

Time to get engaged

Though it has dragged its heels, private equity is starting to take notice of environmental, social and governance factors in investment. But is it just paying lip service to these issues, or has it fully engaged?




The formation of the UN Principles for Responsible Investment Initiative (PRI) Steering Committee on Private Equity in September 2008 was a watershed moment for the asset class.

Even if GPs themselves had not initiated – or even necessarily welcomed – the PRI committee, that such global titans as KKR, The Blackstone Group, The Carlyle Group, TPG and Permira were grouping with LPs to give environmental, social and governance (ESG) issues their attention sent a clear signal to the market: private equity was waking up to responsible investment.

The subsequent release by the steering committee in July this year of a set of guidelines for LPs to “support the integration of ESG issues into private equity investments” brought the topic one step closer to becoming a key aspect in investment decisions.

Thirty eight private equity fund managers and fund of fund managers are now listed among the signatories to the UN PRI - Abraaj Capital, Actis and Squadron Capital among them. Several firms, with long histories of incorporating ESG issues into their investment processes, have carved a niche for themselves as



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over the last five years, to implement in a more thoughtful and structured way what they’re going to do on responsible and sustainable investment. The reason the asset owners are the driving force here is that they’re the ones that face the original and quite critical fiduciary issue.”

That asset owners are streets ahead of GPs on responsible investment can be witnessed in an email sent by the Australian Private Equity & Venture Capital Association (AVCAL) to its members in August recommending they “seriously consider” signing up to the UN PRI. The email noted that while 26 Australian superannuation funds had already signed up to the principles, only two Australian GPs had so far done the same (and one of these signatories was an American parent).

The AVCAL email suggests its members need to “educate themselves on the implications of the PRI” in order to meet the future expectations of their LP base. The email ends by saying that “the drive for development of ESG policies and associated reporting and undertakings from GPs to their

pioneers in this area; Actis being a prime example. However, for the majority of fund managers, the forces pushing ESG onto their agendas are external.

One impetus has come from what Melissa Brown, investor consultant at Singapore-based fund of funds IDFC Capital, terms the “asset owners” – the pension funds and other large institutions which form the bulk of the private equity LP base.

“The private equity discussion is coming up because – in PRI language – a number of the largest asset owners have begun, really

investors is inevitable”.

That the drive has already begun is beyond doubt. According to Tom Rotherham, the PRI’s special adviser on private equity, and head of its Private Equity Steering Group, feedback from GPs and national private equity associations indicates that somewhere between 15 and 20 percent of LPs are now asking questions on ESG issues during the fundraising process.

The second big external driver, especially in relation to some global buyout firms, is the quantity of (negative) public and



Rotherham: private equity firms should start to look at market drivers behind ESG

government attention private equity has received in the past two years – particularly in Europe and the US.

“Large buyout players, who tend to look for opportunities in politically sensitive sectors, have had to become stakeholder-oriented,” says IDFC’s Brown. “It’s pointed them in a direction many of them didn’t expect to have to go. A lot of them had regarded this stuff as kind of ‘fluffy’ – well they’ve now found themselves in a situation where it’s not fluffy, it’s essential for value creation.”

There is no turning back on ESG now. However, because the prompts on these issues have come from outside parties, many GPs feel it is something they can’t afford to ignore, rather than something they want to actively embrace. ESG has been classed by some as an investor relations and fundraising issue, or a way to play ball with public policy, rather than a way to enhance returns.

This attitude was encapsulated by the response Rotherham met when he first set out to speak to GPs on the PRI steering committee.

“The first obstacle was just general awareness and understanding of the agenda we wanted to discuss and address,” he says. “I think a lot of people initially thought the focus was a public policy objective rather than a commercial objective. Once we got over that hurdle and said ‘look this isn’t about saving the world, this is about making improved long-term risk-adjusted returns,’ we had a very constructive discussion.”

However, not everyone is convinced yet, as Rotherham notes: “At the moment the GP market divides into three main buckets. For the first, ESG is not an issue at all; for the second, it’s an investor relations issue; and for the third, this is something that they are really paying attention to and see as an important part of their investment process.”

Proof needed

One thing sceptical GPs might be keen to see before they wholeheartedly adopt consideration of ESG issues into their

investment processes is proof of these improved long-term risk-adjusted returns.

Some benefits to returns are immediately obvious. For example, focusing on the environmental component of ESG, it is clear to see how cost-savings can be made.

“Just taking energy efficiency and waste reduction as examples, significant amounts of money can be saved through better management. If you save three or four million dollars a year across a portfolio, once this is leveraged it becomes a considerable amount of money,” says David Russell, co-head of responsible investment at UK pension fund, the Universities Superannuation Scheme (USS).

But social and governance issues are altogether less tangible – how do you gauge the exact impact of improved labour conditions or the appointment of an independent director on returns? The answer is that no one knows, though everyone would love to – measurement in this area is, according to more than one source, the “holy grail” of ESG.

“It’s hard to put a precise figure on how much value you’ve added,” admits Mark Goldsmith, director of the environmental, social and governance team at Actis. “It’s always seen as an ‘add-on’ and not part of the financial modelling and it’s difficult to separate from good management.”

While lots of research focused on developing measurement tools can be expected, there are those who remain unconvinced that conclusive evidence will ever be attained. One such sceptic is Rotherham, who points out that such proof has yet to be achieved in the listed equities space – in which ESG awareness has a head start of a couple of years on private equity – and likens the search for it to “a bit of a blind alley”.

“Where are your matched pairs?” he asks. “And what’s your matched pair set that’s big enough and consistent enough that you can reduce all of their variables and say ‘actually, the fundamental difference between this company and that company is the management of the ESG issues and therefore that explains the

different returns on investment?”

While concrete evidence may remain hard to come by, for the reason Rotherham highlights, anecdotal evidence of the enhancing effect of proper treatment of ESG issues on returns abounds.

“We did a survey with 17 of our investment managers and we asked them how much value ESG had added on exit. Over 70 percent said it had added over 10 percent,” says Actis’ Goldsmith.

ESG in Emerging Asia

It might be easy to assume that developed market private equity industries have the edge on emerging markets when it comes to a proactive approach to environmental, social and governance issues – after all, it is developed markets which have invented the terms ‘ESG’ and ‘socially responsible investment’ (SRI).

However, just because emerging markets might lack the stylised language that surrounds these issues in the West, does not necessarily mean they are being neglected.

“The best GPs in emerging markets oftentimes have very good awareness of the issues, but none of the vocabulary,” says

Melissa Brown, investor consultant at Singapore-based fund of funds IDFC Capital.

“Many of the people looking at and dealing with these issues in emerging markets are non-native English speakers and they see issues in local terms – they don’t have visions of Greenpeace around them, they just tend to be very practical.”

Tom Rotherham, the UN PRI special adviser on private

equity, says that anecdotally there seems to be greater recognition of the potential impact of ESG factors on returns in emerging markets. One possible reason is the absence of a solid regulatory and compliance infrastructure. As he puts it: “You need to look at this stuff because there aren’t laws for everything.”

There is also the broader economic context to consider. Countries like India and China, with ambitious growth plans, are aware that they lag behind when it comes to things such as employee rights and environmental standards and are keen to

“Over the last five years we have made some of the best returns in the industry and we have always insisted on good ESG standards,” states Shonaid Jemmett-Page, chief operating officer at CDC Group. She is keen to address the impression some managers have that paying attention to these issues can somehow be detrimental to their returns. “You don’t trade off good commercial results for good ESG – that really is a complete fallacy.

overcome these hurdles without impeding economic progress. Even so, a manager in Emerging Asia often faces a more complex task when tackling ESG issues than a manager in other markets, simply because of the nature of the challenges they are likely to find.

“Although the Western pattern is always to put these issues in silos and say, ‘climate change = environmental’, ‘labour issues = social’, ‘board of directors = governance’, in emerging markets the issues are entirely inter-mingled,” says IDFC’s Brown.

“In China, climate change will result in water scarcity; water scarcity of course will result in population migration and poverty issues; it’s going to result in groundwater pollution; groundwater pollution is going to result in toxicity problems. Your governance issues and your corruption issues are all going to become inter-mingled.”

One example of the way these issues can unravel in Asia came last year when it was discovered that the banned industrial chemical melamine was being added widely to milk products in China. The affected products killed six babies, poisoned thousands more and led to a massive public backlash against the dairy industry. “At a business level, the dairy problem was fundamentally a supply chain management and governance oversight issue,” points out Brown, “but it became an immense public health issue.”

Despite the overlapping nature of these issues, there is one area that clearly stands out as the trickiest for practitioners to work on: governance. In fact, in many instances they are starting from scratch with a company as far as governance is concerned.

“Environmental and labour standards – such as no child labour – are things that are more easily understood, probably because they’ve been around for longer,” says Shonaid Jemmett-Page, chief operating officer at CDC Group. “We are often dealing with family companies, and things like board meetings, independent directors – they’re just not there.”

The ability for a manager to really work on a company’s governance is made more difficult, as Alice Chow, a managing director at Hong Kong-based fund of funds Squadron Capital, points out, by the fact that many deals in the region are minority investments.

“You don’t have majority control of the board and you don’t have majority control of the management of the company. You’re really relying on your judgement of the management team that they are honest, do their job with integrity and follow the rules,” she says.



Brown: environmental, social and governance issues are intermingled in Asia

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I think people are beginning to understand that it’s an ‘and and’ not an ‘either or’. You can and should have a good commercial return and good ESG standards.”

Time to make a difference

Even without the figures to support it, the business case for integrating an active stance on ESG issues into private equity investment is fairly self-evident. The asset class, with its long investment horizons, close ties to company management teams, and hands-on approach, gives managers ample time and influence to act on these issues, especially in buyout and growth transactions.

“Since investment managers have a close relationship with the company management, it becomes easy for them to engage on issues relating to ESG factors,” says Rita Kumar, London-based senior adviser, environmental, social and governance, at Actis. “Very often private equity investment managers sit on company boards, giving them direct access and influence to shape an ESG agenda. Private equity firms generally hold their investments for three to five years, a period long enough to bring about change and

add value – for example, through carbon reduction programmes, energy efficiency, improved environmental management systems, and health and safety management systems.”

A quick comparison with listed equities, where responsible investment has been around for much longer, highlights how much more room for manoeuvre private equity managers have on these issues.

“With listed equities, management is often under pressure for returns over shorter time periods from a vast shareholder base,” says USS’ Russell. “There are investors who are potentially looking for returns this week – or this hour – and those who’ll be looking for returns over a four-, five- or ten-year period. The potential exists for GPs to make investments in processes that save money over the long term, which perhaps listed equity managers may find more difficult because of the pressure to perform this quarter.”

“Even though private equity is seen as lagging behind on this issue, we have many years in which to catch up,” says Goldsmith. “We take an ownership stake – we are part of that company. It’s not just letters to the board as in the SRI approach – we can actually get involved. We can insist on various actions being

Investing in society

Consideration of the indirect impact a firm has on environmental, social and governance (ESG) issues through its investments in private companies is arguably the most pressing area of responsible investment in private equity for many private equity firms.

However, private equity firms – like all companies – also have a direct influence on the environment and society through their own business activities.

One firm that is more aware of this than most is Dubai-based Abraaj Capital, a UN PRI signatory, which alongside standard environmental efforts like cutting down on electricity consumption and the use of recycled paper for its business cards, has set out to make even more of a direct impact on society through its philanthropic initiatives.

Earlier this year, the firm set up a \$10 million trust fund, the Gaza Orphans Education Trust Fund, to pay for the education of over 1,200 children and youths orphaned by the violence in Gaza last December and January. The fund, which will be managed over its 22-year life by Palestinian NGO the Welfare Association, is part of what Abraaj founder and CEO Arif Naqvi described at the time as the firm’s commitment to “driving sustainable, positive change in

the communities in which we operate by investing in them for their wider long-term welfare”.

This focus on sustainable investment in society is an evolution of the firm’s philanthropic activities, which started with a Community Partnership Programme and involve everyone in the company.

“The resources for our programmes, grants and donations come from the 5 percent of our revenues that are earmarked for social investing, and also from employee donations,” says Fred Sicre, executive director at Abraaj. “That’s the financial part of it, but what we’re also evolving right now is the actual time commitment and providing everybody in the firm with up to three days of paid leave a year in order to work on specific projects that we earmark and propose internally.”

Since 2007, the partnership programme has made donations to around 35 projects in the Middle East, North Africa and South Asia. Now, however, Abraaj is “trying to evolve from the system of small, one-off grants to a more sustainable approach”, as evidenced by the Gaza trust fund, says Sicre.

Another way Abraaj is helping to drive sustainable investment

“It’s not just letters to the board as in the SRI approach. We can insist on various actions being taken to improve the value of the company – and our returns.”



Jemmett-Page: good ESG standards are not a trade-off against good returns

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But the longer timeframe also gives private equity managers more pressing incentives to act. Firstly and most obviously, there is more time for any potentially calamitous issues lurking under the surface – fraud,

corruption, pollution – to blow up in their faces. But secondly, there is time for some of the more subtle market drivers behind ESG to play out: employee engagement and retention being one example, according to Rotherham.

“Will disengaged employees affect a company’s performance over a period of three months? Not likely. But over 30 months? Of course they will.”

Rotherham hopes private equity firms will soon start to move beyond being responsive to outside demands – ticking boxes to appease their LP base or following regulatory leads – and start to recognise key market drivers in ESG such as employee engagement, health and safety within the workplace, and general resource efficiency.

But it is very early days and the conversations around ESG are only just beginning in private equity.

The biggest and most urgent of these will be over levels of engagement. Should LPs invest only with those managers with good ESG processes or instead commit to others on the understanding that their ESG standards will improve? Do investors want managers to invest only in ‘clean’ companies or do they want to see them invest and engage with companies that lag on ESG standards?

These questions will merit much further discussion in the industry – but the very fact they are being asked at all points to the progress that has already been made. ●

in society is the support – in the form of pro bono advisory work for example – it can and does offer to certain other philanthropic investors.

One such investor is Acumen Fund, a US-headquartered non-profit venture firm which raises philanthropic capital from institutions, HNWLs and major foundations for investment in fledgling businesses in low-income markets. It basically seeks to apply the private equity and venture model – in the firm’s own words, “small amounts of capital, combined with large doses of business acumen” – to get companies providing essential services to the world’s poor off the ground and running.

“Our brand of ‘patient capital’ takes companies to the point where commercial investors can come in,” says Ankur Shah, business development manager for the fund in Dubai, who explains the level of commitment needed for this kind of work. “We’re working in markets that don’t have a lot of infrastructure – and progress takes time. Rural locations may not have tar roads and companies do not have the same corporate governance standards as might be expected. It takes a lot more due diligence, and a lot of time working with management afterwards.”

However, he clearly believes the effort is worthwhile. “Risk capital can and does play a positive role in development in emerging markets,” he says.

In order to maximise its impact – and also ensure the future of its projects – Acumen searches out businesses that are easily scaleable. An example of an Acumen investment is LifeSpring, a chain of maternal and paediatric care hospitals in India aimed at the low-income market. Acumen invested \$1.9 million in equity in 2007 and has helped take the company from one to seven hospitals already, with a total of 30 planned by 2012.

Acumen depends on the largesse of its investors and firms like Abraaj to go about its business. But in turn, says Shah, Abraaj is getting more than just a good social conscience.

“Building a partnership with us is a chance to offer employees a chance to give back,” he says. “It also helps spread notions of best practice across the region, bearing in mind that we may work with a lower target market than Abraaj. Also, gaining access to our donor community gives exposure to different approaches to philanthropy, which is at an early stage in the Middle East. There are some fairly strategic alignments to be had.”