

# Good business



Though environmental, social, and governance-driven investing may be winning more advocates, we may still be a way from systematic implementation of a responsible investment strategy that goes beyond a commercial definition of smart investing.

By *Francinia Protti-Alvarez*

■ Ideas that make money make the world go round; come up with a commercially viable idea and you should be on to a winner. This has always proved an obstacle to the implementation of environmental, social and governance (ESG) objectives, which have been part of the global political agenda for some time: linking political interests with commercial ones has not always been straightforward. It is, however, becoming simpler.

**“ESG goes beyond a black-and-white discussion related to profit- or loss-making decisions. It’s about ‘good corporate behavior’ and this may mean making, at times, tough decisions which will not necessarily result in increased returns”**  
*Wim Borgdorff, Alpinvest*

“The decision to incorporate ESG concerns into the investment process and portfolio management is not based on ethical or moral positions, it is about good, long-term investing. GPs and their portfolio companies need to manage these issues correctly to maximise returns,” says David Russell, co-head of responsible investment at USS. “ESGs are part of an integrated approach to investing that in the end just makes ‘good business sense’ and that can make a significant difference in terms of returns.”

Institutional heavyweights such as CalPERS and the Universities Superannuation Scheme (USS) are signatories of the Principles of

Responsible Investment (PRI) Initiative, which has been gaining momentum as more money managers come on board. These recently published, non-prescriptive guidelines propose a set of pre-investment and post-investment considerations, which are not presented as part of a political agenda but as an approach to “smart investing”; developed by investors for investors.

“The principles are not about a ‘feel good factor’ or the advancement of a global political agenda,” says Tom Rotherham, adviser to the UN PRI initiative. “All investors are concerned with the delivery of superior risk-adjusted returns. LPs who are PRI signatories believe ESG issues can impact returns and so are firmly within their fiduciary duties. It is this that the PRI is addressing”.

In a time where LP/GP relations are particularly strained, the guidelines could also become a useful communication tool. “The guidelines will help LPs and GPs to engage more effectively on these issues,” observes Doughty Hanson investor relations executive Guy Paisner.

## Profit principles

While most agree a focus on ESG is positive, different groups are driven by different aims and there are different levels of interpretation when it comes to defining exactly what ESG concerns are and how measures should be implemented. “GPs can be classified into three sorts: those who believe ESG issues are irrelevant and focus only on legal compliance; those that see it as a fund raising issue, which falls under the investor relations team; and those that see the value driver in this investment approach and allocate the task to the investment teams as well,” Rotherham notes.

Consider the business savvy angle to a responsible investing approach. It

can have straight forward, quantifiable returns where a one off investment can result in consistent, year-on-year savings. Rendering your company more energy efficient will cut down on costs related to energy consumption as well as on costs related to the offset of carbon emissions (see box, right). “Implementing ESG initiatives in portfolio management provides clear opportunities to create value, but it also reduces risks, both financial and reputational, which can lead to more attractive valuations at the point of exit,” emphasises Paisner.

Those GPs that comply with the initiative hope that they will also reap additional rewards, namely in the way of LPs re-upping during future fund raising campaigns. According to an LP PRI survey, 93% of institutional investors would expect all their potential and future GPs to respond to questions surrounding ESG issues, while 86% of LPs would not only expect ESG information to be part of the annual reporting, but also that these issues be integrated into capital calls or investment memos. “We believe the value of the investments are enhanced by considering long-term economic sustainability, reputation risks, corporate governance, and other extra financial issues,” stresses Russell.

### The value of responsibility

However, while ESG seems to be centred on ‘smart investing’ and its use as a GP/LP communication tool, it does not always translate to return maximisation. Borgdorff goes on to assert that “ESG goes beyond a black-and-white discussion related to profit- or loss-making decisions. It’s about

### What is PRI?

In early 2005, then UN secretary-general Kofi Annan invited a group of the world’s largest institutional investors to join a process to develop principles for responsible investment.

Since November 2007 a partnership between the UN and LPs, GPs and industry associations has been working together to develop a set of non-prescriptive guidelines that has led to the PRI. The PRI are designed as a framework to promote greater understanding and awareness of ESG issues in the private equity industry and across other financial asset classes. The initiative has over 530 signatories, of which 33 are sizeable private equity firms on both sides of the Atlantic. By February 2009 the group represented \$18tr of assets under management.

### ESG in the practice: Doughty Hanson’s Impress Holdings

**Acquired:** 1997      **Deal value:** €660m (est)  
**Sector:** Packaging & containers      **HQ:** Netherlands

Doughty Hanson acquired Dutch metal packaging manufacturer Impress Holdings in 1997, for around €660m. Since the acquisition, Doughty has been actively engaged with the company on a wide range of initiatives, including ESG.

Recently, Doughty’s ESG focus for Impress has been on energy use and climate change issues. In the first half of 2008, Impress improved roof and window insulation and started using gas-operated fork lifts instead of diesel ones. Additionally, more energy-efficient arrangements for generating compressed air used to move machinery and materials around the factory were installed. In Q3 2008, oxidisers used

to incinerate solvent emissions from the shop floor were redesigned, achieving, according to Doughty, a significant reduction in energy use and associated carbon emissions of more than 1,200 tonnes a year. The decrease in carbon emissions has reduced the tax liability of the plant and has resulted in cost savings of about €1.5m a year from reduced energy consumption.

“The PE governance model is well suited to the implementation of ESG initiatives. Several factors contribute to this: the shareholding structure is less diffuse; the alignment between investors and the company is more important; and the private nature of the business also allows it to focus on implementation away from the prying eyes of market commentators or analysts, notes Paisner.

‘good corporate behavior’ and this may mean making, at times, tough decisions which will not necessarily result in increased returns.”

AlpInvest, an active member of the PRI steering committee, believes in a more nuanced approach to ESG. At present, the engagement with GPs follows an exploratory nature to improve visibility and understanding where GPs stand on ESG issues. “It was first necessary to get a clear grasp of what ESG issues were. The notion can be so vast it can appear unattainable but we relied on the principles laid out in the UN Global Compact [a policy initiative committing businesses to align their operations and strategies with principles in the areas of human rights, labour, environment and anti-corruption], which are well in tune with the corporate setting,” stresses Borgdorff.

“We then went on to assess to what degree GPs have a ‘well defined’ ESG process in place and to what extent it is integrated in their decision-making practices. While at this time there is not a huge level of discrimination, over the years we expect this to evolve into a more discriminating approach in the determination of our relations with GPs. For now the focus should be on improving the clarity and visibility of ‘how’ GPs handle their investments and make decisions.”

As is often the case, the devil lies in the detail, and in this case that may well be in the working definition of “responsible”. Perhaps it remains difficult to omit a ‘moral’ angle to the PRI initiative after all. In the end the world is made up of shades of gray requiring a unified and more nuanced ESG definition and framework. This could have at least two other added advantages: advancing the industry’s ‘self-regulating’ position (thus averting further meddling from Brussels) and showing the outside world private equity has value to add to business. ■