



# SECA Yearbook 2017

**SECA**

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# Responsible Investment in Private Equity – a key component of operational value creation

**A recent Capital Dynamics survey of private equity managers reveals that responsible investment and ESG are increasingly used for value creation**

## Introduction

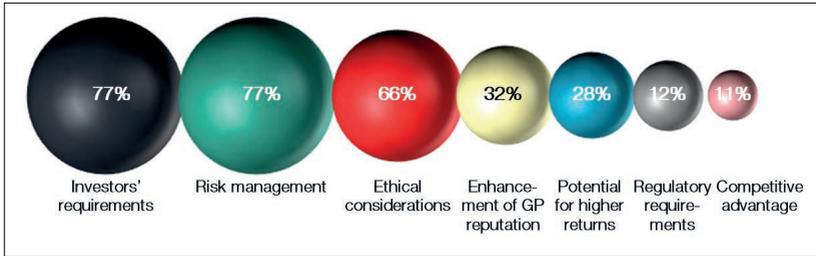
Responsible investment in private equity is typically defined as an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions to better manage risk and generate sustainable, long-term returns. As controlling and active owners of portfolio companies, private equity managers are in the best position to manage ESG issues and drive the implementation of principles of responsible investing to help create sustainable growth and increase returns. Aligning the interest of owners and managers as well as bringing additional strategic, financial and operational expertise is at the heart of the private equity business model. Our survey provides insights into GPs' responsible investment practices and the current state of implementation of ESG factors throughout the investment cycle.

## About the survey

In late 2016, Capital Dynamics surveyed 109 general partners (GPs) from private equity funds to gauge how principles of responsible investing and environmental, social and governance (ESG) factors are implemented in the investment process. The survey accurately represents the general responsible investment practices across the global private equity industry – the majority of respondents (55%) were outside Europe and all strategies of the private equity spectrum were represented. The participants of our survey were well-balanced by size of their most recent flagship fund with the majority managing mid-market funds. Similarly, in terms of headcount, most respondents were mid-sized managers with 25-100 employees.

## High ESG commitment by GPs

The formalization of the commitment to responsible investing and the consideration of ESG factors is becoming prevalent among the private equity industry. 78% of survey respondents have already established RI/ESG policies, while 9% plan to establish policies in the future. There were only a few firms that did not have such policies in place - typically venture firms - and hold the belief that ESG factors are not material to their investments, while the remaining participants decided against an explicit formalization, as responsible investing and ESG principles are already embedded in their investment processes and culture. Investor requirements and risk management were the main and equally important drivers for GPs committing to RI/ESG.

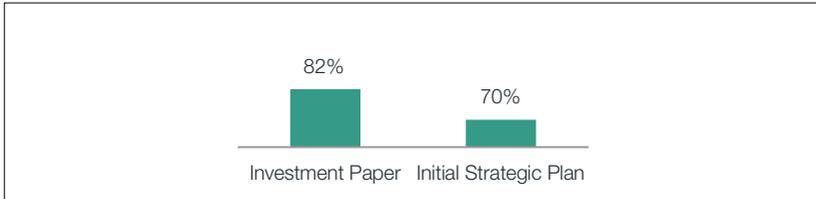


**Figure 1:** Primary drivers for RI/ESG Implementation

Many LPs that have adopted RI/ESG principles expect their private equity managers to have formal policies and processes in place, which has prompted GPs to show commitment by establishing such policies. The motivation is more nuanced when results were broken down by type of firm. While investor requirements was the main driver for venture and growth capital firms, risk management was firmly on the agenda for those pursuing buyout, infrastructure and private debt strategies.

### Degree of RI/ESG implementation varies significantly

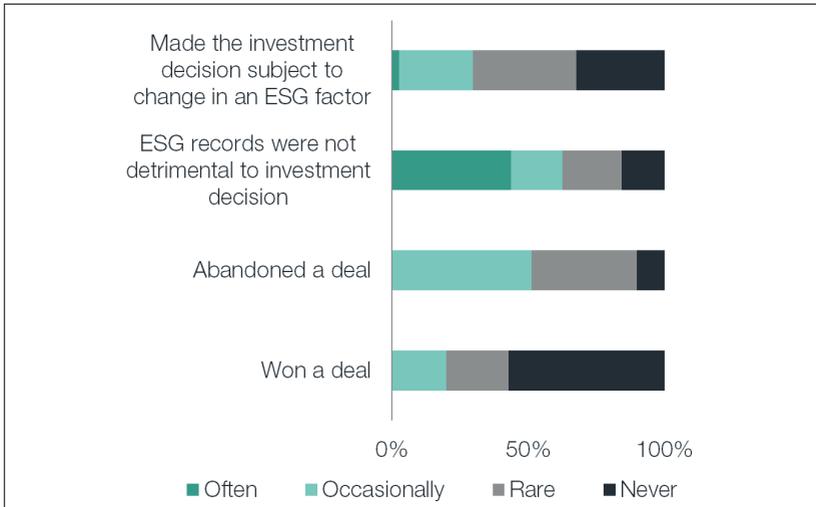
When it comes to the implementation within the investment cycle, the progress varies among GPs. At sourcing, about 60% of respondents make decisions based on RI/ESG and generally avoid sectors that are prohibited by international conventions or typically not in favor with investors (e.g. narcotics, pornography, weapons). Some firms do not maintain a predetermined list of excluded industry sectors, but determine the suitability on a case-by-case basis. Almost all GPs that participated in our survey said they implement an ESG analysis during their acquisition diligence process. However, surprisingly there is still a significant share (18%) who do not include an ESG analysis in investment papers.



**Figure 2:** Inclusion of RI/ESG analysis in investment papers and strategic plans

Post-investment, fewer firms include ESG actions and monitoring in their strategic plan, indicating a less consistent approach among GPs. While 82% of respondents include ESG in investment papers, only 70% continue to track ESG matters and incorporate them in their strategic plan.

Additionally, ESG records of a target company were usually not detrimental to making investments. This could be linked to the notion that firms may consider ESG issues concerning potential investments as an opportunity to enhance their value during ownership.



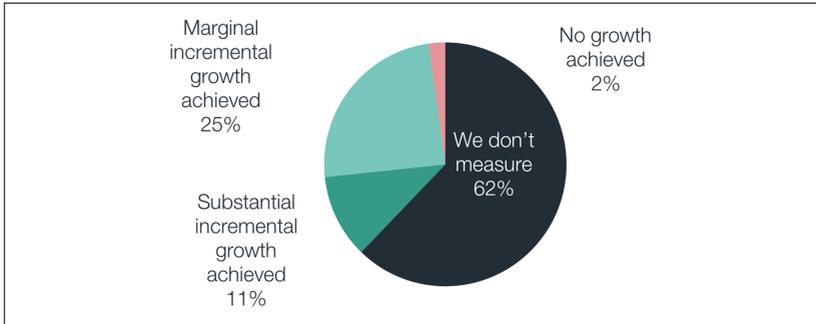
**Figure 3:** The analysis of ESG factors or the ESG records of a target company led to the following outcomes

However, in cases where records indicate substantial risks regarding the future development of a company, deals have been abandoned; in fact, half of our respondents claimed that including an ESG analysis in investment papers led to a few abandoned deals. Requiring portfolio companies to have ESG policies is one way of ensuring the RI/ESG issues are being considered across the portfolio. About a half of respondents reported an existence of such requirements. However, it appears that many firms are flexible and only encourage companies to establish ESG policies and processes, but do not impose mandatory requirements.

Most GPs (76% of all respondents) focus on ESG issues during ownership and document remedial actions by portfolio companies. The more advanced GPs not only focus on the issues, but also require companies to perform regular reporting on the ESG key performance indicators, which they also use in order to report to their LPs as part of their regular reporting cycle.

In Capital Dynamics' experience, private equity firms can draw up ESG measures and initiatives that address the companies compliance with ESG principles, improve governance and decision-making, engage with the workforce for better health and talent retention as well as improve customer satisfaction and brand in order to gain market share. All of these actions can indirectly and directly have a positive impact on the top and bottom line of a portfolio company, reduce operational risk and improve asset quality leading to an increased company valuation.

Measuring the impact on revenue can be a challenging endeavor - 80% of respondents have not yet established such metrics. However, those who do measure the impact appear to achieve growth in revenue (15%) - 2% experienced a substantial growth in revenue.



**Figure 4:** Impact of RI/ESG on EBITDA

More GPs quantify savings or costs resulting from ESG initiatives. 38% of respondents measured the ESG impact on EBITDA and almost all saw a positive impact – two-thirds of those respondents experienced a substantial increase in EBITDA due to ESG actions. Importantly, no GP experienced a decline in EBITDA despite the cost that is incurred during implementation of ESG actions. If anything, ESG appears to pay for itself.

### ESG implementation is set to improve

The small number of respondents who have not yet established an RI/ESG policy plan to do so in the future. Additionally, firms that have already established such policies and processes still see potential for improvements. Two-thirds of respondents acknowledged they need to further invest in their respective ESG efforts.



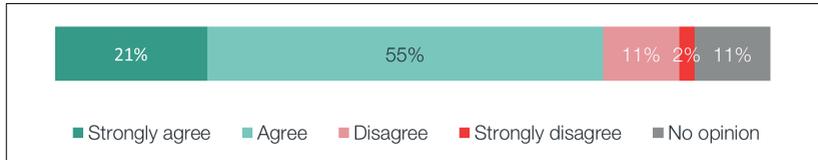
**Figure 5:** Areas where GPs plan to enhance RI/ESG

ESG relevant data collection from portfolio companies and reporting to investors on ESG matters are the most pressing issues among GPs who see a need in boosting the level

of their ESG implementation. Finally, GPs are expected to focus on the implementation of ESG efforts as a value creation tool.

### RI/ESG will increasingly serve as a building block for operational value creation

Since the onset of the private equity industry, the road to success has continuously evolved. After the global financial crisis, the private equity model has relied more heavily on operational value creation rather than financial leverage, and new sources to increase returns are being sought to support future success. The value creation potential associated with ESG initiatives is strongly recognized by GPs.



**Figure 6:** We will increasingly use RI/ESG as an opportunity for value creation

Three-fourths of our respondents said that they will increasingly use RI/ESG for value creation. Many GPs are still in the early stages of their RI/ESG programs and consider the value creation aspect as one of their top three incentives to implementing such a program. The results of our survey suggest RI/ESG does not solely play a role in preserving value - experienced GPs have already started to see additional benefits, resulting in increased returns to investors.

### Conclusion and Outlook

As conveyed by our survey, a continued increase in the importance of ESG for GPs is expected. Further, we anticipate rapid improvements in the way GPs communicate their responsible investment efforts to investors and the public. For investors, it will be crucial to lift the curtain and look behind these marketing efforts. Capital Dynamics believes and observes that implementing responsible investment policies leads to robust long-term returns for investors. Most importantly though, we are firmly convinced of the need for responsible investment principles to be deeply embedded into an organization's culture and values to have such an effect.

Our study underpins our responsible investment approach in private equity and demonstrates that GPs that put their money where their mouth is in regards to RI/ESG were able to measurably improve operational performance and reduce business risks for their investments. We envisage that RI/ESG will become a vital building block for the operational value creation model in private equity, and – as our study shows – this trend is manifesting. Therefore, analyzing the implementation of ESG principles and measuring its impact on value commands a pivotal role in due diligence.

The complete results of Capital Dynamics' survey can be requested by emailing [info@capdyn.com](mailto:info@capdyn.com).

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