

WHERE DO
PRIVATE EQUITY
BUSINESSES STAND
ON THE
INTEGRATION OF
ESG ISSUES?

novethic

A PART OF CAISSE DES DÉPÔTS ■

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Introduction

The SRI¹ market of equity funds on regulated markets, followed by fixed income, has grown over the past ten years and become more structured, using assessments of listed companies based on Environmental, Social and Governance (ESG²) criteria. Private equity businesses are now applying a similar approach to unlisted companies, which brings new issues into play concerning:

- access to extra-financial information from issuers without the adequate resources available to meet these new expectations;
- how this management approach can be adapted to extra-financial requirements, particularly in markets that are typified by limited liquidity and therefore limited capital inflows and outflows but enjoy closer-knit ties between shareholders and management.

Although private equity remains a relatively small segment in the industry of financial management, it plays an essential role in aiding innovative companies that could become tomorrow's business leaders. The adoption of responsible investment practices by managers could indeed proactively guide these high-growth companies in their sustainable development approaches in anticipation of future issues.

The businesses associated with private equity, more specifically those that experienced strong growth in the past few years through Leveraged Buyouts (LBOs), are now under severe attack as they normally focus on reaping large profits quickly, sometimes prompting them to disregard tangible industrial issues, in particular labour relations in the invested companies. The sector's incorporation of ESG issues may offer a concrete solution to these debates.

The purpose of this working paper is to review and define a few recommendations on these nascent approaches, by presenting practices specific to the diverse private equity businesses, as each segment is faced with its own issues in terms of extra-financial management approach.

This study focuses on the main initiatives promoted by private equity investors. It is not intended to be an exhaustive review of all private equity practices in France.

¹ Socially Responsible Investment (SRI), although currently not subject to any standards, has evolved over the past ten years into an approach that incorporates extra-financial issues into fund management in a systematic and structured manner.

² Extra-financial issues generally refer to the Environmental, Social and Governance (ESG) aspects that could affect the characteristics of an issuer.

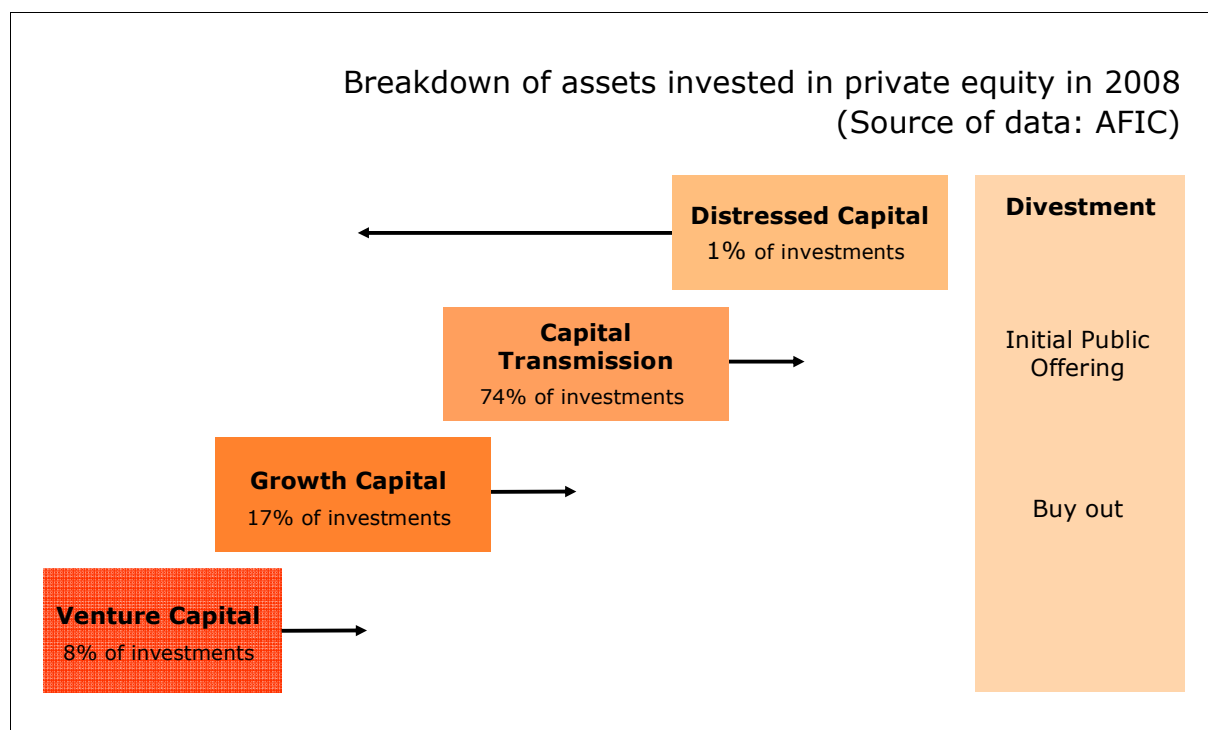
I. Definition: private equity, a multi-faceted segment

Glossary

Private Equity is the business of investing in unlisted companies. Investors guide the companies they finance and contribute to their development by raising quasi-capital or capital. Private equity investments average 5 to 8 years and boast higher yields than investments in financial markets (upwards of 15% per year) but bear greater risk.

Generally speaking, private equity investors are significant or majority shareholders in the companies in which they invest, affording them a more influential role in their relations with company management.

Active throughout all stages of company growth, private equity gears its strategies to the specific needs of each stage. It is broken down into four major segments³: venture capital, growth capital, capital transmission - accounting for three-quarters of the sector's financial volume - and distressed capital.



³ Source of definitions: AFIC and Novethic.

- **Venture capital:** Investment in the capital of start-ups that bear risk but promise strong growth thanks to the innovative nature of their technologies, products or services. Venture capital is sometimes set apart from seed capital, which is invested far upstream of the company set-up. The latter is used to finance the development of new technologies, define a business model or, more generally, prepare a product or service launch.
- **Growth capital:** Entails a minority stake in a developing company with a firm foothold in its market and a high-growth outlook. The purpose of this type of investment is to guide the director in devising the company's development strategy in order to create value and a strong cash position in the medium term.
- **Capital transmission:** Funding of the acquisition of a minority or majority stake in a company by financial investors and/or managers in exchange for a contribution in capital and debt through a holding company.
- **Distressed capital:** Acquisition of financially stressed companies in order to turn them around. Large amounts of debt can also be used in these situations.

LBOs (Leveraged Buyouts), prevalent in capital transmission, refer to the acquisition of a company by capital investors, in association with the management of the company purchased, by using varying levels of debt that will be repaid through future cash flow. The name of this type of deal derives from the potential significant leverage effect in periods of growth.

Investment vehicles

Private equity funds mainly include venture capital funds, innovation funds as well as local investment funds depending on the type of investor targeted (institutional or individual).

Facts and figures

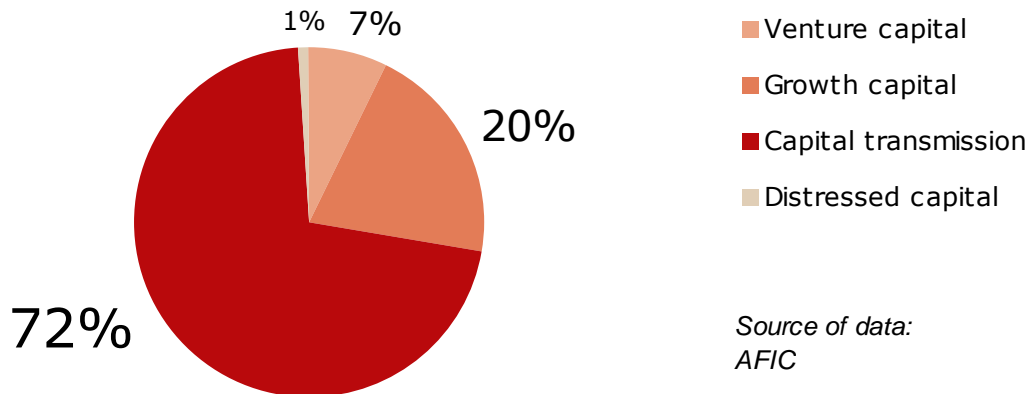
Review of global trends

In 2008, the French private equity market was the largest in continental Europe, ahead of Germany, Italy and Spain, but represents only a small portion of total financial management.

In France, this sector has reached a turning point in its development, following the significant growth it has seen in the past ten years. In 2008, inflows hit a record high of EUR 12.7 billion (up 27% in one year), while fund investment in companies plummeted (down 20% on 2007) to EUR 10 billion, i.e. roughly its 2006 level.

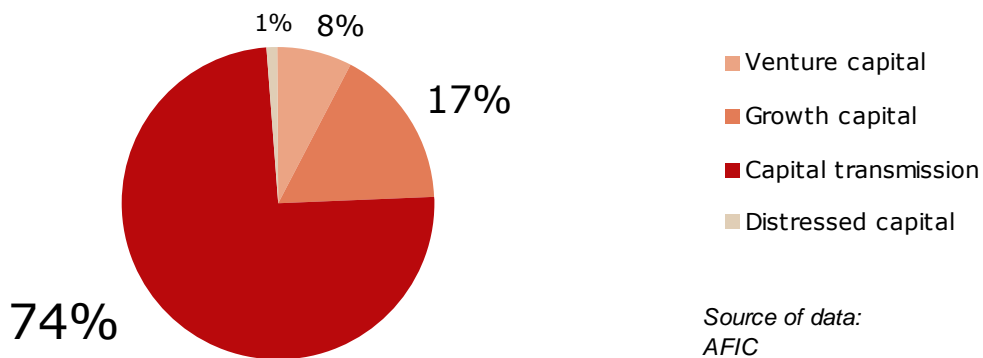
Inflows and investment, recent trends in France

Breakdown of inflows in 2008



In 2008, assets under management inflows principally came from French investors (60%), of which only one-quarter were individuals. Inflows rose across all private equity segments except venture capital, which was down 17%. Inflows in growth capital and capital transmission jumped by one-third, while distressed capital inflows, still marginal, increased four-fold.

Breakdown of investments in 2008



Investments draw quite a different picture. The financial crisis has darkened the outlook for the private equity business, which is particularly sensitive to the economy situation: investment opportunities dwindled while banks were faced with new challenges, thus complicating the supply of debt necessary to raise capital for LBOs, the backbone of private equity. Falling investments in this segment (down 28%), not surprisingly, have pulled the entire private equity business downward, despite higher investment in all other segments, up 12% for venture capital, 26% for growth capital and 18% for distressed capital. Given the current economic uncertainty, this downward trend seems to have grown stronger in 2009.

Moreover, it should be noted that only 70% of the sums invested finance unlisted companies, with 18% funding CAC 40 companies and 12% going to listed small- and mid-caps, as investment vehicles do not expose all of their assets under management to the risk of private equity.

The companies targeted

In the last ten years, over 10,000 companies were funded and nearly EUR 70 billion invested by private equity funds, EUR 40 billion of which in the past four years.

According to AFIC (the French Private Equity Association), private equity funds are currently invested in 4,500 companies employing close to 1.5 million people, which represents between 8% and 9% of all private sector employees. This is a considerable impact but must be put into perspective as private equity is not always these companies' sole source of financing, therefore remaining a modest contributor to the economy.

Out of the some 1,600 companies financed in 2008, 40% are in innovative sectors⁴, and a very large majority (over 85%) are French.. Private equity lacks geographical diversity. Half of its assets are invested in French companies in the greater Paris region, while this region only represents 28% of French GDP.

Interestingly, the sharp fall in private equity investment volumes in 2008 did not reduce the number of companies funded (up 2.4%, to nearly 1,600 companies). This is most likely due to the fact that venture capital and growth capital investments are generally much smaller in amounts but in a larger number of companies than LBOs.

A sector under attack

Private equity falls repeatedly under attack in its involvement in LBOs for its emphasis on short-term financial profits over long-term industrial growth of the companies it finances. This results in investors sometimes dismantling or restructuring companies without much consideration for labour issues.

The crisis has only added oil to the fire. As long as the economy is healthy and credit is easily accessible, investors praise LBOs. They boast high returns thanks to the value created by the companies, easily offsetting the cost of the debt while ensuring ample gains upon resale. In a period of crisis, however, this system fails, with companies caught in the squeeze between the challenging economic outlook and investors under the strain of debt under tightening lending terms.

As witnesses to this undesirable reputation, the publication by the SEIU⁵ of its "Behind the buyouts" reports, which blame the industry's lack of transparency and foresight in labour relations and medium- and long-term planning, or the set-up of the "LBO collective", an example of the union and media protest to the private equity industry. Despite the data-packed reports⁶, professional associations are having trouble convincing the general public and media of the virtues of private equity in terms of job creation and improvement in working conditions.

Consequently, some management companies consider a strategy that incorporates ESG standards as a means of restoring honour to LBOs and throughout the private equity sector as a whole.

⁴ Representing 24% of the assets under management. The sectors selected by AFIC are: information technology, telecommunications and communication, medical and biotechnology.

⁵ The SEIU (Service Employees International Union) represents over 2 million employees in North America. It published a number of reports outlining the negative effects of LBOs on employees.

⁶ AFIC Report, "Labour impact of LBOs in France", March 2007.

II.

Overview of existing practices

In the past few years and especially since the beginning of the financial crisis, a certain number of ESG initiatives were taken by management companies, presumably in a move to limit their reputational risks.

What practices characterise the different investment segments?

Investment approaches incorporating ESG criteria in private equity are disparate and rapidly changing. It would therefore be difficult to give an overall estimate of the amounts involved, both in France and abroad, and even more so to provide specific numbers on the different approaches or investment segments most often concerned. Clearly, structured approaches are relatively rare, prompting us to describe approaches rather than try to measure them⁷.

The considerable range in practices means they can be adapted to either define the pipeline universe, conduct the due diligence process⁸, or adopt an engagement approach throughout the investment period.

Although the classification of practices, often combined within a single management approach or fund, is complex, we noted three major types of approaches:

1. Thematic ESG approach

This involves selecting companies whose products and services offer sustainable solutions to societal issues (environmental and/or social). The most common themes are the environment⁹ (climate change, energy efficiency, renewable energy, waste and water management, etc.), demographics and well-being services (healthcare, personal services, etc.), sustainable agriculture and fair trade...

Regarding funds invested in listed securities, these themes were already noted in SRI thematic funds mainly invested in listed small- and mid-caps, which have propagated across Europe since 2007¹⁰.

This is the most widespread approach to date, notably used by funds invested in cleantech sectors, but does not always meet all ESG standards for two reasons. First, a number of funds concerned focus on environmental rather than social value-added

⁷ According to a Eurosif study published in 2007, the "SRI" private equity market represented EUR 1.25 billion in Europe at the end of 2006. The study estimates that the majority (60%) of these assets under management were from the United Kingdom, followed by 16% from France.

⁸ The pipeline is comprised of companies which, upon their initial review, interest the fund manager, while the due diligence phase that follows, involving various audits, either confirms or invalidates the interest in these potential investments.

⁹ The sectors involved are generally referred to as cleantech or ecotech companies.

¹⁰ For further details, see Novethic's study of November 2008, "What role for environmental funds within SRI?"

II. OVERVIEW OF EXISTING PRACTICES

sectors, and second, thematic approaches often disregard companies' ESG practices (e.g. relations with their stakeholders: shareholders, employees, suppliers and contractors, surrounding and local communities) and look exclusively at the type of product or service. Still, this approach may raise managers' general awareness of ESG issues, but in practice, they are rarely incorporated thoroughly or systematically.

To date, the venture capital and growth capital segments have used thematic approaches the most, but this could change considering the growing importance of some cleantech companies.

Partnerships in expertise

At the end of 2007, the Nef, a banking cooperative involved in solidarity investments, teamed up with the French branch of Bank Sarasin to set up Nef Capital Ethique Management. In June 2009 was the first closing on the Sarasin & Nef Synergies growth capital fund designed to invest in companies positioned on the responsible consumer sectors of the future (energy efficiency solutions, organic and fair trade products, etc.). The fund's management team will benefit from the Nef's pool of promising companies and the expertise of Bank Sarasin's extra-financial analysts to determine whether or not potential projects are indeed responsible.

In early 2009, Financière de Champlain, an asset management company specialised in the environment, joined forces with Siparex to launch a private equity fund focused on cleantechs. This partnership is designed to combine Financière de Champlain's knowledge of environmental sectors with Siparex's private equity expertise.

2. ESG screening

Investment decisions and/or the pipeline universe are impacted by the analysis of a company's ESG practices. This approach remains relatively rare, particularly if it implies structured, systematic selection, as is often the case with SRI funds invested in listed securities. There are two reasons for this:

- first, unlisted issuers are not typically screened, as the extra-financial rating agencies mainly review listed companies, which are most often large caps.
- second, as they are invested over a comparatively long period with significant or majority stakes in the issuers' capital, private equity funds naturally lean towards engagement approaches in order to improve the company's ESG practices rather than an initial selection of companies showing best practices.

Furthermore, these approaches are often applied across the board within a private equity firm's investment universe rather than to a specific fund sold as such. Their main objective is to reduce the risks associated with certain externalities that are not taken into account in the financial due diligence rather than seize investment opportunities using broader analysis tools.

These approaches are usually implemented first by setting up special teams or integrating extra-financial research teams into traditional private equity management teams. These initial phases include mapping out the strategy and assessing the main risks associated with the company's business. This is determined through direct dialogue or, less typically, questionnaires sent to target companies. Finally, in most cases, priority

improvement plans are defined in conjunction with company management, and, less often, quantitative assessments are performed.

These approaches may represent valid solutions to the labour issues highlighted by the controversy surrounding LBOs, but often raise questions as to the trade-off between investment in human capital and profitability. This is a concern on which the managers involved generally do not express a clear position. Although it occurs less frequently, these approaches can also be adapted across all private equity segments, including venture capital and capital growth.

So-called “ESG screening” approaches include those that best align certain private equity funds with the SRI practices for listed assets. Interestingly, they may also be associated with another practice, so-called “ethical” sector-based exclusion, a far cry from the sector’s usual priorities, which tend to focus on risk reduction. Some private equity managers, either in order to appeal to individual investors who are sensitive to this type of approach or due to their “local culture” (these approaches are very widespread in Anglo-Saxon countries), list sectors excluded from their private equity fund investment strategy (e.g. weapons, animal testing, etc).

Upstream selection and investment monitoring: Two distinct approaches

In launching the *Sustainable Innovation* fund in 2007, Alto Invest decided to provide training for its entire staff on sustainable development issues, and to design an in-house ESG screening procedure for unlisted companies based on the expertise of specialised rating agencies. The systematic assessment applied thereafter resulted in a strict selection process: the fund could only invest in companies with at least an average rating.

OFI Private Equity’s approach consists in working alongside rather than selecting companies. Since the recruitment of its sustainable development director at the end of the 2008, the company has established an overview of the ESG practices of invested companies in order to gauge potential ESG risks and encourage companies to work on preventing them.

3. Community venture

The companies selected focus on a social aspect and/or contribute to the economic recovery of a region. Originating in Anglo-Saxon countries, this approach is relatively uncommon in France and involves a very specific ESG element: relations between companies and civil society, more specifically local communities. Primarily associated with venture capital or growth capital, this type of approach focuses on a social benefit. Promoters use it as an argument to attract targeted institutional investors.

A recent concept in France

Business Angels des Cités, set up by Aziz Senni in 2007, seeks to repair the social ladder that is often broken in disadvantaged urban areas. The venture capital company exclusively finances companies active in underprivileged suburbs and provides high-quality professional assistance: an industry leader or financier acts as a mentor, offering his or her experience, expertise and network of contacts.

The Citizen Capital fund expands the investment scope from sensitive urban areas to rural improvement areas and the twenty most disadvantaged employment regions. It also looks at the director's profile, favouring self-taught managers, entrepreneurs with an unusual background, those from overseas territories, immigrants or descendants of immigrants. Lastly, preference is given to companies offering an innovative product, service or internal structure from a societal point of view, i.e. activity involving sustainable development, social issues or human resources policy.

Special features of funds of funds

Some funds of funds are developing by using the following approaches:

Thematic ESG: This is the most widespread approach, usually focused on cleantech sectors.

Unigestion joins Ethos Services

In Switzerland this year, the Ethos Foundation and the asset management company Unigestion launched the Unigestion-Ethos Environmental Sustainability Fund of Funds. The roles in managing this fund have been clearly defined. Unigestion handles the financial aspects of the fund, while Ethos, through a committee of experts, reviews the sectors eligible for investment based on a "life cycle analysis" ESG approach. The fund targets a variety of segments ranging from seed capital to infrastructures and growth capital. All the sectors invested must meet sustainability requirements. Different levels have been defined: "first best" (e.g. renewable energies), transition contributions (recycled fossil fuel products, CO₂ capture, etc.), short-term substitution contributions (gas versus carbon) and finally insignificant contributions, rejected by the fund for their negative impact (e.g. certain agro-fuels).

ESG screening: This less common approach refers to certain fund of funds' managers seeking to ensure that ESG issues are taken into account by managers of underlying funds, often to maintain their reputation as responsible investors.

This is done by:

- expecting a declaration of compliance with a charter or guidelines;
- questionnaires;
- monitoring changes in management practices, notably through reporting requirements.

Robeco Responsible Private Equity II, the United Nations Principles for Responsible Investment (PRI) at work

Since 2004, Robeco has developed expertise on private equity funds of funds focused on environmental thematic approaches. In conjunction with SAM (Sustainable Asset Management), acquired by Robeco, a new fund was launched in 2008 based on the PRI. The fund's investment objective is to develop an ESG engagement approach amongst managers of underlying funds so that they enforce the principles themselves in the companies in which they invest. Information is reported on a regular basis in order for Robeco to ensure that the principles are applied in the long run.

A significant proportion of approaches observed in this study date back to 2008 or the first half of 2009, with a notable pick-up in announcements and commitments since the peak of the financial crisis in the autumn of 2008. Since then, news reports have stressed the increasing challenges faced in setting up LBOs.

The differences with this segment of financial management should be examined against developments in the segment of funds invested in regulated markets in order to understand how these approaches could be standardised or at least become a more common element of the private equity universe.

III.

Extra-financial issues specific to private equity

Although the best practices observed have increased over the past few months, we should analyse the factors that have set this management segment apart from that of funds invested in listed securities, where structured SRI approaches have grown significantly in the past ten years.

Ongoing obstacles to understanding ESG issues

Private equity managers have often been criticised for focusing too much on profits during a time frame that is sometimes shorter than the theoretical period for unlisted investments. This automatically limits the interest they could have in ESG issues. However, other more technical factors are also likely to have impeded the implementation of these approaches.

Diversity in private equity businesses and the companies financed: The diversity of companies financed, in terms of their business as well as their development stage (set-up, growth, restructuring, etc.), gives rise to a variety of ESG issues and ways in which companies deal with them, with different degrees of structure or constraints. The purpose of these approaches also ranges from managing productive risks (e.g. knowledge management within an innovative start-up by ensuring the quality of human resources management) to preventing reputational risks or even crisis management affecting restructuring financed by an LBO.

Lack of structure and resources to produce any reporting: Since investors began to heed calls for issuer transparency on extra-financial issues,¹¹ the largest companies listed on regulated markets were encouraged to report in reaction to these expectations. This was followed by the question of communication on ESG issues by mid-size companies. Mid-sized companies are actually less willing to allocate resources to structure sustainable development approaches and then communicate on them.

The private equity segment, depending on the type of company financed, also reflects this observation: some companies that are financed, in particular industrial groups delisted following LBOs, are already prepared to implement sustainable development policies and structured reporting. Others, primarily young, high-growth companies funded by venture or growth capital, are relatively unfamiliar with these issues, even more so if it requires communication for an external assessment.

Absence of extra-financial research: The development of SRI funds in large listed firms has also been driven by the set-up of extra-financial rating agencies, which, like Vigeo in France, are committed to covering all of the securities included in the major

¹¹ In France, investors' expectations were furthered from a regulatory standpoint by the NRE (new economic regulations) law, with Article 114 stipulating the requirements of listed companies in terms of extra-financial reporting.

European stock market indices. To expand their universe to smaller listed companies, or even private equity companies, they are confronted with a dilemma: the extra-financial economic research model, as opposed to the financial rating model, developed with the investor rather than the issuer bearing the research costs to reduce the risk of conflicts of interest. The more concentrated a company's capital, the more difficult it is to promote the value of the research, as the clients will only be a handful or just one investor. To develop or diversify the range of businesses included in extra-financial research, some agencies such as EthiFinance in France nonetheless offer this type of personalised service, provided the investor is willing to bear the cost.

Consequently, private equity managers do not have the same tools as "public equity" to establish systematic, structured extra-financial analysis. The initiatives developed remain rather few and far between, although some are genuinely innovative, based on conviction approaches. They are expected to grow, as the fundamentals of private equity provide excellent justification for the integration of ESG factors.

Strong drivers for integrating ESG issues

Concentration of capital of unlisted companies: The capital of unlisted companies is typically less fragmented than the capital of listed companies. This allows for closer relations between the issuer and shareholder, fostering dialogue and the exchange of best practices. However, entrepreneurs sometimes bemoan the focus of this dialogue on financial performance. Investors' timeframe may appear short-sighted in light of certain industrial issues that may require long-haul investment and product release before reaching a profitability phase and hence profit-taking. Extending the shareholder-entrepreneur dialogue to ESG concerns should be warmly welcomed as a way of expanding the exchange to areas that are closer to the real economy and industrial activity.

Assistance in structuring corporate governance: Corporate governance concerns may establish inroads into extra-financial issues as they are more frequently integrated by private equity managers than other social or environmental themes. With seats on companies' boards of directors, asset managers are naturally more involved. Nevertheless, this approach can be developed into a specific ESG practice. The outcomes of a study published in June 2009 by the Investor Responsibility Research Center Institute¹² seem to demonstrate that companies that have undergone LBOs "fail to deliver superior governance," particularly with regard to management compensation, and the rights of minority shareholders.

Long-term investment horizon: Private equity is particularly well-adapted to engagement and dialogue in order to make constructive improvements to companies once in the capital, rather than restricting the pipeline universe, due to the duration of the investment periods (5 to 8 years). As such, although extra-financial issues do not seem to have their place in "speculative" management on regulated markets, private equity's medium- to long-term management entails that companies' improvements in ESG areas can be monitored over time.

¹² "What Is the Impact of Private Equity Buyout Fund Ownership on IPO Companies' Corporate Governance?"

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Companies' inexperience in dealing with exposure to extra-financial risks: The companies financed by private equity, notably those in the growth phase, are naturally quite young. At this stage, they are not shielded from extra-financial risks, which must be monitored. As a result, the guidance provided by their "professional shareholders" can prove to be useful in limiting risks.

Growth companies need to build the loyalty of their talented staff members: Intangible capital is often the prime value of innovative firms. They must therefore structure their human resources policy early enough in their development to promote staff loyalty, despite often lacking the resources necessary to compete with better established firms in terms of appeal. The shareholder's support in implementing employee share ownership programmes or compensation benefit systems in line with personal involvement can help to guarantee the company's durability and shareholder's profitability.

The survival of a growing company often depends on a relatively small client base: For some, a contract with a "corporate client" means that the company is taking off. Whether they are listed corporations or public authorities, an increasing number of these potential clients are including sustainable development clauses as part of their sustainable development approach (or Agenda 21) in their contracts with suppliers and sub-contractors. Conversely, SMEs that are unprepared for these new requirements may be prevented access to lucrative markets.

Anticipating new regulations: By taking a proactive ESG strategy, SMEs, which may end up growing rapidly, anticipate future regulatory requirements (in particular on reporting). As voluntary upstream preparation is, generally speaking, less costly than forced compliance, they invest in order to optimise future costs.

Financial pressure involving compensation: Companies funded by private equity are subject to high financial pressure due to the stake held by professional shareholders in their capital. As a result, new, tougher productivity expectations may be set for employees, potentially leading to impaired labour relations or dialogue in a large number of LBOs. Here again, a multi-criteria investment strategy that can promote employee development helps temper relations between employees and management as well as those between management and shareholders.

Natural ties with societal issues: Private equity is naturally drawn to innovative sectors that are sensitive to the economy, such as cleantech or personal services. Despite the clear line drawn between the company's business and its overall ESG behaviour, crossover can be found in businesses involving the environment (e.g. resource management, such as water) or people (e.g. healthcare services), and the relationship that the company maintains with its people (employees, clients and suppliers) and the environment (resource consumption, polluting emissions). Although it is not a general rule, environmental or social issues are more readily taken into account by managers that focus on these areas.

Alignment with the Group's policy: Another notable external motivation is a social responsibility policy at the level of the financial groups to which some private equity firms belong. A number of them (AGF Private Equity, Axa Private Equity, Goldman Sachs Private Equity, Lombard Odier, etc.) are backed by financial groups, some of which are listed, with responsible investment policies that are to be rolled out globally (sometimes

as signatories of the PRI¹³) regardless of asset class. Their private equity subsidiaries are thus expected to apply some form of responsible investment practices.

Meeting the expectations of institutional investors

SRI funds invested in listed shares or fixed income were first developed before the emergence of any real demand from investors. In the past few years, the extra-financial assessment of "traditional" asset classes has nevertheless encouraged major institutional investors to standardise the integration of ESG criteria into their equity or bond portfolio management. Investors concerned with safeguarding their reputation find the criticism of private equity, particularly LBOs, for questionable labour, social or governance practices, disquieting. This is particularly true of deals that are nationwide, public or involve individual investments.

The incorporation of ESG criteria by private equity fund managers (more specifically, by AGF Private Equity, Gimar Capital Investissement, etc.) often meets expectations clearly expressed by institutional investors referring to extra-financial standards, notably in their side letters, when outsourcing their asset management.

For instance, the European Bank for Reconstruction and Development (EBRD), PROPARCO (AFD Group), Commonwealth Bank (UK), Swedish AP7 fund, *Fonds de Réserve pour les Retraites* (FRR) and the *Caisse Des Dépôts* have expressed concerns of this nature.

However, surprisingly, institutional investors' expectations - often set out formally in charters or questionnaires - may appear rather strict, suggesting differences with actual management practices.

The EBRD, an exacting investor when it comes to ESG standards

In May 2008, the European Bank for Reconstruction and Development (EBRD) released its environmental and social policy, which defines the rules for financing and monitoring projects. These procedures form an integral part of the agreements between the EBRD and private equity funds. They lay down the bank's environmental and social requirements and the appropriate tools to meet them. For each project, managers must assess the environmental and social impacts and their financial consequences. High-risk companies or proscribed businesses (fur, asbestos, child labour, etc.) are excluded from the investment universe. Before investing, the manager must propose a policy for managing and formally monitoring ESG risks. Once invested, the manager is required to check that the company publishes its ESG reporting, controls its risks and appropriately addresses potential incidents. Lastly, the manager must send an annual environmental and social report in a format defined by the EBRD and must notify it of any incidents within three days of their occurrence. The ESG process defined by EBRD covers all investment stages, from upstream selection to downstream monitoring.

There are a large number of reasons justifying the incorporation of extra-financial issues that can be combined in different ways. The current economic and financial crisis is

¹³ United Nations Principles for Responsible Investment.

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fuelling this trend. This leads us to believe that private equity companies will gradually allocate the resources necessary for improving the incorporation of ESG issues. Any overlap between the models developed for SRI funds invested on stock markets and those developed for private equity should be identified and applied in order to establish an equivalent structured approach in the medium term, while still allowing for innovation, in which private equity has always excelled.

IV.

Recommendations

Increasing transparency

It is difficult to examine ESG approaches given the public communication provided by private equity firms. Generally speaking, the profession's standard practices do not push for transparency, including in this area¹⁴. However, further openness, based on conviction approaches, could easily help improve the image of private equity, often flaunted as a vector of innovation, job creation and, in general, local economic development. For managers, this means overcoming the preconceived notion that communication exposes one to risk, especially in today's world in which opacity itself is considered a risk factor.

That said, some initiatives are being developed, especially since the beginning of the financial crisis, which primarily involve announcements or commitments rather than actual transparency on extra-financial management processes and the impact of these ESG approaches on company monitoring and practices.

In line with the recommendations set out for SRI fund managers invested in regulated markets, Novethic urges transparent and informative communication on:

- the resources implemented to incorporate ESG issues into private equity fund management, be it in the selection of issuers or their long-term guidance,
- the outcomes of these approaches.

Novethic believes that increased transparency on the part of private equity investors, i.e. faithful, accurate communication on extra-financial factors, can only foster a greater understanding of the sector and improve its image. The 2008 annual report published by OFI Private Equity is a notable example in this respect, as it includes a detailed section on the sustainable development risks and practices of each of the companies in which it invests. Furthermore, an approach to managing present and future risks helps internalise and control not only short-term financial risks but also long-term externalities.

Tackling the most important issues in each business segment

Customarily, ESG issues are integrated gradually, often starting with more general commitments, such as those outlined in the PRI's Private Equity Council's charter, followed by integration at a more operational level. Identifying these issues, whether they are sector-based, thematic or economic, improves risk management and prevention.

¹⁴ According to Collier Capital's Global Private Equity Barometer published on 15 June 2009, 65% of investors in European capital think fund managers need to improve their risk management and transparency.

Jean-Louis de Bernardy, specialist in LBOs featuring small and medium-sized companies and recently appointed Chairman of AFIC (French Private Equity Association), explained in an article published by *Agefi* on 16 June 2009: "My role as Chairman will be focused on transparency, an area that needs improvement. We must incite AFIC members to disclose more information (...)."

A comprehensive approach that includes a dual monitoring system is advised:

- structured monitoring of all ESG issues that can affect the companies, regardless of the level of risk with regard to the investment;
- for the company's most immediate risks, assessment and expectations for specific improvements. For example, technological and environmental risks, notably when financing innovative industries; risks associated with delays in structuring human capital management in high-growth companies, deficient corporate governance within the regulatory framework that could lead to failings and eventually stymie the terms of transfer, or poor labour relations, in particular in companies involved in LBOs.

In addition, these approaches will allow managers to take advantage of related opportunities:

- identification of new issues and future risk factors;
- closer ties with the company and dialogue that is not based on financial performance alone, therefore improving shareholder-issuer relations.

Supporting extra-financial research

Extra-financial research on unlisted companies depends on the allocation of funds, which are generally lacking in the sector. In the same way as private equity companies typically devote time and resources to the financial due diligence necessary for any investment, they should be able to allocate teams or contract agencies or consultants to obtain structured information that can be used to form an opinion, establish healthy dialogue with management and perform constructive monitoring of the ESG trends in invested companies.

V.

International expansion

The overview provided above chiefly concerns the initiatives taken in France, but the incorporation of ESG issues in private equity extends outside the country.

Thanks to the commitment expressed through the United Nations Principles for Responsible Investment, we can expect to see the development of ESG practices amongst private equity managers worldwide. The Private Equity Workstream was set up within the PRI to focus on the issues specific to the segment and is steered by the Private Equity Council, comprised of LPs and GPs. In February 2009, the PEC adopted a set of guidelines and will release a statement in July 2009 on an action plan concerning their rollout within the industry.

At the same time, in the United States and United Kingdom, two countries with particularly well-developed private equity markets, commitments have been made by the sector's heavyweights (3i, Apax Partners, Aureos Capital, Doughty Hanson & Co, KKR, etc.). To paraphrase David Rubenstein, co-founder of Carlyle Group: *"We should act like a public industry. The funds are private but they are so large that we need to deal with the public, with labour unions and with environmental groups, as if they [private equity funds] are public companies..."*

A number of both French and foreign investors have adapted existing SRI strategies to design global responsible investment policies that embrace private equity.

The development of ESG practices is expected to spread to various regions of the world, all the more since, given the current economic climate, extra-financial issues are increasingly emerging as a ready means for finance experts to reinstate the fundamentals of the real economy.

Private Equity signatories of the UNPRI

To date, 33 UNPRI signatories, of which 5 French companies, are private equity firms. Within the PRI, the Private Equity Workstream offers the opportunity for exchanges of best practices, favouring the implementation of ESG criteria in this asset class. The PRI website has a dedicated page: www.unpri.org/privateequity

List of signatories as at end June 2008: Abraaj Capital, Access Capital Partners, Actis, Anacacia Capital, AXA Private Equity, Baltcap, BC Partners, Blue Wolf Capital Management, Capital Dynamics, Cinven, Cordiant, Direct Capital Limited, Doughty Hanson & Co, Endeavour Capital Limited, Gimar Capital Investissement, Global Private Equity, Hamilton Lane, Holland Private Equity B.V., Impax Asset Management, Kohlberg Kravis Roberts & Co, LLP, LGT Capital Partners, Limestone Investment Management, NSG Capital, OFI Private Equity, Pantheon Ventures Limited, Partners Group, PCG Asset Management, Satori Capital, L.L.C., Souls Funds Management Limited, Squadron Capital, Stratus, Westmount Pacific LLC, Growthworks Capital.

Appendix:

Benchmark initiatives and studies

- In 1996, the **EVCA** (European Venture Capital Association) published the first Economic and Social Impact Study of Venture Capital in Europe, which has since been a recurrent theme. In 2007, governance came under review, and in 2008, the EVCA Symposium addressed the following topic: Environmental, Social and Governance Issues - How does Private Equity deal with them? Endorsed by the EVCA, the EVPA (European Venture Philanthropy Association) links private equity to philanthropic investment.
- **Eurosif VC4S Report** (Venture Capital for Sustainability): Published in February 2007, the purpose of this report is to define a Europe-wide market for "Venture Capital for Sustainability." The market was estimated at EUR 1.25 billion at the time.
- **Walker Report**: Published in November 2007, this report sets out recommendations for UK private equity companies to be more transparent by publishing information on the ESG impact of their investments.
- Published in November 2007 in partnership with the Social Investment Forum and Eurosif, the **Handbook on Responsible Investment Across Asset Classes** of the Boston College Center for Corporate Citizenship (B4C) includes a section on private equity that outlines the strategies observed and provides a few examples, primarily in the United States.
- **AFIC Charter** (French Private Equity Association): The Charter published in June 2008 encourages its signatories to consider the ESG practices of the companies in which they invest. In addition, AFIC's 2009 training programme includes for the first time an SRI module.
- **EBRD** (European Bank for Reconstruction and Development): An environmental and social policy was defined in May 2008: integration of the monitoring of the ESG impacts of projects; reporting and promotion of projects with high environmental and social benefits; country and sector strategies; definition of ten ESG performance requirements for financed projects (specific criteria) and environmental norm-based exclusion (detailed examples) are included.
- The **UK Companies Act** (2006, revised in April 2008) toughened transparency obligations on ESG matters for unlisted companies in the United Kingdom.
- **Private Equity Council Guidelines based on the United Nations Principles for Responsible Investment (PRI)**: In 2009, this working group, which is comprised of PRI signatories, drew up a charter aiming to adapt PRI commitments and the principles of the United Nations Global Compact to private equity businesses.



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Where do private equity businesses stand on the integration of ESG issues?

Study conducted by Dominique Blanc, Batiste Goldet and Samer Hobeika,
Novethic SRI Research Centre.

Since 2001, Novethic provides expert resources and mobilises business leaders, investors, NGOs and other stakeholders on key topics related to CSR and SRI. Novethic is the only source of analytical and statistical information on the French SRI market. The SRI research team conducts thematic studies, analyses product trends and assesses the SRI processes of asset management firms.

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