRICEWATERHOUSECOOPERS 

bvca The **voice**
of long-term
investment

 **waterman**



Contents

Preface	3
Introduction	4
Key factors to consider throughout the investment cycle	7
Pre-investment	7
• Summary of key ESG risks and opportunities	9
Immediately post-deal	10
Post-investment stage	11
• Managing residual risk in the portfolio	11
• 'An ongoing system for engaging portfolio companies'	12
Exit	13
Case studies	
Doughty Hanson – Balta Group	4
3i	6
Bridges Ventures	8
Climate Change Capital – Creating Wealth Worth Having®	10
KKR – Green Portfolio Program	11
Earth Capital Partners	12

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

As its potential to affect profitability and value grows, the field of environment, social and governance (ESG) aligned management practice is swiftly coming of age. An increasing number of leading private equity (PE) and venture capital (VC) firms are now factoring these investment considerations into their investment strategies. They are progressing from complying with regulations and mitigating risks, to seeking strategic advantage from managing ESG issues.

Private equity and venture capital firms invest in companies across a range of sectors, employing many thousands of people. As an important part of the economic mainstream it is therefore critical we deepen the engagement of private equity and venture capital companies towards responsible investing.

Managing the integration of ESG issues requires a deep understanding of how portfolio companies are managing associated risks and planning to exploit related opportunities. Monitoring responsible investment (RI) requires information to be monitored throughout the investment cycle, from pre-deal due diligence to the long phase of portfolio company management.

Through this publication, we intend to improve PE firms' understanding of ESG risks and opportunities, showing how these can be managed within a structured investment framework and, therefore, supporting our members incorporate these issues into both their investment decisions and management of assets, helping both to manage risks and improve long term returns. We have worked in conjunction with PricewaterhouseCoopers LLP (the UK firm) and Waterman Group PLC, in the writing and preparation of this publication.

We want to raise awareness of RI in the PE sector, so stimulating further thought and discussion among BVCA members. As such this document should be thought of as a guide, not a set of standards for RI.

Simon Walker
Chief Executive
BVCA

Wol Kolade
Managing Partner
ISIS

June 2010

Introduction

Evidence is mounting that private equity (PE) houses view responsible investment 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 ESG issues could influence the realisation process."¹ Further evidence of rising recognition is seen in a survey conducted by the Australian Private Equity and Venture Capital Association in November 2009, which revealed that "68% of the respondents agreed that ESG issues can impact exits."²

Yet just a few years ago, ESG issues did not feature as business priorities for PE Houses. So what's 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.

Investors are becoming more socially and environmentally aware. They are avoiding or selling, investments seen to be materially harmful and likely to suffer negative commercial or reputational impacts. The recent economic crisis has exposed a serious ethical gap 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.

Development of responsible investment in the PE sector

Outside banking, until recently only specialist firms had 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.

Some 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 or corruption.

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 20% of its total global portfolio. The sector increasingly views RI as, potentially, differentiating portfolio companies, balancing risks and creating new business opportunities.

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

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

² http://www.unpri.org/files/ILPA_RI%20article_Winter%20Newsletter_Dec09.pdf

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

investment decisions. Today, 38 PE fund managers and fund of fund managers are signatories to the UNPRI. 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 importance. The US Private Equity Council, which represents 13 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 recently 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 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 decision-making during deals, 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 strategies towards RI, PE firms should consider the following success factors.

Ambition – A firm should have a bespoke ambition, 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 becomes more fully integrated and the external environment changes. RI should also be aligned with the firm's overall business strategy and risk management procedures.

Suitability to stakeholders – A firm interested in developing a 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.

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 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 330 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.

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 policies 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 a RI approach requires effective governance to outline ownership of the strategy and ESG policies (see below), 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 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 deal 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 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 CSR. 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

In 2008, 3i conducted a Group-wide review of its business needs and policies in relation to corporate responsibility. As a result of this review, existing policies and procedures were developed and implemented.

Main features of this new approach include:

- a single, short policy document with a clear overall corporate goal, supplemented by a set of broad aspirations and commitments
- a set of new investment procedures for all stages in the investment process – fundraising, investment, growth and realization
- a series of guidance notes for investment teams, covering key issues and sectors, with links to case studies, international norms and standards and information about specific emerging markets; and
- clear arrangements for policy governance and accountability Investment Policies

Summary of new 3i corporate responsibility policy

As a public and international company, 3i is committed to putting its core values into effect by investing responsibly and encouraging responsible business conduct among its portfolio companies. Our revised policy and procedures are designed to help employees understand and manage the impacts they and investee companies have on society and the environment, including and relevant ethical issues.

Specifically, 3i is committed to:

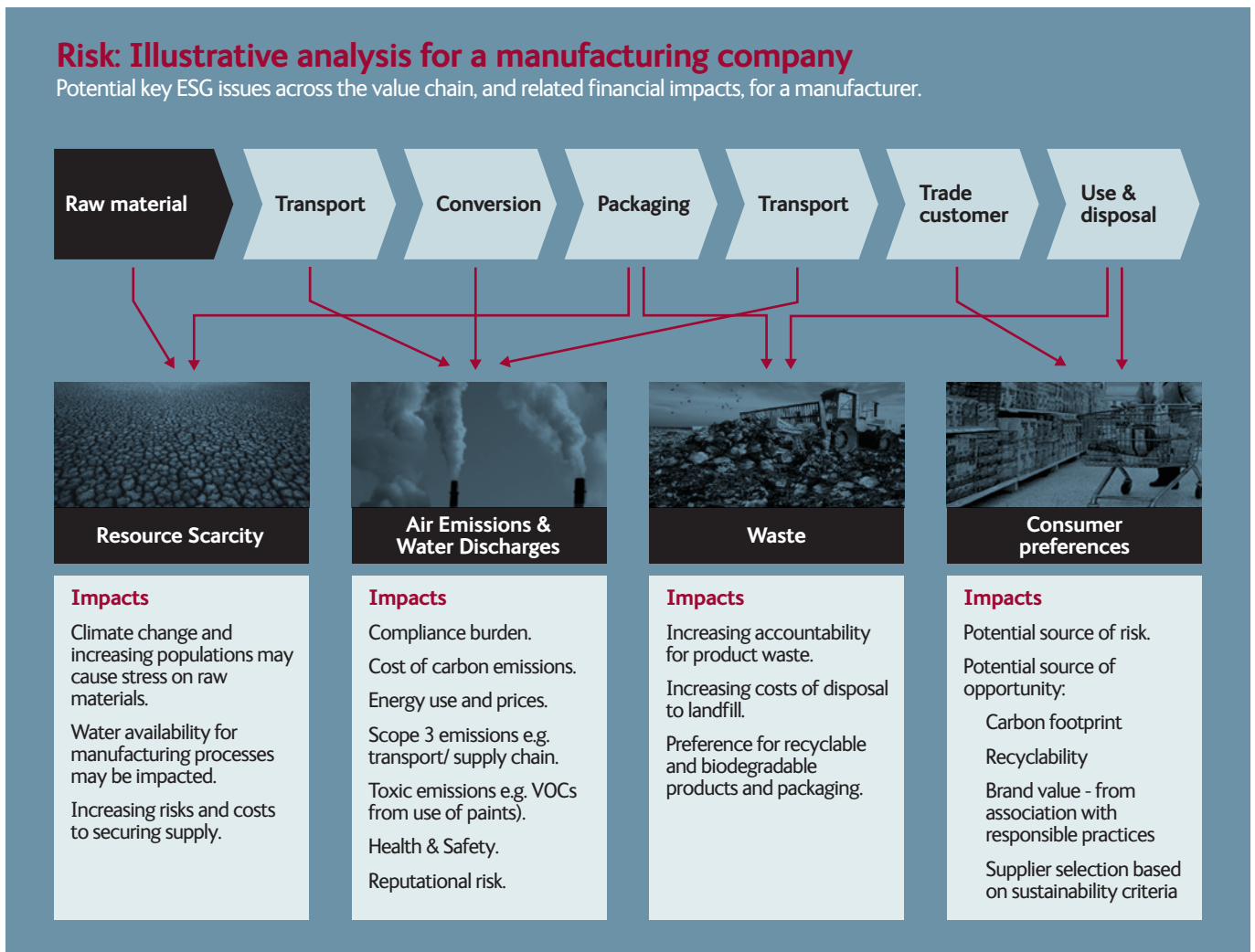
1. **Human rights** – Respect the protection of international human rights and avoid complicity in human rights violations
2. **Labour/workplace rights** – Uphold the right to freedom of association and collective bargaining; abolish child labour; eliminate forced and compulsory labour; and end employment discrimination
3. **The environment** – Take a cautious and responsible approach to the environment; promote compliance with environmental law, improvement in management standards and the sustainable management of natural resources; and help combat climate change by supporting the development of products and services that are environmentally beneficial.
4. **Anti-corruption** – Avoid corruption in all its forms, including extortion and bribery, upholding compliance standards and integrity and complying with relevant anti-fraud and money-laundering regulations.

Key factors to consider throughout the investment cycle

Pre-investment

Decisions made during the pre-investment stage can be critical to defining a GP’s “de facto” ESG impacts. Where GP strategies exist on ESG, key pre-investment evaluation of a target 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.

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 contamination to cause clean-up liabilities. 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-deal 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 break a deal 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 but could include one or more of the elements below. 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 a directory of qualified consultants who may be able to assist.

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.

Summary of Responsible Investment Risks and Opportunities

Economic performance	Environmental performance	Social performance	Supply chain management / producer responsibility
<p>Direct value generated and distributed – how does the target contribute to the local or national economy?</p> <p>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?</p> <p>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?</p> <p>Government assistance – does the target receive government incentives or similar?</p> <p>Wages relative to local norm –how well is the workforce remunerated relative to accepted (including legal) local standards?</p> <p>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?</p> <p>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?</p> <p>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.</p>	<p>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?</p> <p>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?</p> <p>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?</p> <p>Impacts on biodiversity, both positive and negative – how does the target’s activity impact on global and local flora and fauna?</p> <p>Emissions, effluents and wastes from both normal and abnormal (e.g. accident) conditions – what are the outputs of target’s activities, and how can these be mitigated or minimised?</p> <p>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?</p> <p>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?</p> <p>Impacts of transportation of goods, raw materials and labour force – what is the carbon footprint associated with logistics, business travel and commuting?</p> <p>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?</p>	<p>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?</p> <p>Collective bargaining agreements – percentage of workforce covered.</p> <p>Notice periods for operational changes – are contractual and operational changes notifiable within reasonable periods?</p> <p>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?</p> <p>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?</p> <p>Diversity of staff and equal opportunities (pay relative to gender, age and ethnic origin) – is this in line with recognised best practice?</p> <p>Human rights conformance and awareness – does the target ensure that human rights of its employees are considered and protected?</p> <p>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)?</p> <p>Freedom of association and collective bargaining – does the target meet legal requirements or best practice?</p> <p>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?</p> <p>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?</p> <p>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?</p> <p>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?</p> <p>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?</p> <p>Public policy positions, e.g. lobbying and political donations – could any of these public positions result in positive or negative reputational impact?</p> <p>Anti-competitive behaviour – is there a risk of penalties, legal intervention or reputational damage?</p> <p>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?</p>	<p>Investments with human rights screening/clauses – have agreements been made to ensure legal liability through the supply chain is minimised in key areas?</p> <p>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?</p> <p>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?</p> <p>Product and service labelling - does this conform with legal requirements or seek to meet best practice standards?</p> <p>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?</p> <p>Complaints data regarding breaches of customer privacy – has there been any significant evidence of such breaches?</p>

Bold – likely core considerations for any transaction.

Due diligence should consider both current and reasonably foreseeable ESG issues, so providing maximum visibility into 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 Index,³ 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 Principles⁴).

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-deal

On balance, ESG issues are rarely so material that they scupper deals, but their significance could merit inclusion of key items within the 100-day plan 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 100-day plan. The required actions are likely to vary, depending on the business’s known or suspected issues.

As a start, GPs should consider report disclosure 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 timescales 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.

³ www.globalreporting.org.

⁴ 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 100-day 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 “hold” 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 risks in their current portfolios.

To mitigate these risks, 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 relates 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 is also in the process of building 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 July 2010.

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 CO₂ 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 hold 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 or costs saved, plus plans for the next set of actions. Reporting should be:

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 in the portfolio companies
- Create an ongoing system for managing and reporting on ESG risks 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 a secondary buyout.

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.
-

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/IIGCCGuideonClimateChangeforPrivateEquityInvestors.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- 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>)

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 450 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.

Disclaimer

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For further information
contact the BVCA

1st Floor North
Brettenham House
Lancaster Place
London WC2E 7EN

T: +44 (0)20 7420 1800

F: +44 (0)20 7420 1801

E: bvca@bvca.co.uk

bvca.co.uk