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APRIL 2015

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Contents

Page

"ESG has become one of the most powerful tools in the world for change alongside legislation and social media."

Not our words, but those of Jeremy Coller, Founder & CEO of Coller Capital, the secondaries buy-out firm and one of the biggest names in private equity globally.

In a recent interview with Responsible Investor, Coller acknowledges that he is making a 'big' statement. But it's a sign that major private equity houses see a long-term sea change in how investment can be an important social benefit outside of pure economic growth.

And there's no doubt that Limited Partners (LPs) demands to the General Partners (GPs) to integrate ESG factors into portfolio analysis and decision-making has changed the way GPs are having to think about their portfolio companies, and reporting on their activities.

As Kris Douma, former Director Responsible Investment & Governance at MN, the Dutch pension fund conglomerate, writes in this inaugural RI INSIGHT focus on private equity (see pages 4-5): "Private equity funds that are planning to do their first fundraising since approximately 2010 will find that the landscape of European institutional investors has considerably changed,"

There's plenty of evidence to back him up.

In RI's Asset Owner Benchmarking survey (to be published April 2015), 66% of the LP respondents say they will undertake a private equity request for proposal/manager search in the next two years with 79% regarding ESG as a differentiator when hiring private equity managers.

And those same LPs already want to talk in some depth to their managers about strategic sustainability risks and return drivers within their portfolio holdings: 59% expect to spend time engaging on ESG with their existing PE managers. That means the pressure is on regardless of whether PE managers are raising new money or managing and reporting on invested funds.

A skill of the private equity industry, however, is to absorb client demand and quickly learn how it could be a business driver and differentiator. It has done just this.

Recent research of 42 PE firms across a broad range of geographies and industries representing $640 billion AUM by Professor Francesca Cornelli and Dr Ioannis Ioannou of the London Business School, looks at how ESG is moving away from compliance towards private equity business strategy. http://www.collerinstitute.com/content/userdocuments/newsdocuments/25.pdf.

The growth of social venture capital is another area where private investing is making a difference by applying sound business rationale to good, sustainable and profitable companies.

This RI Insight report on private equity takes a closer look at some of these major developments in the fast-moving private equity arena.

Hugh Wheelan,
Managing Editor, Responsible Investor

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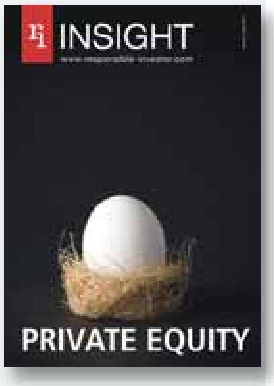

Managing Editor: Hugh Wheelan
Tel: +44 (0) 20 3640 9153
Email: hugh@responsible-investor.com

Editor: Daniel Brooksbank, London
Tel: +44 (0) 20 8694 6390
Email: daniel@responsible-investor.com

Senior Reporter: Vibeka Mair,
Tel: +44 20 3640 9154
Email: vibeka@responsible-investor.com

Senior Correspondent: Jan Wagner, Frankfurt
Tel: +49 (69) 548 06184
Email: jan@responsible-investor.com

Publisher: Tony Hay, London
Tel: +44 (0) 20 7709 2092
Email: tony@responsible-investor.com

Business Development Manager,
Haydon Zaccaria, Subscriptions & Delegates
Tel: +44 (0) 20 7709 2067
Email: haydon@responsible-investor.com

Business Development Manager,
Simon Wilton, Subscriptions & Delegates
Tel: +44 (0) 20 3640 9158
Email: simonw@responsible-investor.com

Business Development Manager,
David Machikiche, Sponsorships & Advertising
Tel: +44 (0) 20 7709 2037
Email: david@responsible-investor.com

Business Development Manager,
Aneta Atanasova, Sponsorships & Advertising
Tel: +44 (0) 20 7709 2036
Email: aneta@responsible-investor.com

Office Manager & Subscriptions:
Gabrielle Fox, London
Tel: +44 (0) 20 7709 2093
Email: gabrielle@responsible-investor.com

Publishing Assistant: Paul Verney,
Tel: +44 (0) 20 7709 2088,
Email: paul@responsible-investor.com

Correspondence:
Response Global Media Limited,
Tower Bridge Business Centre
46-48 East Smithfield, London E1W 1AW
Tel: +44 20 7709 2093
Email: info@responsible-investor.com

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An LP perspective on Private Equity and Responsible Investing: Why Private Equity makes sense

David Russell
Co-Head of Responsible Investment
USS

There has undoubtedly been increased interest from asset owners in investing in Private Equity over recent years. Underpinning its investment strategy, USS has a commitment to long term investing which the fund believes aligns closely with private equity as an asset class: investments in PE funds tend to be for 10 years at a minimum, and the holding periods for companies held within PE funds tend to be longer than public markets.

> "The Private Markets team . . . consists of 24 professionals, has invested $6 billion with over 30 PE managers, and in over 20 co-investments"

As a result, USS has been an active investor in PE for almost a decade. The fund took the decision to invest in PE in 2006 and built an in house team to both select and provide oversight of PE funds. The Private Markets team, which invests in PE, Infrastructure, Private Credit and Real Estate now consists of 24 professionals, has invested $6 billion with over 30 PE managers, and in over 20 co-investments. The PE portfolio represents approximately 8% of USS's total assets of £45 billion.

Investments in PE are usually structured as Limited Partnerships where pension funds (or Limited Partner - LP) invest via a PE fund manager (the General Partner - GP). With this structure, it is essential that LPs have appropriate processes in place to ensure that detailed due diligence is undertaken of the GP prior to any investment decision, and that monitoring processes are put in place to track performance and activity post investment.

Why invest in PE

There are a number of reasons why investing in PE has a role to play as part of a diversified asset owner portfolio:

- Returns: According to the Ernst and Young[1], between 2005 and 2013, data for the sector show that PE has consistently outperformed public market equivalent.
- The long term nature of investments in PE is also enables funds to ride through economic cycles, as there is a relative de-correlation from short-term cycles. This provides funds with diversification. USS hopes to gain returns from the illiquidity premium associated with PE.

- Governance: the governance of PE portfolio companies is much more tightly held than the massively distributed public equity market. As a result, PE funds have closer links to portfolio company management than public equity managers, and are in a position to make changes to improve performance.
- PE enables pension funds to make direct investment in the real economy – accessing positions in companies with higher stakes than is usually possible in public markets. In addition to the financial aspects, PE is frequently directly involved in the development of the real economy, job creation and innovation. To complement their investments via GPs, asset owners like USS also pursue active co-investment strategies, leveraging off of the funds in which they invest.

What are the issues?

Private Equity is an asset class that some love to hate: whenever a PE-backed venture fails, the press have a field day, focussing on the negatives, with a narrative of "vultures" destroying jobs. But it is often more complicated that the press would have us believe. PE portfolio companies do sometimes fail, as do other companies, both public and private. Many PE portfolio companies are already in a distressed state when they are bought by PE firms, it's no surprise that sometimes turnarounds do not work. This is not to say that PE is perfect, like many private or public companies, there is often a risk that they can act in ways that can be socially, environmentally or even economically unacceptable.

"Many PE portfolio companies are already in a distressed state when they are bought by PE firms, it's no surprise that sometimes turnarounds do not work"

Some of the positives above are also negatives: for example, illiquidity is a real issue for many asset owners, where tying up capital for ten years would be difficult.

In addition, the fees associated with the asset class are considered by many to be too high, with the classic "2 and 20" model being seen to enrich the GP and their managers at a cost to LPs. This is one of the reasons USS has built its own team as it enables the fund to invest directly in good GPs (rather than via Fund of funds which add an additional layer of cost) and negotiate firmly on fees.

Finally, there is also a risk to capital if an investment or a portfolio company fails.

Relationships with GPs

Once a manager is selected, it is important that asset owners don't "invest and forget". Whilst maintaining relationships with Private Equity funds does take resource, oversight of the GP is critical to ensure that the fund is actually investing in the way and the types of assets it said it would during its fundraising. Maintaining an ongoing and strong relationship with the GP enables this oversight to be effective. Given the scale of its investments, USS will usually take a position on a funds' Advisory Board, helping cement the relationship with the GP.

How does RI fit into this?

At USS, RI policies and strategies apply to all asset classes, and therefore PE is no exception. The fund has, since the early days of its allocation to PE, undertaken RI focussed due diligence on potential PE GPs prior to investment. This RI due diligence is hard wired into the overall internally undertaken PE due diligence process: USS can't invest in a PE fund without sign off from the RI team. Given the nature of PE investing via GPs, where asset owners invest in a strategy rather than assets (as these will be bought with the invested monies), the focus of due diligence is on the processes in place at a prospective GP, and how they approached ESG integration in previous funds.

The sector has responded well to increased pressure from a range of asset owners to up its game on ESG issues. From a start where many funds had no idea what RI or ESG was, we are now at the point where many funds include ESG information in their documentation when they are fund raising. The PE membership of the UN supported PRI is significantly higher than would be expected for an alternative asset class. We are also seeing increased public transparency on ESG issue amongst the leading funds – something unimaginable just a few years ago for a sector where the "Private" in PE meant "secret"!

"we are now at the point where many funds include ESG information in their documentation"

With appropriate due diligence and oversight by asset owners, the sector can and has been encouraged to integrated ESG issues into investment process's, and to communicate better the actions undertaken. So whilst PE firms sometimes get a negative press, it is an asset class which often fits well with the needs of asset owners as long term and responsible investors. n

1. Taking stock: How do private equity investors create value? E+Y, 2014

David Russell co-heads the Responsible Investment Team of USS Investment Management, the fund manager for Universities Superannuation Scheme, where he has worked since 2001. USS is one of the largest pension funds in the United Kingdom, with assets in excess of £45 billion and over 330,000 members. USS has a Responsible Investment (RI) team of six and a RI strategy which focuses on integrating extra financial factors into its investment processes across asset classes, and on engaging with public equities and other assets where these issues pose a risk to the fund's investments.

David is a Board member of the PRI Association and is an advisor to the Board of the Institutional Investors Group on Climate Change (IIGCC). He is also on the Board of the International Centre for Pensions Management. David has previously worked as an Environmental Manager for a UK retail company, and was for five years a University lecturer in Environmental Management. He has a Masters Degree in Environmental Impact Assessment.

PE challenges:

how to be 'in control' of ESG-risks and opportunities

Kris Douma
Independent RI-consultant

Private equity funds that are planning to do their first fund raising since approximately 2010 will find that the landscape of European institutional investors has considerably changed. Without a credible policy and track record of responsible investment and integration of environmental, social and governance (ESG-) issues in pre investment due diligence, a structured approach to monitoring and managing portfolio companies, backed by relevant expertise and adequate ESG reporting, that PE fund will find most doors (or wallets) closed. Why and how did this change from 'nice to have' RI-policies to 'must have' solid RI-practices come about and what next requirements can PE funds expect their European institutional investors to demand? The simple answer is, institutional investors have to be 'in control' and will only invest if the PE fund provides sufficient guarantees to that end.

> "institutional investors have to be 'in control' and will only invest if the PE fund provides sufficient guarantees to that end"

At the start of the 'movement' of responsible investment PE funds could get away with a rather general statement of their RI-policy or even with a promise that they would develop such a policy and make some reference to that in an obscure part of a side letter. Besides a critical public opinion and the general need to be more 'in control' the experience of many limited partners (LPs) has shown that ESG-related issues do indeed have a reputational and material impact. A critical public opinion and skepticism at pension fund boards about the added value of relatively illiquid and expensive PE-investments have led to a situation where 'no mistakes are allowed'. They don't want unpleasant surprises in the media and the neglect of material ESG-issues that ultimately affect financial performance of the fund negatively are no longer tolerated.

Without mentioning names, let me give you a number of (near) misses that worried some of the pension funds I have worked with. First there was a PE fund with an Austrian portfolio company in the metal industry that thought it could restructure the company without proper negotiations with the unions. In Austria that is almost a criminal offence and shows a gross neglect of local industrial relations. After I contacted the fund they changed their attitude and a strike could be prevented. Second example is a fund that invested in a oil storage company that turned out not to have its environmental management in order. Environmental authorities had to close the facility, additional investments had to be made and the major client did not want to wait and left, causing the company to lose 30% of its turnover. Third example is the exit of a portfolio company in the mining industry through a partial IPO (approximately 25%). A couple of months later it became public that the company was accused of bribery in western Africa under the FCPA and the shares lost 30% of their value, with 75% of the shares still owned by the fund. And if these issues were not bad enough, the worst is that LPs were not properly, timely informed and had to find out from other sources.

Let me also mention a near miss. A US-based PE firm planned to invest in a company in the meat industry in southern US but shortly before closing the deal found out that one third of the employees were illegal immigrants. They called (some of) their LPs to ask if they could still invest? My answer was that I was glad they found out just in time and that they could still invest if they thought they could solve the issue of the illegal immigrants and still make the company profitable. The basics are, as always, that 'an unidentified risk is a threat, an identified risk is a management issue'. A more difficult example was when we were asked if a PE fund could invest in a company providing armed security to protect merchant navy ships along the coast of Africa. I admit I struggled with that one, but one other LP apparently already gave a 'no' before I could discuss this more ethical issue with relevant clients, including the Dutch pension fund of the merchant navy. And then I haven't even mentioned the opportunities that resource efficiency, good employee relations and other ESG best practices can offer for making profitable businesses. Because fortunately some PE firms have started programs for energy saving, resource efficiency and have brought best practices from one portfolio company to other companies, benefiting of abundant low hanging fruit.

> "an unidentified risk is a threat, an identified risk is a management issue"

The examples show that a credible RI/ESG-practice is not something exotic, but should be key for any PE firm that claims it will create a good long term financial performance by making better companies. What is needed is not just a paper policy, but a tone at the top that makes clear that RI and ESG-integration are a key to success, a structured approach in the different stages of pre investment due diligence, the 100 day plans, monitoring and managing portfolio companies and making sure that the company's ESG-risks and opportunities are adequately managed at the time of exit. If a good ESG-record of a company may appear not be relevant for a company now, it definitely will at the time of exit, approximately seven years from now. That RI/ESG approach needs to be backed by in house and if necessary external expertise that goes beyond 'mere' compliance. Of course this has to be accompanied by sufficient ESG-reporting for which excellent ESG reporting frameworks have already been developed by PRI and a coalition of LPs and PE industry associations.

> "What is needed is not just a paper policy, but a tone at the top that makes clear that RI and ESG-integration are a key to success"

So far for the 'must haves' for fund raising in 2014, but 2015 will see new demands. Because for LPs to be in control it does not suffice to 'trust' that the GP will make sure that there will be no unpleasant surprises. The PE industry is generally acclaimed for having a good corporate governance model. But that refers only to the relation between GP and portfolio company, not to the LP-GP relation. Because that is one of the worst governance models in the entire financial industry. Taking into account the legal characteristics of a limited partnership, LPs have to seek improvement of the governance models to make sure they are 'in control' of their investments. If there are potential ethical concerns about investments in portfolio companies, LPs have to be in a position to exert their influence. But more important LPs should be granted the authority to adopt the annual accounts of the fund, appoint the independent auditor of the fund and be involved in the appointment of additional or new 'key persons'. A more formal structure than the current advisory board model is needed to allow LPs to monitor and control if the GP acts in accordance with the letter and spirit of the Limited Partner Agreement and potential side letters.

> "LPs should be granted the authority to adopt the annual accounts of the fund, appoint the independent auditor of the fund and be involved in the appointment of additional or new 'key persons'"

For PE firms that in the near future will do their first fund raising in years, there are important lessons to be learned. But even those PE firms which have already become accustomed with current LP-demands, will find that the bar keeps rising. Major European institutional investors, but also a growing number of North American and Asian investors, will require more credible and robust RI policies, structural ESG-practices, backed by concrete examples of actual cases, better alignment in fees structures, remuneration and better fund governance. If PE firms are not prepared or able to facilitate LPs in their demands to be 'in control' of their PE-investments, public opinion and pension fund boards will eventually turn their back upon them. But I am sure many PE firms will not take that risk, after all: 'an unidentified risk is a threat, an identified risk is a management issue'. To all fundraising PE firms: a warm welcome to the world of better governance, ESG-integration and responsible investment. n

Kris Douma worked with the Dutch trade union FNV for 12 years. From 2003 till 2007 he was an MP in the House of Representatives in the Netherlands for the social democratic party. Following that he was (2007-2014) Director Responsible Investment & Governance and member of the fiduciary management team at MN (formerly Mn Services), the asset manager for 15 Dutch and UK pension funds with €100 billion AUM. From 2010 to 2014 he was also chair of the investment committee and board member of Eumedion, the Dutch Investor platform. Currently he is (parttime) interim program manager 'In the Public Interest' at the Dutch Professional Accountants Organisation, coordinating the implementation of a set of more than 50 measures to improve independence, integrity and quality in the Dutch audit industry. He recently started as independent consultant on CSR, RI and ESG risk management for asset managers and private equity.

Driving sustainability with private equity

Thomas von Koch
Managing Partner
EQT Partners

Therése Lennehag
Head of Responsible Investment
EQT Partners

Private equity is one of the most effective and powerful corporate governance models today. EQT strives to use that power to drive sustainable development and growth. By making portfolio companies stronger for the long-term, EQT can create returns for investors and add value to society.

The private equity industry has grown with tremendous speed over recent decades, not least in Europe. In the past five years or so, responsible investment ("RI") has climbed to the top of the agenda at most private equity firms, including EQT. It spans a number of different areas from environmental, social and governance ("ESG") issues such as climate change, stakeholder relations, business ethics and corporate citizenship, but with one common denominator, namely sustainability.

"In the past five years or so, responsible investment ("RI") has climbed to the top of the agenda at most private equity firms, including EQT"

"We like to look at sustainability in two ways. One is that each portfolio company, potential or current, should be, or strive to be, sustainable in its own right. The other is looking at companies that through the nature of their business either helps to counter-act changes like climate change or helps to mitigate the effects that we know a rising global temperature will have," says Thomas von Koch, Managing Partner at EQT Partners and one of the firm's founders.

Consideration and genuine management of ESG factors have been an integral part of EQT's investment process and ownership model since the firm's inception in 1994 and EQT aspires to use current best practice to promote and advance sustainable investment and business practices. Over time, this produces healthier, stronger and future-proof portfolio companies, contributing to value creation while also reducing the risk in the portfolio.

"Consideration and genuine management of ESG factors have been an integral part of EQT's investment process and ownership model since the firm's inception in 1994"

In 2010 EQT formalized what was already a part of the business model in a policy that covers RI practices. It

NORD – cleaning up your business

NORD is a Danish company based in Nyborg and a leading European specialist within sustainable Total Hazardous Waste Management. NORD runs one of Europe's leading incineration facilities and offers end-to-end solutions for all types of hazardous waste.

For over 40 years, NORD has ensured environmentally sound treatment of hazardous waste for the benefit of the environment. Advanced techniques are used, whereby oil, iron and metals are recovered and recycled.

NORD treats approximately 250,000 tons of hazardous waste and oily water per year. The customer portfolio includes manufacturers, processing companies, maritime industry (harbors and offshore), universities, hospitals, waste collectors and workshops.

"Almost all industrial activity produces some sort of hazardous residual. We help our clients minimize their risk and we do it in the most environmentally sound way possible. We also deliver full traceability throughout the process, so our clients know and can show to others exactly what happened to their waste," says NORD's CEO Carsten Fich.

NORD incinerates hazardous waste and in that process generates considerable quantities of surplus heat which is used to produce district heating and electricity. NORD tries to minimize its carbon footprint and prepares annually a greenhouse gas protocol that states the total emission of greenhouse gases from its activities. There is also an online version of a CO_2 calculator that allows customers to do a CO_2 calculation for different waste types. The certificate from NORD is an important part of customers' calculation of the climatic load from their products or processes.

A new area for NORD is the decommissioning of ships and off-shore rigs. Something which is often done in Africa and Asia, all too often under poor and unsafe conditions with scant regard for the environment. Instead, NORD can offer a fully controlled, regulated and documented process, which can be an important part of clients' CSR work and profile.

In 2014 NORD received the prestigious EU environmental award in the "International corporate co-operation" category for its successful clean-up of fire-damaged German container ship *MSC Flaminia*.

NORD was acquired by the EQT Infrastructure I fund in June 2010. It has since changed its name from Kommunekemi to NORD (Nordgroup A/S). Nord was divested in January 2015.

describes what is expected of EQT as an investor and owner as well as what EQT expects from its portfolio companies. The EQT RI Policy considers factors such as the environment, labor and human rights and ethics when a potential investment is assessed. Once an investment has been made, EQT raises awareness, promotes high standards and monitors observance of RI factors.

> "Already today, ESG considerations are a natural part of all portfolio company governance and the investment process"

"EQT is also a signatory to the PRI and the process of deepening and widening EQT's integration and engagement in this area is an on-going effort. Currently, we are looking at more innovative and inspiring ways of following up, measuring and setting targets for both portfolio companies and EQT as a whole. Already today, ESG considerations are a natural part of all portfolio company governance and the investment process," says Therése Lennehag, Head of Responsible Investment at EQT Partners.

RI factors that are highlighted in the EQT RI Policy are limitations and reductions of the emission of harmful substances and waste, limiting and reducing consumption of scarce resources, zero-tolerance regarding child labor, discrimination, corruption and unethical business practices, as well as promoting the right to collective bargaining and actively seeking positive involvement with stakeholders and communities.

> "EQT also looks for companies that are actively part of the pursuit of global sustainability including climate and environmental issues"

These criteria are applied in the investment screening and evaluation process. In addition, EQT also looks for companies that are actively part of the pursuit of global sustainability including climate and environmental issues.

These fall into two main categories; either their products and services help to prevent or mitigate climate change or other undesirable environmental impacts such as pollution or deforestation, or in some cases they may provide products and services that help people and companies deal with

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or prepare for the often very diverse effects from climate change and global warming.

"Solutions to sustainability or environmental issues are one of the fastest growing and most sought after sectors today"

By investing in companies that are an active part of a global movement towards greater sustainability, environmental concern and reduction of greenhouse gases, EQT can contribute to a positive development whilst remaining commercially viable. Solutions to sustainability or environmental issues are one of the fastest growing and most sought after sectors today.

"Obviously, the company as a whole and its business model are at the center when an investment is made, but the business aspect of ESG considerations have quickly entered center stage for EQT in the investment process, because it helps in building more resilient companies and makes very good business sense," Thomas von Koch continues.

Principles and policies are critical, but it is when they are put into practice that the approach truly shows how the private equity ownership and business model can unleash tremendous value driving the sustainability agenda. The cases of NORD, StormGeo and Scandic give more insight on how three EQT portfolio companies work with sustainability and ESG matters.

StormGeo – a business for every weather

Norwegian company StormGeo has its roots as a weather forecasting service. Since it was founded in Bergen 17 years ago, StormGeo has evolved into a global supplier of decision support for weather sensitive operations in a range of industries.

StormGeo collects data from over 5,000 sources and produces advanced weather forecasts. These form the basis for decision support services to a range of industries. Currently the largest are ocean-going shipping and the off-shore industry, including renewable wind energy.

Typically the decision support service is used by clients to minimize risks, optimize operations and lower costs or prepare for extreme weather conditions in order to lessen the impact on operations.

In the case of ocean-going shipping, StormGeo helps the ship's captain calculate the safest, best, most cost efficient route and speed given weather forecasts and the ship's specific design. This can result in fuel savings as great as 12%, which reduces the client's carbon footprint. A shipping company operating around 150 ships typically spends around USD 1.5 billion on fuel alone in a year so the potential reduction in greenhouse gas emissions and costs is large. Today, StormGeo services around 6,000 ocean-going vessels on a continuous basis, but the addressable market is around 40,000 ships. StormGeo expects the number of ships using decision support and routing services to quickly increase in the coming years.

"Ships get better data connections, fuel emission standards get tighter and ship owners are also becoming more environmentally aware so the number of ships using these services will increase," says Erik Langaker, Chairman of the Board at StormGeo.

StormGeo also plays an important role in the emerging off-shore wind power industry by supplying weather forecasting and decision support that allows efficient operation of wind parks and also minimizes the risk for damages.

"For operations like these, weather conditions are crucial and I think we have only seen the beginning of off-shore wind power. We are well positioned to take a leading role in this green revolution," StormGeo's CEO Kent Zehetner explains.

StormGeo was acquired by the EQT Mid Market fund in April 2014.

Scandic – the most sustainable hotel chain in the Nordic region

Scandic is the leading hotel chain in the Nordic region with approximately 230 hotels in eight countries and 13,000 employees. In 2014, it was voted, for the fourth consecutive time, the most sustainable hotel chain by 9,000 consumers in Sweden in a survey by Sustainable Brands. The Sustainable Brand Index is Scandinavia's largest annual brand survey focusing on sustainability.

Scandic's sustainability work dates back to 1993. Today, Scandic has the leading program and is a trendsetter in the industry. Currently Scandic has almost 160 Swan eco-labelled hotels, all electricity comes from renewable sources and Scandic is working to eliminate net fossil carbon dioxide emissions altogether.

In 2007, Scandic was the first hotel chain to introduce the key figure of fossil carbon dioxide per guest per night. This was possible because Scandic had put a great deal of effort into making sure that each hotel could report how the energy they used was produced (wind, hydro power, oil, coal or other). In those days, an average night at Scandic produced 2.9 kilos of fossil CO_2 per guest. As of today this has been reduced to 1.4 kilos for comparable hotels. Scandic's target is to make that zero by 2025.

"It is an ambitious target but we are convinced we can get there. Scandic's track record so far is evidence of that. The key is of course to have staff and management fully committed to these targets and feel they are doing something important," says Frank Fiskers, CEO of Scandic Hotels.

Scandic can today measure its environmental impact live and on its website customers can see the current status and also calculate their own impact and carbon footprint. Since 1996, Scandic has cut energy consumption per guest night by 34%, water consumption has been reduced by 29% and fossil CO_2 emission per guest night have been cut by 69% to 1.4 kilos in 2014.

Scandic was acquired by the EQT V fund in April 2007.

Thomas von Koch

Thomas von Koch was part of the team that founded EQT Partners in 1994 and as from March 1, 2014, Thomas is Managing Partner.

Thomas graduated from the Stockholm School of Economics in 1992 with two majors (Financial Economics and Accounting & Finance). Prior to joining EQT, Thomas worked at Investor AB which he joined in 1992 to work in equity research, corporate finance and mergers and acquisitions.

Therése Lennehag

Therése Lennehag joined EQT Partners as Investor Relations Controlling Manager in May 2009 and was promoted to Head of Responsible Investment in 2014.

Therése holds an M.Sc. in Economics and Business Administration from the Stockholm School of Economics. Prior to joining EQT, Therése most recently worked as an Associate at Morgan Stanley's London and Stockholm offices in the investment banking division covering and executing transactions for clients in the Nordic region as well as working closely with EMEA IBD management.

Therése is a member of the board of directors of EPER, the large private equity platform of EVCA (the European Private Equity & Venture Capital Association) (since June 2014), as well as a member of the EVCA Responsible Investment Roundtable. Between May 2011 and December 2014, Therése served as member of the EVCA Professional Standards Committee and between January 2013 and December 2014, she was Chairwoman of the EVCA Responsible Investment Roundtable.

Responsible investment in private equity: **a clear opportunity**

Misperceptions have abounded for too long about private equity and responsible investment. Most institutional investors wanting to take account of environmental, social and governance (ESG) factors focused initially on their listed equities investments. In contrast, the implementation of responsible investment policies in relation to their allocations to private equity and other alternative asset classes is still "uncharted territory for many pension funds".

> "recognizing there is a range of ways in which ESG factors can be relevant for private equity enables more effective responsible investment implementation"

Recognition of two important points has been lacking. Firstly, private equity has inherent corporate governance advantages which enable managers to be more effective and more responsible owners of companies and assets on behalf of their clients than public markets investors. Secondly, recognizing that there is a range of ways in which ESG factors can be relevant for private equity investment enables more effective responsible investment implementation.

Partners Group's experience as a private markets manager in private equity, private debt, private infrastructure and private real estate provides a good basis for illustrating these corporate governance advantages and the different ways in which ESG factors can be relevant.

The inherent corporate governance advantages of private equity

One of the biggest hurdles facing private equity limited partners (LPs) is the perceived lack of transparency in the inner workings of private equity, often described as a "black box". Ironically though, behind the scenes, private equity managers (general partners) actually enjoy much greater transparency than public markets managers where it counts, i.e. in their relationship with their portfolio companies. In fact, this transparency is directly attributable to the typical long-term ownership model of private

Adam Frost,
Responsible Investment Manager,
Partners Group

equity, whose inherent corporate governance advantages mean there is far greater potential for private equity managers to act as a positive agent for change with their investments than public markets managers, as the table opposite shows.

The best-performing private equity managers use the transparency of information and inherent governance advantages available to them to their full potential to drive further value creation in their investments. Partners Group research conducted by the firm's Private Equity Team concluded that 75% of expected value creation by leading private equity firms is generated by direct operational improvements within portfolio companies.[2] Research from the firm's Industry Value Creation Team meanwhile highlights that across all portfolio companies, more than 70% of this operational value creation is ultimately generated through top-line improvements.

Corporate governance: private equity v. public equity

	Private investors	Public investors	Examples
Information	**In depth:** full access to information on firms during due diligence and ownership	**Limited:** only public information available to investors	A leading global consumer goods company reporting neither assets employed nor return on capital across its divisions[1]
Influence	**Large, concentrated shareholdings:** more control and better alignment of incentives	**Limited:** small, fragmented shareholdings hamper coporate governance	No UK FTSE 350 board director candidate proposed from 2006-2010 was not approved by the shareholders[2]
Patience	**Long-term ownership:** enables long-term value creation	**Short:** increasingly short term focus impedes long-term value creation	Average duration of US & UK public equity investors' holdings has fallen to 7 months[3]

Source: Partners Group, 1) "Relief on the emerging markets front, but bigger questions loom", Financial Times (21 January 2014)
2) PIRC quoted in written evidence from Cevian Capital (UK) LLPs submission to Kay Review (2011)
3) "Patience and Finance", speech by Andrew Haldane (2010)

Different ways in which ESG factors can be relevant

Most perceptive private equity managers and LPs now recognize that ESG-focused initiatives can directly contribute to the top-line improvement generated during the investment period, enhancing investment returns, as well as managing ethical or reputational risk. The different levels at which ESG factors are relevant to private equity investments and can contribute to value creation efforts is made transparent in the chart below. How this framework works in practice is illustrated by describing how these ESG factors have been integrated into current investments made by Partners Group on behalf of its clients.

1. Mitigate ethical & reputational risk

Action is one of Europe's fastest growing non-food discount retailers. It is headquartered in Holland and has more than 500 stores in four countries. The nature of Action's business exposes it to the risk of poor environmental or labor standards in its supply chain. The majority of its stock is procured indirectly from over 400 suppliers, around 60% of its stock is sourced from countries in Asia with high supply chain risks, and over 200 new products are introduced each week. Recognizing these risks, Partners Group's responsible investment team initiated a project with Action in 2013 to ensure responsible practices in its supply chain. Although Action had never faced negative reputational incidents from its supply chain, an initial benchmarking against other discount retailers identified opportunities to further improve its supply chain management. The project resulted in Action introducing a responsible procurement policy, hiring a responsible procurement manager, and implementing enhanced monitoring of supply chain standards for all its suppliers. Action was voted by consumers as the "Retailer of the Year Europe" for 2014-15. Partners Group is helping Action to maintain this excellent reputation amongst consumers through the supply chain management project.

2. Mitigate investment risk

In 2013, Partners Group completed a direct infrastructure platform investment on behalf of its clients in Fermaca, a Mexican gas pipeline business, with plans to expand the business in the US and Mexico. This asset contributes positively to Mexican economic development by supplying around 20% of Mexico's gas: a low-cost, low-carbon form of energy. However, Partners Group recognized that ESG factors such as corruption, operational safety and community relations posed potential risks to investment returns that needed to be reviewed and mitigated during due diligence. We undertook a thorough assessment of the character and standards of the management team. This concluded that Fermaca has a clean track record and robust measures in place to mitigate the risk of corruption. Secondly, we were encouraged that Fermaca had a zero

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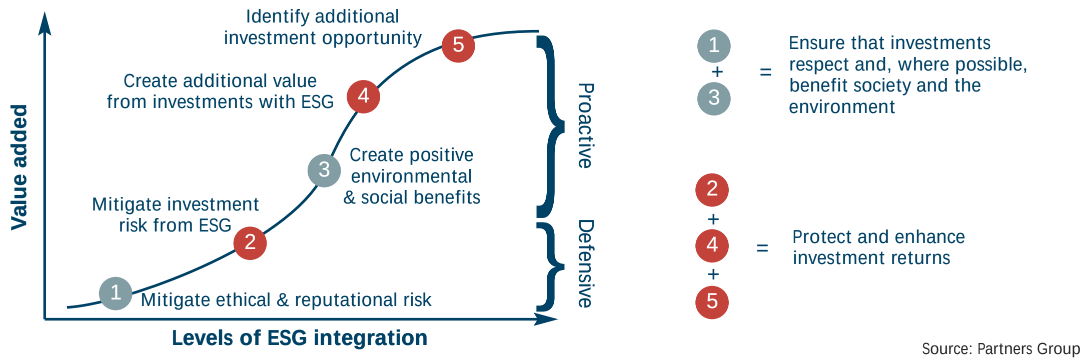
Partners Group's ESG integration methodology



Source: Partners Group

accident rate during its nine years of operations. Thirdly, we were impressed by Fermaca's collaborative approach to working with local communities and land-owners along the pipeline route. It manages the negotiation and procurement of rights of way in-house, which reduces the risk of bribery or mismanagement. Partners Group therefore gained sufficient comfort that the potential investment risks were sufficiently well-managed to warrant proceeding with the investment.

3. Create positive environmental or social benefits

The North West Rail Link (NWRL) is Australia's largest public transport infrastructure PPP and will deliver a 36km rapid transit service connecting Chatswood on Sydney's North Shore to Sydney's north-western suburbs. In 2014, Partners Group announced a direct infrastructure investment on behalf of its clients in the NWRL as part of a consortium of investors. It includes the building of 15km of twin tunnels, eight new railway stations and 4,000 commuter car-parking spaces, as well as the upgrading and converting of an existing railway line. NRWL is expected to be operational in 2019 and will be the first fully-automated rapid transit service in Australia. It will reduce constraints on existing transport networks; in fact, during the morning peak rush hour it is expected to take 12,000 cars off the road. The improved transportation infrastructure will also encourage businesses and employees to locate in the area. More than 26,200 additional jobs are expected to be created in Norwest Business Park following the arrival of the NWRL.

> "during the morning peak rush hour it (the NWRL) is expected to take 12,000 cars off the road"

4. Create additional value from investments

The work that Partners Group undertook to enhance the sustainability of Kowloon East, a real estate investment made on behalf of its clients in 2013 in Hong Kong, is a good example of how a company or asset can be reconfigured in a way that delivers environmental or social benefits and increased investment returns. Kowloon East, previously a largely industrial zone, is emerging as an important office area after the Hong Kong Government launched an initiative to transform it into an affordable, alternative central business district (CBD) to Hong Kong Island. Aligned with the government's strategy, Partners Group and its operating partner set out to convert a former industrial warehouse building into a class A office building with a modern design. An integral part of the redevelopment plan is for the building to meet high environmental sustainability standards, in fact the aim is for it to be one of the first industrial conversions in Hong Kong to receive a BEAM Plus sustainability rating, a green building standard recognized by the Hong Kong Green Building Council. Once completed, the building is expected to have energy usage over 20% lower than comparable properties. After the conversion, the office building would be suitable for large occupiers from a range of sectors seeking premium office space at more affordable rents than those offered in Hong Kong Island's CBD, but higher than the original industrial building, allowing for favorable investment returns to our clients.

5. Identifying investment opportunities

Long-term environmental and social trends can create strong demand for products and services that drive companies' growth. The need to manage growing social services expenditure in aging developed countries is a good example. For example, the number of people in the US aged 50 and over is expected to be 70% higher in 2030 than it was in 2000. This puts pressure on healthcare costs as elderly people tend to have greater medical needs. It is forecast that expenditures on healthcare in the US are likely to reach about 29% of GDP in 2040, compared to about 15% in 2008. In 2014, Partners Group made a direct equity investment in MultiPlan, a leading provider of healthcare cost management solutions in the US, on behalf of its clients. With a network of over 900'000 healthcare providers and extensive proprietary analytics, MultiPlan generates over USD 11 billion in medical cost savings on about 40 million claims annually. It therefore benefits individual consumers while also reducing pressure on healthcare expenditure in the US. Partners Group's conviction in making the investment in Multiplan was deepened by the fact the company addresses a long-term societal need.

Rising to the transparency challenge

Private equity investors have an opportunity to be more responsible and more effective investors than public equity investors. This opportunity is based on their inherent corporate governance advantages of better information, higher influence and longer holding periods. These advantages enable private equity managers to use ESG factors to mitigate investment risks, enhance investment returns and ensure that the assets and companies in which they invest operate transparently in a way that respects and where possible benefits society and the environment. n

> "Private equity investors have an opportunity to be more responsible and more effective investors than public equity investors"

1 "Benchmark Responsible Investment by Pension Funds in the Netherlands" VBDO,2013.
2 "Understanding Private Equity's Outperformance in Difficult Times", Partners Group, January 2012

Adam Frost is Partners Group's Responsible Investment Manager and a member of its Industry Value Creation team, based in Zug, Switzerland. He has 16 years of industry experience. Prior to joining Partners Group, he worked at Sarasin and Partners, McKinsey, Apax Partners and BP. He focuses on incorporating environmental, social and corporate governance (ESG) concerns into the due diligence and investment approval process and maintaining responsibility for ESG initiatives from a corporate perspective. He is also the investment manager responsible for Partners Group's foundation, Partners Group IMPACT. He holds an MBA from Harvard Business School, Massachusetts. Adam is on the UNPRI Private Equity Steering Committee and chairs its working group on Value Creation.

ESG integration into PE practice: The UK perspective

Jeremy Lytle – Chairman, BVCA Responsible Investment Advisory Group; Investor Relations Partner, ECI Partners

There is a growing conviction within the private equity and venture capital community that responsible investment is a logical extension of our primary objective as investors to build better and more sustainable businesses. Whilst investors and their portfolio companies have long been aware of the need to account for their wider social impact, a recognition that the proactive management of environmental, social and corporate governance (ESG) matters generates and maintains value has ensured that the responsible investment agenda now sits at the core of our industry. Indeed, a recent survey[1] of 42 private equity firms by the London Business School found that 38, or 90.5 per cent, had adopted ESG policies. As an asset class private equity is particularly well suited to integrating this approach given its hands-on, active stewardship of businesses and long-term ownership timeframe. This has meant that as responsible investing has shifted from a focus on reputational issues to one of improving financial performance, firms have been able to implement transformative ESG strategies across their portfolios swiftly and effectively.

> “the responsible investment agenda now sits at the core of our industry”

The transition to a more rigorous form of responsible investment has been driven by several factors. As mentioned, General Partners (GPs) have recognised the opportunity for value creation across the investment cycle, employing coherent and structured frameworks to reduce costs and minimise risks whilst securing opportunities such as promoting supply chain sustainability and improving employee engagement. At the same time, Limited Partners (LPs) have pushed for private equity firms and private equity managers to demonstrate their commitment to ESG issues through non-financial performance. Many have signed up to schemes such as the UN Principles for Responsible Investment to highlight their view that investor activity should be better aligned with broader objectives of society. Increased legislative obligations in the wake of the financial crisis have strengthened this requirement, with pension funds in particular now mandated to consider ESG issues in their investments as part of their fiduciary duty.

Within global private equity and venture capital the BVCA has been, and continues to be, at the forefront of the responsible investment agenda. Since the formation of the Responsible Investment Advisory Group in April 2009, we have sought to encourage the development of the approach within our membership and the industry at large. The Group comprises both GP and LP investors, intermediaries and sustainability professionals to provide a coherent strategy and firm direction for its work. In order to achieve its objective the Group has integrated responsible investment into all of the BVCA's core functions, namely policy and public affairs, events and training.

To date, the Group's most notable output has been the Responsible Investment Guide. First published in 2012 and now in its second iteration, the Guide aims to serve as a reference tool for private equity and venture capital fund managers, offering detailed and practical advice accompanied by a number of concise case studies on ESG integration into each stage of the investment cycle. It includes information on how to effectively profile businesses when identifying targets; ways to incorporate ESG into detailed due diligence; how to identify priority actions during ownership; and sets out procedures to follow during the exit process in order to enhance value. The Guide has been well received by the ►

industry and is under constant revision to ensure that it remains at the forefront of sustainability and responsible investment practice.

As a supplement to the latest version of the Guide released in 2014, last month we published a series of in-depth case studies to showcase examples of best practice in the field and highlight how responsible investment can be an important competitive asset. The supplement notably features 3i's innovative ESG due diligence tools; Terra Firma's integration of sustainable practices in its portfolio company Wyevale Garden Centres; and the development of a Responsible Investment Code by Palatine to enable rigorous ESG monitoring and reporting. It remains of great importance to the BVCA that our work on responsible investment is shared as much as possible and as such both of these documents are freely available on our website.

The Guidelines for Disclosure and Transparency in Private Equity, published in 2007 and overseen by the Guidelines Monitoring Group, have provided an important means to monitor and assess the take-up of the responsible investment agenda and ESG matters by the largest private equity firms and their portfolio companies. The Guidelines require in-scope organisations to provide enhanced disclosure of information relating to social and community issues and environmental matters. Notably, these requirements were included from the project's inception, requiring private equity firms to match disclosures expected from the public FTSE 350 companies.

> “the Environmental, Social and Corporate Governance Disclosure Framework . . . is currently supported by more than 40 LPs, 20 private equity associations and a number of GPs”

The BVCA has also been involved in the establishment of broader efforts to encourage transparency in the responsible investment space. In 2011, we were approached by a group of 39 LPs for our support in co-ordinating private equity associations around the world to develop what would eventually be known as the Environmental, Social and Corporate Governance Disclosure Framework. Launched in March 2013, it is currently supported by more than 40 LPs, 20 private equity associations and a number of GPs. The Framework aims to provide guidance relating to the changing and diverse expectations of LPs for the disclosure of ESG information from private equity firms and their portfolio companies, and to facilitate informed discussion between the parties involved. As a result it has proved particularly useful in encouraging mainstream acceptance of ESG disclosure and ensuring that GPs are aware of the likely demands of LPs.

Alongside guides and frameworks, the BVCA recognises the importance and value of highlighting responsible investment through events and training programmes. Our flagship Foundation Course, designed for junior investment professionals, includes a session on the topic ensuring that recent entrants into the private equity industry are made aware of the ESG agenda and its growing importance to GPs and LPs alike. Ever keen to reach as large an audience as possible, the topic has also been incorporated into the popular annual BVCA Summit, which was attended by over 700 individuals last year. The most recent panel discussed 'responsible investment in action', providing delegates with the opportunity to hear about the first-hand experiences of GPs, LPs and portfolio companies in their management of ESG issues. Again recognising the importance of institutional investors in the broader responsible investment relationship, the BVCA also holds regular investor relations fora which allow IR professionals and partners to share knowledge and exchange ideas on best practice.

Whilst providing our members with guidance on ESG integration is our core objective, we also believe that it is vital to champion and celebrate the best our industry has to offer. This is achieved through the annual Responsible Investment Awards which were launched in 2011. Presented at the BVCA Summit, the Awards demonstrate the growing commitment to responsible investment with a greater number of submissions received each year. Members are encouraged to enter under two categories: demonstrating an ESG framework in place, and active ESG engagement with portfolio companies. To encourage participation by smaller private equity and venture capital houses these are split into two groups, with separate awards for firms with less and more than £1bn under management. 2014 saw Palatine, Northedge Capital and Terra Firma rewarded for their efforts, with all three having demonstrated how ESG practices feature at the core of their operations. The 2015 Responsible Investment Awards will be launched in the spring and we hope to see a continued improvement of the impressive work submitted in past years.

Since the publication of our first Responsible Investment Guide in 2012, the number of private equity and venture capital firms engaging with ESG issues has grown substantially. Nevertheless, the BVCA remains dedicated to demonstrating how such an approach makes real business sense, complementing our industry's existing efforts to combine strategic, financial and operational expertise to grow better companies. Over the coming months and years we will continue to develop our engagement with GPs, LPs and associated professionals, providing information and insight through our guides, highlighting best practice with our events, establishing benchmarks through guidelines and celebrating success at the annual Responsible Investment Awards. All of these efforts recognise that the wider debate concerning the role of business in society, and in particular the contributions of the financial sector to our national prosperity, is not going to fade. Private equity and venture capital firms have actively embraced this reality, leading our industry on a path to a more socially aware and financially sound future. As such, the BVCA and its members are committed to shaping a more responsible capitalism. n

1 Source: Ioannis Ioannou, Francesca Cornelli, Thomas Zhang (2015) 'ESG moving out of the compliance room and into the heart of the investment process'. The Coller Institute of Private Equity, London Business School.

Jeremy Lytle is ECI's Investor Relations Partner. He joined ECI in 2007 having spent the previous three years as COO at FM Capital Management Limited. Before that, he spent seven years with Cazenove Capital, and had an early career in the British Army. Jeremy is currently Chairman of the Responsible Advisory Board of the British Private Equity & Venture Capital Association (BVCA), the industry body and public policy advocate for the private equity and venture capital industry in the UK.

ri INTERVIEW

Private equity in Africa - building better businesses

Erika van der Merwe
CEO
Southern African Venture Capital and Private Equity Association (SAVCA)

Responsible Investor speaks to Erika van der Merwe, CEO of the Southern African Venture Capital and Private Equity Association (SAVCA) on the recently launched SAVCA Case Study Compendium, which demonstrates how Southern African private equity firms are uplifting environmental, social and governance factors in the companies in which they invest.

Q: What is driving this increased focus on ESG issues in the private equity industry?

A: To a large extent this process is driven by institutional investors into private equity funds – referred to as limited partners – who are paying increasing attention to how these issues can influence the future value of their investments. There is a clear understanding that a tight handle on ESG issues is a good indicator of the success, sustainability and financial performance of these investee companies. Internationally, there is a groundswell towards responsible investment practises in the industry; a measure of this is that more than 130 limited partners are signatories of the UN Principles for Responsible Investing.

> “Internationally, there is a groundswell towards responsible investment practises in the industry”

This focus by capital providers to funds has meant that private equity fund managers, or general partners (GPs), have sought out best practice in measuring, improving and monitoring ESG factors at the portfolio company level.

Private equity is highly conducive to responsible investment owing to the long-term nature of its investment and its hands-on management approach. The typical holding period by a fund of a portfolio company is three to seven years, which gives fund managers time to influence company management and implement ESG initiatives. An understanding of and careful management of ESG matters is also one the mechanisms that private equity fund managers actively use to add real value to their portfolio companies. u

Q: How do Southern African private equity firms compare with their counterparts in other regions in terms of ESG implementation?

A: The Southern African market is a sophisticated business environment, known for high levels of corporate governance standards, a focus on sustainable social practices and stringent environmental legislation. As a result, the appreciation of the significance of sensible ESG practices is advanced.

> "The Southern African market is a sophisticated business environment, known for high levels of corporate governance standards, a focus on sustainable social practices and stringent environmental legislation"

Moreover, the standards imposed by institutional investors into Southern African private equity – investors who range from local and international pension funds to development finance institutions from various developed markets – guarantee that private equity fund managers remain accountable for their ESG practices and outcomes at a level that is consistent with practices across global jurisdictions.

Q: How does incorporating ESG practices bolster the return profile?

A: Private equity firms invest with an exit in mind and tangible improvements to ESG standards do help to secure a better valuation at the disposal stage. Multinationals are increasingly looking to have a presence on the continent and acquisitive growth is an obvious route to achieving this. These types of buyers are concerned that the companies in which they invest have good governance and world-class risk management systems in place, as well as good ESG and sustainability policies.

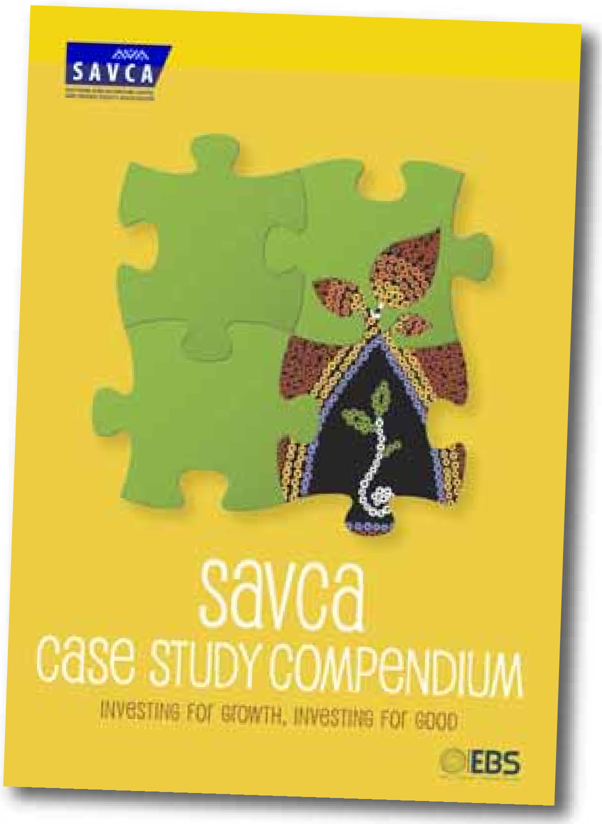
> "buyers are concerned that the companies in which they invest have good governance and world-class risk management systems in place"

Q: Finally, give us some examples from the recently released SAVCA Case Study Compendium?

A: The SAVCA Case Study Compendium provides 16 in-depth examples of how private equity investors are making meaningful contributions to ensure improved ESG outcomes in the businesses with which they partner. The case studies are taken from across the industry spectrum, including agriculture and food, infrastructure, retail and services, and manufacturing. Each case study demonstrates how smart investing, careful planning and considered management can have far-reaching and meaningful influence. For instance, there are examples of private equity investors introducing energy efficiency programmes, including the use of renewable energy sources; there is an emphasis on sustainable and ethical practices for a firm in the farming and fishing industry; and there are examples of investments that facilitate communications and connectivity, and that address housing shortages, food security and rural health issues.

> "there are examples of private equity investors introducing energy efficiency programmes, including the use of renewable energy sources"

Across the sectors, this research demonstrates a central focus for private equity investors in raising corporate governance standards and sharpening strategic thinking in the boardroom. There are examples of how portfolio companies are supported to become compliant with the South African governance standards, the King III codes, as well as industry-specific codes and principles, and moves to professional levels of financial reporting. There is also a near-universal adoption of occupational health and safety measures that protect the wellbeing of employees. These measures ultimately contribute to better and more investable companies.



The 2015 SAVCA Case Study Compendium can be downloaded from the Responsible Investor website at www.responsible-investor.com/reports.

Erika van der Merwe is CEO of the Southern African Venture Capital and Private Equity Association (SAVCA), the industry body for private equity and venture capital in Southern Africa. SAVCA has over 130 members and represents about R160 billion in assets under management. Erika holds the Chartered Financial Analyst (CFA) accreditation, has a Master's degree in Economics from Cambridge University and an M.Com in Economics from the University of Natal. Erika's career has extended from economic analysis within the asset management industry, financial journalism and now a leadership position at a private equity association.

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