

# Trends in Responsible Investment in Private Equity

## A discussion paper by the Principles for Responsible Investment (PRI)

*The term 'Responsible Investment' refers to an investment approach that treats extra-financial factors—including environmental, social and governance issues—as being potentially material to the investment decision-making and ownership processes. Investors who apply this approach seek to maximize long-term risk-adjusted returns by basing their decisions on broader information than just the financials.*

*While RI has been implemented in public equity investments for over a decade, more attention is now being paid to alternative asset classes, including real estate, private equity, infrastructure and hedge funds. This article provides an overview of current developments in this area for private equity and suggests some implications for ILPA and its membership.*

*The Principles for Responsible Investment (PRI) is an investor-led association with over 600 signatories representing assets under management of roughly \$USD18 trillion. A full members list is available at [www.unpri.org/signatories](http://www.unpri.org/signatories). In March 2008, the PRI began a programme of work on private equity. More information is available at [www.unpri.org/privateequity](http://www.unpri.org/privateequity).*

## 2009: Some unexpected changes

An audience survey at the October 2009 Private Equity International CFO / COO Conference in London revealed that 71% of the LP and GP attendees agreed that ESG issues could influence the realisation process. In a November 2009 survey of 27 GPs undertaken by the Australian Private Equity and Venture Capital Association (AVCAL), 68% of the respondents agreed that environmental, social and governance (ESG) issues can impact exits.

Other indications of change in the sector include:

- Private equity associations in the US, UK, Australia, France, Brazil and Europe have established permanent working groups on responsible investment.
- In February 2009, the US Private Equity Council, representing 13 of the world's largest GPs, published its own detailed Responsible Investment Guidelines. The PEC is now meeting bi-annually with a leading group of LPs from within the PRI to discuss implementation and share good practice.
- More recently, both the Australian (AVCAL) and Brazilian (ABVCAP) national associations have encouraged their GP members to consider signing up to the UN-backed Principles for Responsible Investment.
- Seven of the world's leading private equity fund of funds are now signatories to the PRI: AlpInvest, Axa Private Equity, Capital Dynamics, Hamilton Lane, Pantheon, Partners Group and PCG Asset Management.
- Leading GPs have also signed up to the PRI, including Abraaj Capital, Actis, BC Partners, Cinven, Doughty Hanson, Ironbridge, First Reserve and KKR.

## Are GPs wasting time and money on ESG issues?

Over the past 10 years, a growing number of public equity investors have developed insight and expertise on how ESG issues can impact investment returns. While few mainstream investors would claim that every ESG issue matters to every company in every market—equally few would contend that ESG issues are never material to financial returns. Pension funds and other asset owners have also begun to recognise the role that they should play as active owners across their investments, including private equity.

Climate change (or, more appropriately, the cost of carbon) is the most high profile example, but there are others. Health & Safety (BP); corruption (Siemens); product safety (MacLaren); labour issues in supply chains (Nike). In each case, the failure to identify and address a particularly relevant ESG factors meant latent risks to the company actually materialized—resulting in a significant amount of senior executives' attention being occupied and, ultimately, destroying value in the company.

Indeed, any investor who thinks EBITDA is the only important measure of corporate performance should talk with Fonterra, the New Zealand-based dairy company whose 43% holding in a Chinese milk producer was written down by 60% in the weeks after it was found to have added toxic substances to its products (see text box). Fonterra's investors might also be able to explain why extra-financial factors like product safety and corporate culture should have a direct role in the investment decision-making process.

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# What is the IRR of product safety?

In 2008, Sanlu, a Chinese milk producer, was found to have been watering down its milk products and then adding a carcinogenic substance to artificially increase the protein levels. The story broke after almost 300,000 children had fallen seriously ill and six had died.

Fonterra, a New Zealand-based dairy producer who owned 43% of Sanlu, was forced to take a 60% write-down on the value of their investment. But the punishment meted out by the markets was minor compared to that imposed by the Chinese government: two of Sanlu's senior executives were executed and the Chairwoman received a life sentence.

This not just an emerging markets issue: on 13 Sept 2009, the NY Times reported that the Environmental Protection Agency (EPA) had found over 500,000 instances of non-compliance with Clean Water Act legislation, including "dumping toxins at concentrations regulators say might contribute to cancer, birth defects and other illnesses" (see <http://www.nytimes.com/2009/09/13/us/13water.html>).

Investors might also want to listen to Chris Ailman, CIO at CalSTRS's, who says:

*"Environmental, social and governance issues are an essential part of good investment decisions. Historically, the market place wanted to disdain environmental, social and governance issues. That myopic view doesn't translate into today's complex global market. CalSTRS policies recognize long-term issues that affect the sustainability of corporate earnings."*<sup>1</sup>

As more experience, better information and targeted analysis have helped investors to more consistently identify the ESG issues that matter most, one would expect to see more and more fiduciaries concluding that it is their duty to consider ESG factors in investment decisions. The fact that 191 asset owners have now signed up to the PRI shows that this is indeed the case. Along with some European giants like ATP, the AP funds, APG, Hermes, FRR, PGGM and USS, a number of North American pension funds have also signed the PRI, including:

- CalPERS
- CalSTRS
- NYCERS
- NYSLRS
- TIAA-CREF
- La Caisse de depot et placement du Quebec
- Canadian Pension Plan Investment Board
- Connecticut Retirement Plans and Trust Funds
- Illinois State Board of Investments
- State Retirement and Pension System of Maryland

## What does this have to do with private equity?

All things being equal (i.e. company size, sector, marketplace), privately owned companies are just as exposed to ESG risks as publicly owned counterparts—particularly if they may one day be returned to the public markets or sold to a large (often publicly-owned) trade buyer. Alliance-Boots, Birds Eye, TDC: their ESG-related risks did not diminish or disappear just because the company was taken private. It follows that a GP has as much cause to pay attention to ESG issues as their public equity fund manager counterparts.

The reality is that many GPs may already be taking these issues into account, particularly in due diligence processes. But the experience of many of the PRI's LP signatories is that most GPs do not have a structured approach in place, meaning it is unclear if the issues are identified and managed consistently, which also means that the information cannot easily be communicated to LPs.

Given the economic situation, it is understandable that other issues would be given a higher priority at the moment. But in the medium term, LPs should be concerned by a lack of structured consideration to ESG issues by their GPs because the evidence suggests that they can have real impacts on company value.

Of course this does not—and must not—mean GPs pay less attention to financial performance metrics: our reasons for investing in the sector are the returns we make. A responsible investment approach involves more information, not less. This also does not mean that GPs need to publicly disclose a host of ESG-related information. Portfolio companies should provide appropriate information to GPs, and the GP should convey appropriate information to the LP. What is considered 'appropriate' in each case will differ between companies, GPs and LPs.

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## The PRI's work on private equity

The PRI is an international network that enables collective learning and action by investors, focused on a set of six high-level Principles. The Principles themselves were developed in 2004-5 by 20 of the world's largest asset owners, acting on an invitation from then UN Secretary General, Kofi Annan. Today, the PRI has offices in New York and London and implements a workplan that is set by a Board composed of 11 asset owners and representatives from two UN agencies <sup>2</sup>.

In March 2008 the PRI initiated a work programme on Private Equity. While many investors have a decade of experience integrating ESG into public equity investments, PE is a different type of investment and so we recognize the need to develop a different approach. Our discussions began at a time when the media, politicians and campaign groups were regularly attacking GPs in public (and LPs in private), and so our initial discussions were held behind closed doors. The programme has two objectives:

1. To develop guidance for our LP signatories on how to integrate ESG issues into their private equity investments.
2. To raise awareness of ESG issues within the GP community and to solicit GPs input to the development of LP guidance.

To this end, in September 2008 the PRI created a Steering Committee composed of 15 LPs and 15 GPs. We recognised that our work would potentially impact actors outside of the PRI network, and so roughly 25% of the committee members were not PRI signatories.

The first tangible product of this work was the publication of the US Private Equity Council's Responsible Investment Guidelines in February 2009 – for which PRI signatories provided both strong encouragement and detailed input <sup>3</sup>.

In July 2009, the PRI itself published two documents: a compendium of case studies on responsible investment in private equity and a Guide for LPs. The Guide was the result of months of detailed discussions within the Steering Committee and the final product had the full support of all LPs and GPs. This Guide will inform how PRI-signatory LPs approach RI in their private equity investments.

A new Steering Committee has been created with over 25 leading LPs and GPs. The workplan and a list of Steering Committee members are publicly available <sup>4</sup>. In addition, PRI signatories are represented on responsible investment working groups in the US, UK, Australia, France, Brazil and at the European level.

## What does this mean for LPs who are not PRI signatories?

Anecdotal evidence suggests that as many as 20% of LPs already include ESG-related questions in due diligence questionnaires. The PRI's LP Guide is intended to increase this further: as more and more of the PRI's over 600 signatories integrate ESG into their investment practices, ESG will increasingly be a part of private equity investing, just as it is being incorporated into investment in other asset classes.

The recognition that RI is a legitimate aspect of investment processes is by no means universal, and we have heard examples of LPs who are not PRI signatories expressing differences of opinion on ESG, for example within LP advisory committees. We do not expect all LPs to prioritise ESG issues to the same extent—either within or outside of the PRI membership. But we see a risk that differences of opinion on responsible investment could detract from the extremely constructive cooperation by LPs on other issues, including in particular through ILPA's efforts.

At the same time, there is a significant and growing acceptance of responsible investment by GPs. As a result, we encourage ILPA and its members to engage with the PRI and its LP and GP signatories to ensure that the objectives and implications of responsible investment are well understood. Given that there is a significant overlap between the ILPA membership and the PRI signatories, this could be done within ILPA itself.

One option for meaningful engagement may be during a possible future review and revision of ILPA's Private Equity Principles. The commitment by a large proportion of ILPA's members to responsible investment implies that the ILPA Guidelines should make clear reference to extra-financial issues, including in its provisions on both governance and the transparency. Without this, the LP-GP relationship will continue to be based on an incomplete discussion of the things that matter to the long-term health of companies and success of investments.

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## What can ILPA members do?

1. Recognize that the growing number of LPs and GPs that have become PRI signatories are doing so in pursuit of improved long-term risk adjusted returns <sup>5</sup>.
2. Read “Responsible Investment in Private Equity: A Guide for Limited Partners” <sup>6</sup> This document provides insight into why RI should be addressed within the PE investment process, and what this may mean, for example, for due diligence processes, side letters, reporting requirements and roles on LP Advisory Committees.
3. Contact a member of the PRI’s Private Equity Steering Committee to hear first-hand what responsible investment means for their investment processes <sup>7</sup>.
4. When the ILPA Private Equity Principles are updated, consider adding a reference to extra-financial risk and opportunity in the sections on Governance and Transparency.

In the past, Private equity and its investors have been put under a bright spotlight over the activities of some within the sector. The corresponding damage to the sector’s reputation hasn’t been helpful for anyone, including the portfolio companies that might otherwise have benefited from private equity expertise and investment. As well as improving risk management, a demonstration that the sector can and does address a broader range of extra-financial issues can only be of benefit for the long-term success of the asset class.

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<sup>1</sup> <http://www.privateequitycouncil.org/press-releases/2009/02/10/private-equity-council-members-adopt-guidelines-for-responsible-investment/>

<sup>2</sup> A list of current Board members is available at <http://www.unpri.org/about/>.

<sup>3</sup> See <http://www.privateequitycouncil.org/wordpress/wp-content/uploads/pec-guidelines-for-responsible-investment-final.pdf>

<sup>4</sup> See [www.unpri.org/privateequity](http://www.unpri.org/privateequity)

<sup>5</sup> A list of PE-focused signatories is available at [www.unpri.org/privateequity](http://www.unpri.org/privateequity)

<sup>6</sup> See <http://www.unpri.org/files/PE%20LP%20Guide%20FINAL.pdf>

<sup>7</sup> A list of PRI PE Steering Committee members is at [www.unpri.org/privateequity](http://www.unpri.org/privateequity)

The ILPA sincerely thanks Tom Rotherham and David Russell for their contribution of this piece to the newsletter.

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Tom leads the PRI’s work on Private Equity, which he has done since March 2008. He has also recently joined Hermes EOS, a subsidiary of the UK-based asset manager, where he addresses ESG issues in private equity. [tom.rotherham@unpri.org](mailto:tom.rotherham@unpri.org)



**David Russell, Co-Head of Responsible Investment, Universities Superannuation Scheme**

USS is the UK’s second largest pension fund and has a Responsible Investment (RI) strategy which focuses on integrating material extra-financial factors into its investment processes across all asset classes, including Private Equity. David is a member of the Management Oversight Committee of the PRI, and on its Private Equity Steering Committee. [drussell@uss.co.uk](mailto:drussell@uss.co.uk)

