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The Global Private Equity Initiative

GREEN SHOOTS:

Can Private Equity Firms meet the Responsible Investing expectations of their investors?

OCTOBER 2020

This report was published and sponsored by INSEAD's Global Private Equity Initiative (GPEI). It was written by Sara Lim, MBA '19J, Research Associate at GPEI, with the invaluable support of Bartek Walentynski, MBA '20J during his internship at GPEI.

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We would also like to thank all LPs and GPs participating in our report for their engagement.

This report follows our earlier research published in 2014, entitled ESG in Private Equity: A Fast-Evolving Standard (https://www.insead.edu/sites/default/files/assets/dept/centres/gpei/docs/insead-esg-in-private-equity-2014.pdf)

GPEI welcomes private equity investors interested in the center's research efforts to reach out to us in Europe or Singapore. For further information on INSEAD's Global Private Equity Initiative, please visit www.insead.edu/gpei.

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1. Overview

Environmental, Social and Governance (ESG) investing has become mainstream, with the reported global pool of ETF assets under management considered "ESG-focused" now exceeding US$100 Bn[1]. Companies are raising their ESG credentials in AGMs and Annual Reports and on occasion, companies perceived to have strong ESG credentials appear to enjoy enhanced valuations compared to their peers.

Private Equity (PE) fund managers have also been actively developing products to meet increasing demand in the ESG space. Many of the largest and most prominent General Partners (GPs) have responded to increasing investor interest with new ESG themed products such as impact-focused funds. These include offerings from TPG, Apollo, KKR and other apex PE platforms. Across the board, many private equity funds assert that they now incorporate ESG considerations into their investment processes if they have designated policy frameworks or have become signatories to the United Nations Principles for Responsible Investment (UNPRI)[2].

According to Preqin, in 2020 GPs have raised in excess of $370Bn of commitments to funds that integrate ESG principles into their investment decisions. But a recent survey by Institutional Investor[3], showed that fewer than 10 percent of 8,810 global private equity firms with a total of $3.4 trillion under management, are signatories to the UNPRI. This would suggest that we are in the early stages of developing the ways that institutional capital is allocated and investment decisions are made in the ESG space. Worryingly, the Institutional Investor survey also found that of 431 PE firms that directly invest and commit to the UNPRI's six principles, fewer than one in eight publicly disclose that they receive ESG reports from their portfolio companies, and only 16 firms shared whether ESG issues impact financial performance.

As with any young market, there is a wide dispersion of measures and information is often compartmentalized and illiquid. We are seeing the same phenomenon in PE. While Limited Partners (LPs), the investing base in the PE world, have historically been the early adopters and advocates for higher standards of ESG in their portfolios, it is relatively recently that GPs have developed products and approaches to accommodate that demand. Much of what appears to be happening is still immature and more theory than established best practice.

[1]Retrieved https://www.ft.com/content/f71f36f5-6271-471c-89d0-2a149a29866d

[2]For further information, visit www.unpri.org

[3]Retrieved https://www.institutionalinvestor.com/article/b1m8spzx5bp6g7/Private-Equity-Makes-ESG-Promises-But-Their-Impact-Is-Often-Superficial

We have expanded on our first ESG report published in 2014[4] to include in-depth conversations with LPs and GPs in INSEAD's network, to gain both perspectives on the changing nature of ESG in private equity. On the LP side, we examined the requirements and asks of the LP community, while on the GP side, we identified key characteristics of best-in-class ESG approaches.

While opinions on best practices are currently too varied to draw strong conclusions about what may become industry adopted standards, we highlight what we believe are better approaches and where the gaps for further effort may be. Some of the common principles for GPs with strong ESG approaches included: high levels of engagement from senior management; tight linkage between ESG principles and the investment process; tracking company level metrics post investment and regular reporting on those metrics to LPs and other stakeholders. What is surprising is not the content of that list of principles, but how rarely all are found in practice.

For both GPs and LPs, the inclusion of ESG criteria in the investment screening and decision-making process is often a recent adaptation and a learned process. As the industry matures, we hope that approaches will become more standardized, with skills more broadly disseminated. For now, there is still an experience gap that makes implementation challenging. This report also attempts to set out some essential implementation steps to help in that process.

More promising is the rate of change. In the process of conducting the survey, aggregating results and writing our report, we witnessed an active parallel identification of issues and an acceleration of proposed solutions. One of the early and obvious challenges identified in the space is the plethora of metrics, standards and styles of reporting on ESG. Recently, several industry leaders agreed to make more collaborative efforts to harmonize measurement standards. Regulators too are paying attention: the International Organization of Securities Commissions recently announced that they will attempt to 'harmonize disclosure' on sustainability risks. Increasing the transparency and rigor of assessment and reporting will benefit performance, as they allow for clear targets to be established and improve investor confidence. While the scope and ambition of ESG integration in PE is appealing, our research shows that the practices and processes are still developing. We hope this report can help the industry move towards a more robust and rigorous approach to ESG investing.

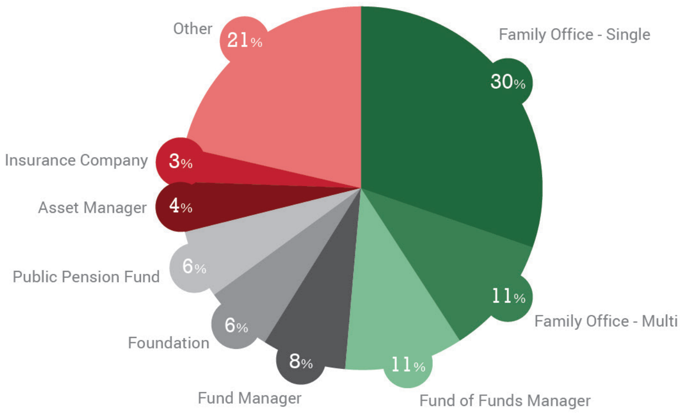
[4] Available from https://www.insead.edu/sites/default/files/assets/dept/centres/gpei/docs/insead-esg-in-private-equity-2014.pdf

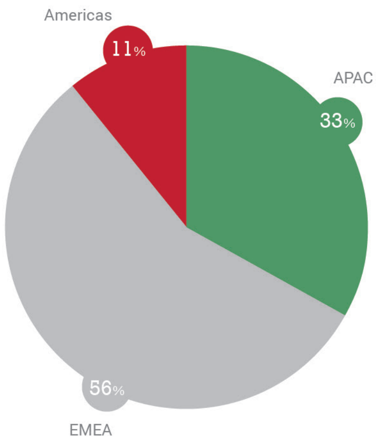
2. Methodology

Limited Partners:

We surveyed a total of **66 limited partners across 6 continents and 22 countries**, including: United Kingdom, Germany, France, Spain, Luxembourg, Belgium, Denmark, Switzerland, Netherlands, Sweden, Australia, New Zealand, Singapore, Hong Kong, Indonesia, Thailand, Malaysia, China, United States of America, Canada, Brazil, and Nigeria. The survey was supplemented by **interviews with select LPs to further understand their views on ESG relevance, implementation, and GPs performance**. Respondents were largely from Europe (56%), followed by Asia (33%) and the Americas (11%).

Respondents **represented a wide range of institutions** including family offices (41%), funds, fund of funds and asset managers (23%), and pension funds and foundations (12%).





General Partners:

We reviewed the annual and sustainability reports of the top 50 global private equity funds by assets under management (AUM). Apart from our review of publicly available data, we also tapped on our network to conduct detailed **interviews with 10 selected funds** for a more in-depth look into their ESG processes.

We thank the following funds for their time:

Apax Partners
Coller Capital
Clayton, Dubilier & Rice
EQT Partners
General Atlantic
KKR
Neuberger Berman
Oaktree Capital Management
Pantheon Ventures
Partners Group

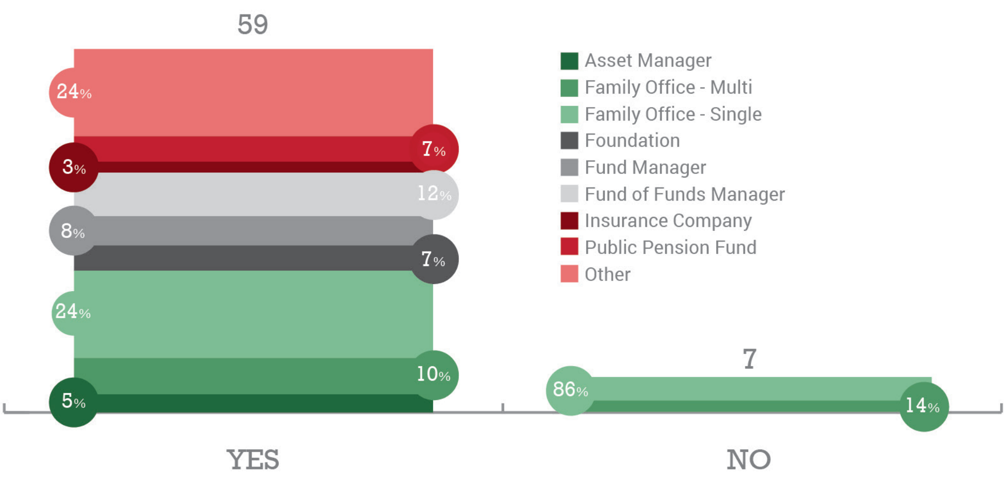
3. Findings: Limited Partners

1. ESG investing, reporting and metrics

89% of surveyed LPs agreed that **Environmental, Social and Governance criteria a play role in their investment decisions**, with only a handful of family offices reporting otherwise:

Fig 3.1:

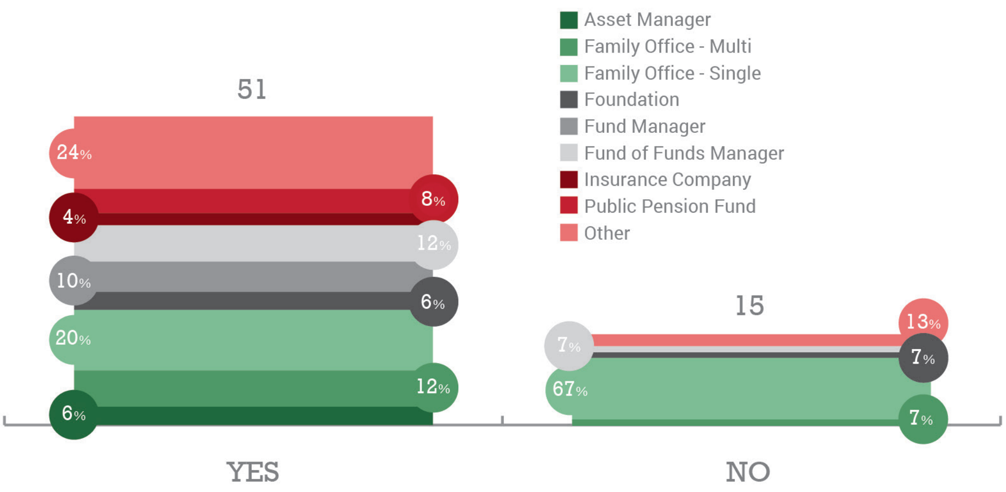
Do Environmental, Social and Governance (ESG) criteria currently play a role in your investment decisions?



Reflecting the growing importance of ESG matters, **77% of surveyed LPs already screen private equity fund managers based on ESG criteria**. Only a small fraction of LPs, mainly family offices, said that screening based on ESG is not yet in place. However, when interviewed, many LPs found it difficult to compare and interpret the ESG measures provided by GPs and differentiate 'greenwashing" from actual impact.

Fig 3.2:

Do you currently screen fund managers based on ESG criteria?

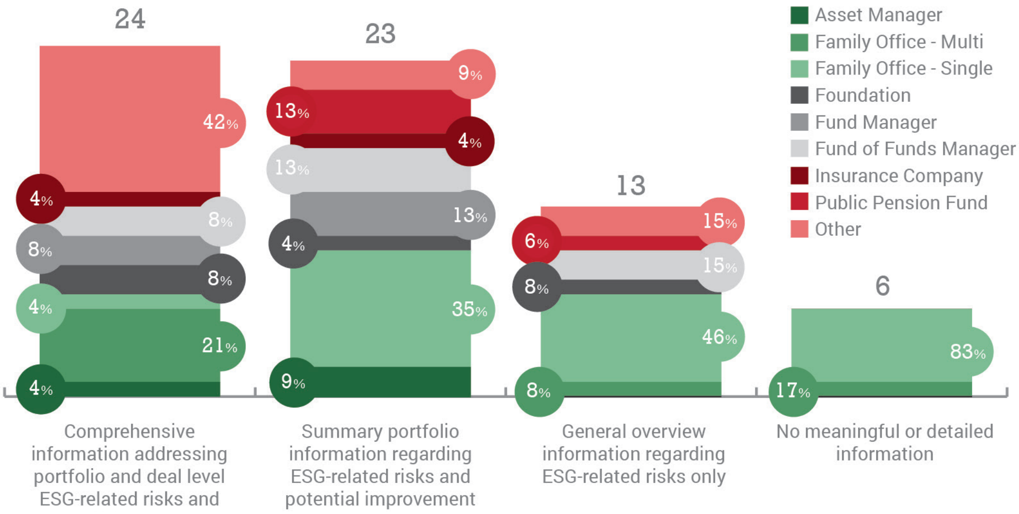


While most LPs currently screen for ESG matters when looking to invest in GPs, only 36% of surveyed LPs believed they received detailed and comprehensive information on ESG issues at the portfolio company level. Another 35% received ESG information summarized across the entire portfolio, while the remaining 29% received only general data or no information.

Family offices are more likely to report that they did not receive relevant information on ESG, **in comparison to bigger investors like sovereign wealth funds.**

Fig 3.3:

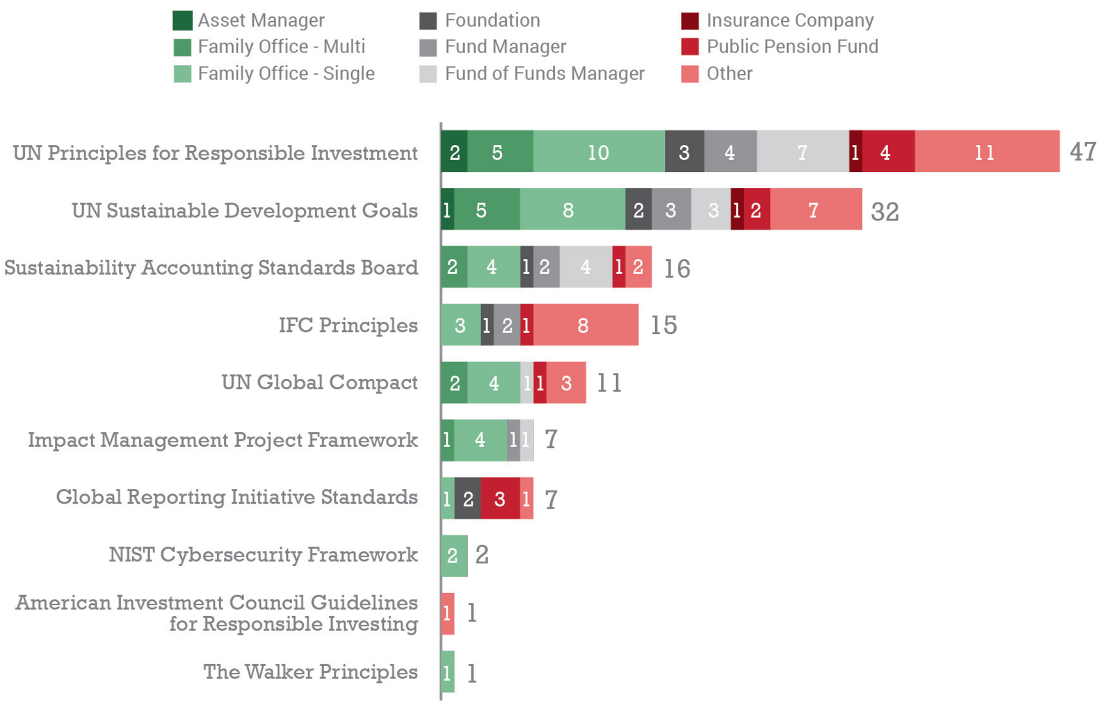
Pre-investment, what information do you receive from prospective GPs on ESG matters?



As per Figure 3.4 below, LPs relied most on the **United Nations Principles for Responsible Investments, Sustainable Development Goals and the Sustainability Accounting Standards Board standards**. However, our interviews indicated these **frameworks currently serve as a quick screening tool and not as a method for assessing ESG performance**.

Fig 3.4:

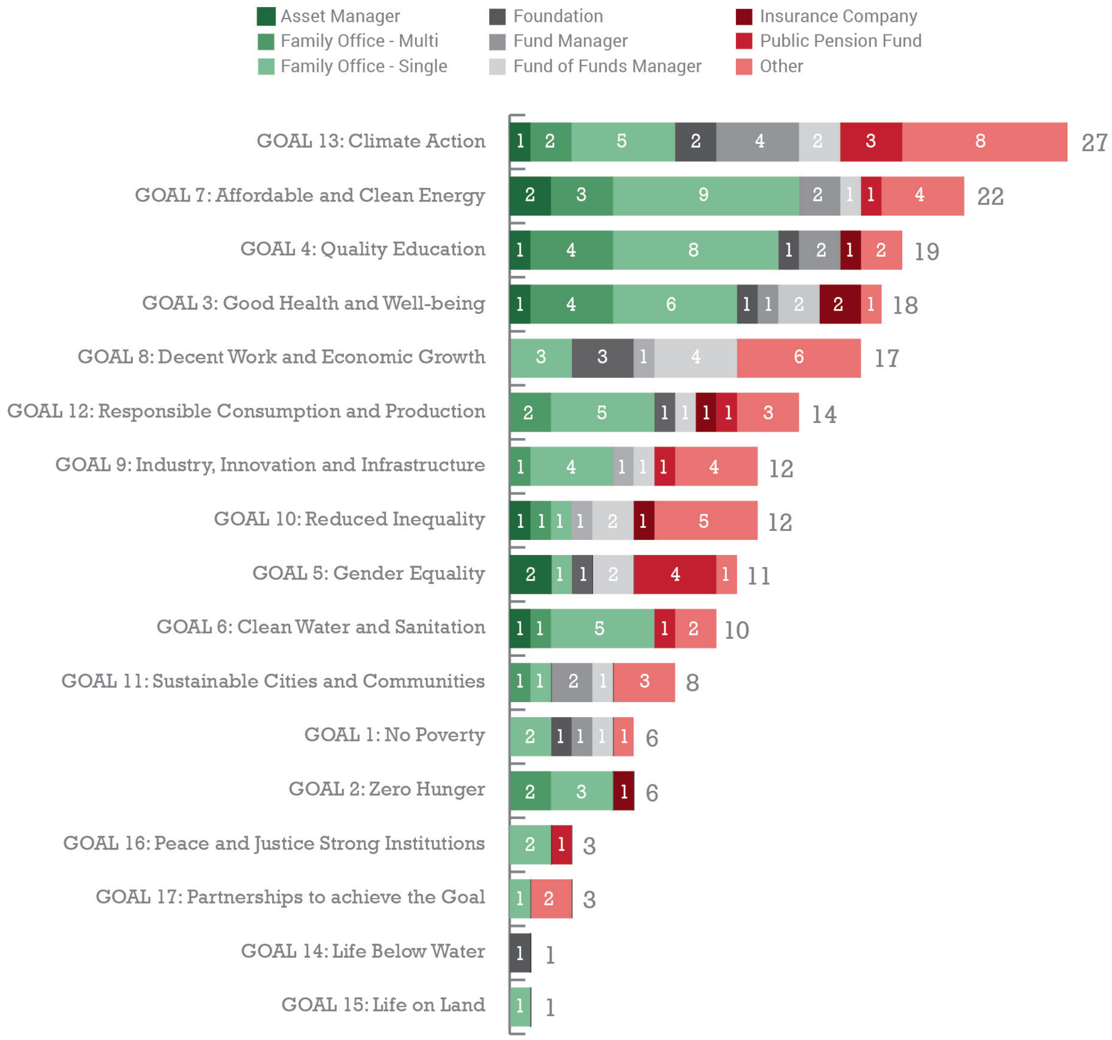
Which are the top 3 frameworks you would use in considering a fund investment?



In terms of specific investment themes, LPs were most interested in the Sustainable Development Goals relating to **Climate Action, Affordable and Clean Energy, Quality Education, Good Health and Wealth Being and Decent Work and Economic Growth.** This suggests that initiatives such as **curbing carbon dioxide emissions, investing in renewable assets (or renewable energy), creating jobs and ensuring that portfolio companies' employees are not harmed** by business operations may be particularly relevant to meeting LPs' demands.

Fig 3.5:

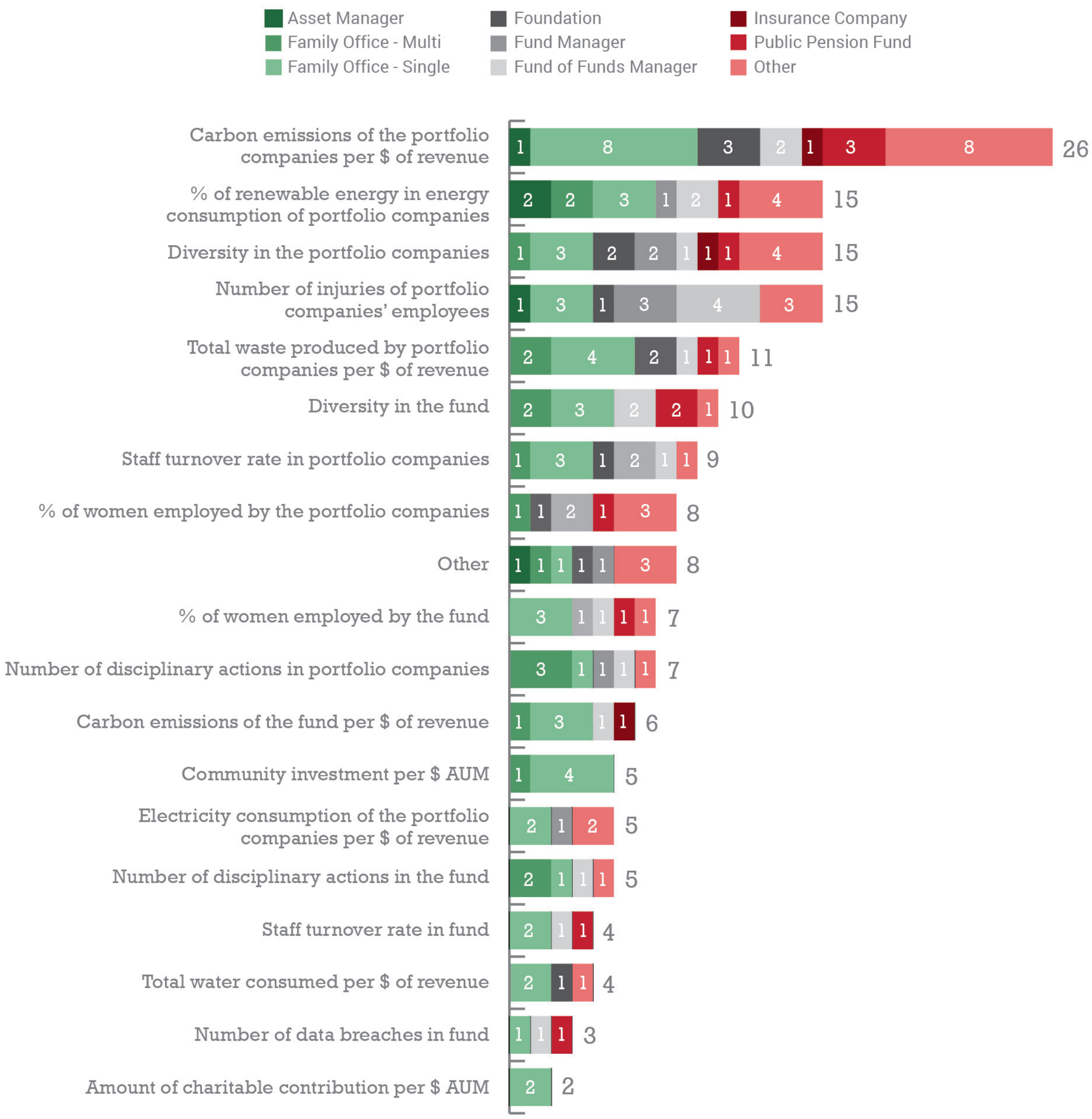
Which 3 Sustainable Development Goals (SDG's) are the most important to you?



Understandably, LPs were most interested in obtaining more granular metrics in line with the key environmental and social themes identified above. The top 3 environmental metrics include **carbon emissions, renewable energy and waste production**, while the top social metrics include the **number of employee injuries, diversity and staff turnover rates** in the portfolio companies.

Fig 3.6:

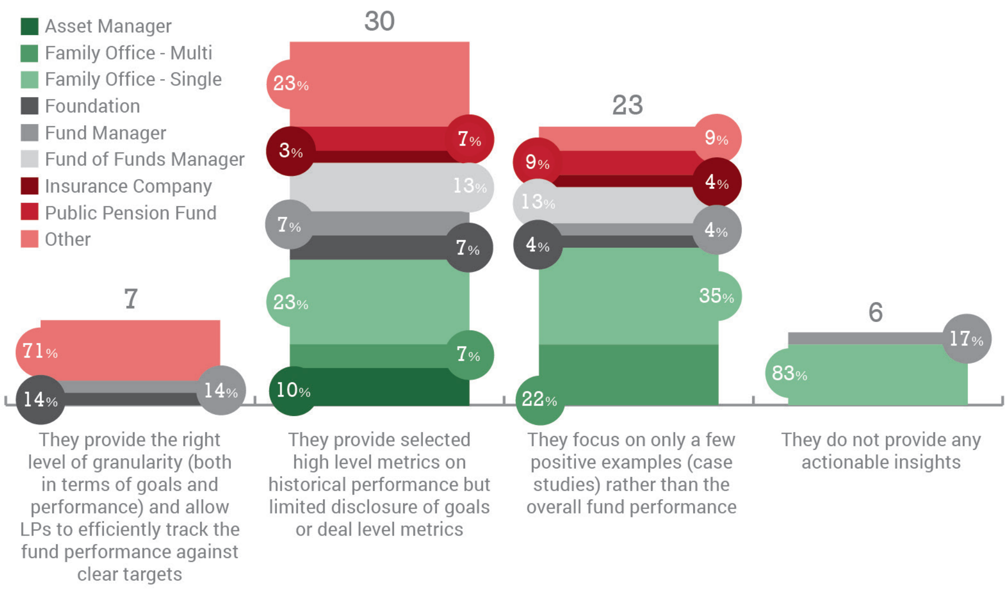
Which are the top 3 ESG metrics which are most important to you?



Post-investment, most LPs expressed that GPs offered less granularity in **reporting ESG-related metrics than they would lik**e. 45% of surveyed LPs stated that GPs only reported high level metrics based on historical performance and none at the deal level, while another 35% said their GPs' ESG reporting focused only on positive case studies. Only 11% believed that the level of granularity was appropriate for LPs to track the funds' ESG performance against clearly measurable targets.

Fig 3.7:

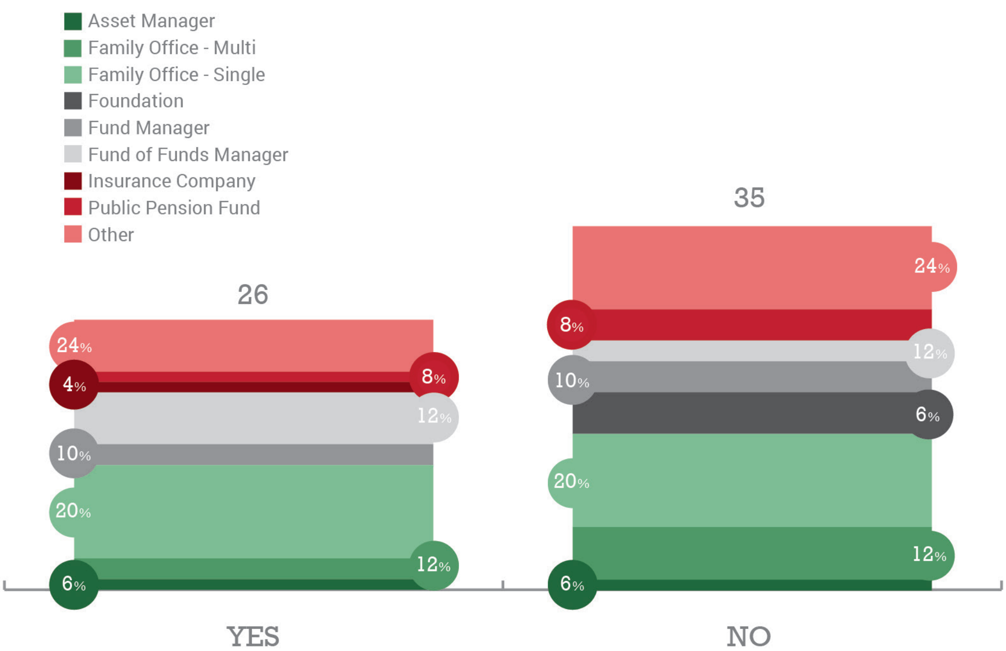
What is your view on the number of ESG metrics reported by GPs post investment?



In addition, 56% of LPs believed that GP's focus on ESG was inconsistent across the entire fund lifecycle, with **ESG considerations appearing important during fundraising but tapering off during the investment period**. One surveyed pension fund commented that "For most GPs, I would say ESG is more relevant during fundraising. Thereafter, only the strongest performers on ESG remain vigilant throughout [the entire lifecycle]."

Fig 3.8:

Do you believe the GPs' focus on ESG is consistent across the fund's full lifecycle?



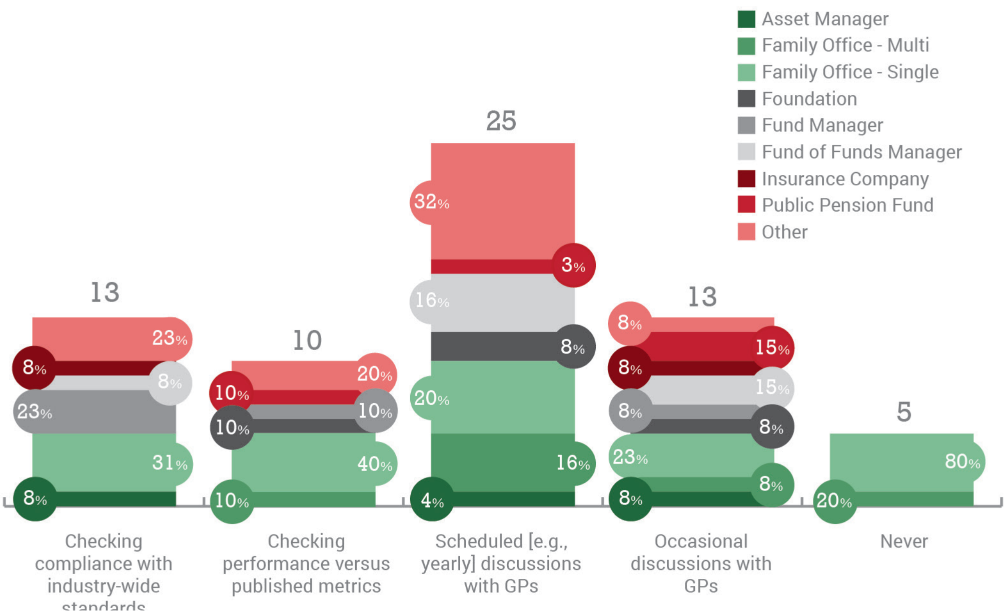
Some LPs also noted that GPs often lacked a clear path for ESG value creation and follow-through on implementation of ESG measures at the portfolio company level. A surveyed LP believes "ESG often needs more intensive attention pre-investment and in the initial portfolio management phase - putting the right governance in place at portfolio company level will reduce required intervention from the GP over time."

As LPs shared during follow-up interviews, they believed **personal contact with GPs is crucial in reviewing their performance and dedication to ESG matters**: "Anyone can produce a glossy report, but asking them a few probing questions can show us if ESG targets are really in their focus". This could explain why most of LPs **review ESG matters during discussions** with GPs.

However, **only 38% of surveyed LPs had discussions at least on an annual basis to discuss the GPs' ESG performance**. Interestingly, family offices also had the biggest spread in how they reviewed their GPs' ESG practices and were most likely not to conduct regular ESG discussions with their GPs.

Fig 3.9:

Post-investment, how would you review a fund's ESG practices and performance?



Looking forward, LPs overwhelmingly believed ESG would continue to rise in importance over the next 5 years, with only 1 family office believing otherwise.

However, only 22% of surveyed LPs believed that GP's have the **right capabilities in place to advance their ESG performance in the future**. This suggests that more **talent development and training is needed** for investment and value creation teams, and funds may need to **recruit ESG specialists** with a deep understanding of ESG issues to deliver on more stringent LP requirements going forward.

While LPs generally acknowledged the private equity industry is currently transitioning towards a more calibrated approach to ESG, they are also demanding that GPs increase their capabilities and efforts to meet rising expectations.

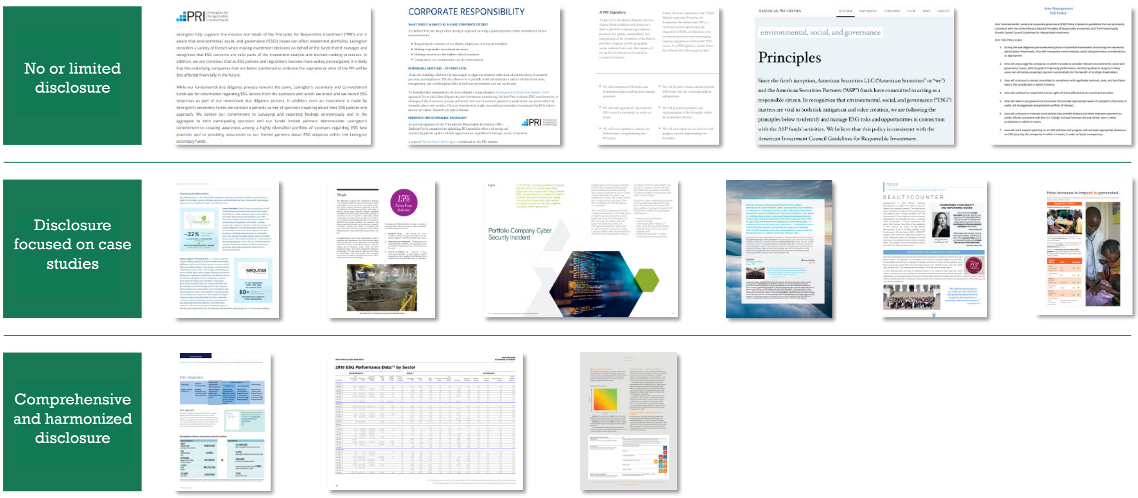
As one pension fund noted, a key sticking point is the lack of robust portfolio company data on ESG: "ESG integration varies a lot - some funds have nothing, and some are more advanced than we are. Generally, we lack data from portfolio companies on ESG metrics to assess if ESG initiatives are working, track progress and identify outliers."

4. Findings: General Partners

We reviewed the annual and sustainability reports of the top 50 global private equity funds by AUM and tapped on our network to interview a select group of GPs for a more in-depth look into their ESG processes. Unsurprisingly, our scan of publicly available data found significant differentiation in the ESG approaches of the top 50 funds.

Fig 4.1:

Level of ESG reporting and disclosures vary significantly across top 50 PE funds



• **64% of the 50 largest funds reported using the PRI and United Nations' Sustainable Development Goals (SDG)** to integrate ESG into their investment processes. However, only 16% adopted accounting-based frameworks like Sustainability Accounting Standards Board (SASB) or Impact Management Project (IMP), which require more in-depth measuring and tracking of ESG outcomes.

• Over a quarter (28%) of the top 50 **funds did not publish public ESG and sustainability disclosures at all**. While we acknowledge some firms might report ESG matters only to their LPs, public disclosure is an important discipline that funds should have in place.

• Only **12% of funds surveyed had published standardized metrics across the entire portfolio**. Key metrics reported had a clear **focus on sustainability** (e.g., carbon emissions) and **workforce issues** (e.g., gender diversity).

Apart from our review of publicly available data, we also conducted more **in-depth interviews with selected funds**, as detailed in page 6 of this report.

Based on our interviews, we found 3 key factors that distinguish a best-in class ESG approach from the rest.

1. Having the right talent within the firm, including strong senior level support

2. ESG Integration into investment process, including post-investment phase

3. Granular approach to portfolio-company ESG metrics, driving value add with clear targets

1. Having the right talent within the firm, including strong senior level support

One key determinant of a well-defined and executed ESG strategy was having the right talent in place. While funds with less developed ESG approaches were more likely to have ESG matters parked under their investor relations teams, top-performing funds placed ESG firmly in the hands of investment professionals responsible for executing the investments and creating post-investment value creation plans. One interviewee mentioned that at their fund, specific due diligence on ESG is covered by the deal team using its internal framework, with findings presented to the investment committee. At another fund, the first internal ESG assessment for due diligence is done by the deal team, to ensure the key people are involved in integrating the ESG issues from day one.

Funds with best-in-class ESG approaches also had senior members of the investment teams overseeing ESG matters for the firm. At one such fund, the head of the ESG team also sits on the fund's Executive Board. According to a fund-of-funds investor that has evaluated hundreds of GPs, it is important for GPs to designate someone to wear the ESG hat and allow ESG to permeate into all stages of the process. Our interviewee noted that while ESG needs to sit with all the employees, funds should have at least one person actively thinking about it and urging the team to do better on monitoring and due diligence.

Funds with less developed ESG approaches typically relied more heavily on external consultants instead of building in-house capabilities. This is understandable as most private equity funds typically operate with very lean teams and could have yet to develop their internal understanding of ESG issues. One such fund mentioned that their deal teams would conduct preliminary ESG due diligence but would bring in an external consultant a comprehensive ESG review at a later stage.

On the other hand, funds with a best-in-class approach to ESG tended to have a team of in-house ESG specialists, subject-matter experts who supported investment teams with training and served a resource for more complex cases. At one fund, deal teams pro-actively reach out to ESG specialists the same way they would reach out to the legal resources teams. Another fund had a dedicated ESG team of 3 people working full time on ESG matters. Yet another fund had an ESG team of 4 professionals sitting within the portfolio management team, which would conduct trainings and workshops for deal team members. This approach did not change regardless of whether funds primarily took controlling stakes or minority stakes – it appears that total fund assets under management is more important in determining whether funds had the resources to create a dedicated ESG team.

We recognize that smaller funds might not have the scale to hire in-house ESG specialists, but there are still some best practices they can incorporate without adding too many additional resources. For instance, having a senior member of the investment team oversee ESG matters, or as some funds did, designating certain investment professionals with a greater interest in ESG as "ESG Ambassadors" are relatively low-hanging fruit.

2. ESG Integration into investment process, including post-investment phase

Funds we spoke to were at varying stages of progress in integrating ESG principles across the investment lifecycle. GPs following UNPRI standards are generally capable of integrating ESG issues into the pre-investment due-diligence process. However, where there is most dispersion is during the post-investment portfolio management and value creation phase.

Among funds taking controlling stakes, only a handful followed up on portfolio companies' ESG metrics and used this data to inform decisions during value creation. Funds with best-in-class ESG approaches go beyond seeing ESG as a pure risk mitigation tool, believing instead that improving their portfolio companies' ESG standing is value accretive to their investments. One interviewee mentioned that "ESG diligence is just part of the table stakes diligence that we do with every private equity investment that we do… Managing risk is accretive to value because risk can be value destroying. Our belief is that good ESG is accretive to value and it's not just a cost to doing business… consumers are increasingly aware of poor practices around [the environment] – so it is accretive to brand value as well as the right thing to do."

As a result, many funds with best-in-class ESG approaches provide the requisite support for their portfolio companies to reach the next phase in their ESG evolution. According to one such fund, ESG is fundamental to its strategy as it is the 'right thing' to do to create value. The fund believes that sustainability provides its portfolio companies with a value uplift, for example, by helping sell more products if the company can prove that it can source sustainably. One interviewee quipped, "Some measures like sourcing sustainably do not necessarily mean higher costs and can improve EBITDA."

Another fund looks for opportunities to improve ESG across its portfolio companies every year and sets up ESG KPI's and targets which are monitored quarterly as part of bigger operational value creation projects. As an interviewee explained, a retail company working with a lot of plastic packaging may realize it's important to reduce plastic use not just for ESG but because it's also a branding exercise to position themselves as a leader in this space.

3. Granular approach to portfolio-level ESG metrics, driving value add with clear targets

At funds with best-in-class ESG approaches, the frequency of ESG reporting from portfolio companies is at least annual, creating a reporting cadence that feeds into the portfolio review and value creation process. In contrast, less-developed funds do not have regular reporting on ESG for portfolio companies. According to one such fund, it has not asked its portfolio companies for information on carbon footprint and diversity. Our interviewee mentioned that "It's a big ask to put on the portfolio companies when we already have so much financial reporting obligations on them."

According to many of the funds with best-in-class ESG approaches, requesting for ESG metrics and having a rigorous ESG data collection process helped to impress upon their portfolio companies how seriously the fund was taking sustainability issues. They also provided support to portfolio companies to ensure that these companies have adequate resources to provide the relevant ESG metrics needed by the funds. As one of our interviewees put it, doing so sends a strong message to investee companies that the investor cares about ESG and is willing to help them improve in this aspect. Another mentioned that, "Portfolio companies do face some challenges in tracking the data, for example it's not that easy to track greenhouse gases or water usage. There is clearly a reluctance in the beginning especially. We have to convince them that this is important and it's just as important to us to have the company work on sustainability as it is for them to deliver financial results."

Funds with best-in-class ESG approaches also had a more granular approach to ESG metrics, usually tracking three to five quantitative metrics across the entire portfolio. While this seems like a small number, it is still a major improvement from allowing each portfolio company to report individualized KPIs – as these cannot be aggregated at the overall fund level.

Funds with less developed ESG approaches did not track specific metrics across the portfolio and did not integrate data on ESG metrics with value creation. Funds primarily taking minority stakes claimed that the lack of control made it difficult for them to dictate how their investee companies track and report ESG matters. As one interviewee put it, “The most challenging thing is definitely metrics and reporting, every company has different ESG KPIs. We cannot just go in and say, “can you make the entire portfolio carbon neutral?””

A few buyout funds we spoke to also believed that ESG metrics needed to be specific to each portfolio company. However, they admitted that certain diversity and safety metrics could be tracked across the entire portfolio. It is more likely that these funds have not spent enough time thinking through which metrics could be tracked across the portfolio and how this data could be used for ongoing value creation efforts.

They can learn from top-performing funds with the most granular approach to ESG metrics, which all have the following metrics in common: GHG (carbon) emissions, waste treatment, water use, employment and gender diversity. As these are also highly aligned with the metrics LPs selected as most relevant in our survey, they would be a good list of metrics for any GP to begin tracking.

Evaluating ESG Approaches of GPs

To summarize, the 3 main practices of funds with best-in-class ESG approaches are as follows:

1. Transparency and rigor: Top-performing GPs clearly outline their ESG approach, leveraging frameworks both to inform their principles (e.g., UN PRI) and accounting standards (e.g., SASB)

2. Comprehensive measurement: Top-performing GPs have a harmonized set of quantitative metrics that are material for portfolio companies and measure key ESG KPIs at the fund level.

3. Clear targets: Top-performing GPs have clear quantitative targets at the fund-level and for all portfolio companies so performance can be assessed over time.

Based on the above, we devised 3 key criteria to evaluate GP's ESG approaches: Integration, Measurement and Reporting, which then allow us to map GPs to 3 categories of ESG performance.

Fig 4.2:

Continuum of ESG Approaches in PE funds

	Passive	Active	Pro-active
Integration	Limited integration into investment and/or portfolio management process	Integrated mostly into investment process, limited integration on portfolio level, varying attention across fund cycle	Advanced integration across possibly all funds activities and across entire fund cycle
Measurement	No or very limited metrics, mostly qualitative	Metrics in place but used on case-by-case basis, no harmonization and limited quantification	Fully or at least partially harmonized and quantified metrics across entire portfolio
Reporting	No or very limited reporting	Regular reporting in line with industry standards, focusing mostly on high-level data	On-demand, granular reporting possible, allowing to clearly track ESG performance of the fund

- **Passive:** Limited integration into investment and/or portfolio management process, No or very limited metrics, mostly qualitative, No or very limited reporting

- **Active:** Integrated mostly into investment process, limited integration on portfolio level, varying attention across fund cycle, Metrics in place but used on case-by-case basis, no harmonization and limited quantification, Regular reporting in line with industry standards, focusing mostly on high-level data

- **Pro-active:** Advanced integration across possibly all funds activities and across entire fund cycle, Fully or at least partially harmonized and quantified metrics across entire portfolio, On-demand, granular reporting possible, allowing to clearly track ESG performance of the fund.

Applying these criteria, we created a scoring system to assess the top 50 Private Equity GPs by AUM based on publicly available data on their approach to ESG.

Fig 4.3:

Scoring Methodology for GP ESG Performance[5]

Key Areas	Scoring
Disclosure	**0-4 points:** Published publicly-accessible sustainability report
Frameworks	**0-8 points:** Following both principle-based (e.g., UN PRI) and accounting-based frameworks (e.g., SASB)
Fund-level ESG measurement	**0-12 points:** Quantified metrics across ESG factors at the fund (GP) level
Fund-level ESG targets	**0-4 points:** Quantified targets across ESG factors at the fund (GP) level
Portfolio-level ESG measurement	**0-15 points:** Quantified, standardized metrics across ESG factors for the entire portfolio
Portfolio-level ESG targets	**0-5 points:** Quantified, standardized targets across ESG factors for the entire portfolio

The results were as follows:

Fig 4.4:

Results of ESG Scoring Methodology based on publicly available data from the top 50 Private Equity Funds by AUM

Passive	Active	Pro-active
Accel Partners	Adams Street	Actis
Advent International	American Securities	Apax Partners
Berkshire Partners	Ares Management	Apollo
China Reform Fund Management	Baring Private Equity	Ardian
JC Flowers & Co.	Blackstone	Bain Capital
Leonard Green	Bridgepoint	BC Partners
Sequoia Capital	Clayton Dubilier & Rice	Carlyle Group
RRJ Capital	CVC	Cinven
Silver Lake	Hellman & Friedman	Coller Capital
Stone Point Capital	Hony Capital	EQT Partners
TA Associates	Insight Partners	HarbourVest Partners
Thoma Bravo	Lexington Partners	KKR
Thomas H. Lee Partners	Permira	LGT
Tiger Global Management	Providence Equity Partners	Neuberger Berman
	Vista Equity Partners	Nordic Capital
	Warburg Pincus	Onex Corporation
		Pantheon Ventures
		Partners Group
		TPG

[5] We welcome questions and feedback on our scoring methodology. Please direct queries to: gpei-private.equity@insead.edu

As can be seen from the results, many of the top 50 GPs by AUM still have a long way to go before achieving best practices in their ESG approaches, and these funds should arguably have the most resources. Many are taking steps in the right direction by adopting UN PRI standards and incorporating ESG into their investment processes but can further improve their ESG approaches by following the best practices, we have identified in this section of the report.

One of our GP interviewees mentioned, “the conversation as I see it evolving is that folks have gotten the process and policies right – ultimately it is now about the so what. What are the implications on the planet of owning these companies?” As a direct investor taking minority stakes, it is about maximizing the integration of ESG into operational decisions at the company level in a way that is appropriate to what you are investing in. If you are a fund taking majority stakes, the expectations may be higher in a couple years’ time for those managers because they are seen to have more full control.”

It is also interesting to note that most GPs with passive approaches to ESG tend to be based in Asia, where LPs have historically not been as active at looking at ESG. Perhaps it will take increasing LP scrutiny to be felt in Asia for these GPs to take ESG more seriously.

As one of our interviewees mentioned, “for those in the LP seat the onus is on them to become even smarter on ESG and to home in on what really matters instead of checking the boxes. LP’s will focus on what did you do at this company and how did you consider all the other stakeholders, also it has to flow back to how investors think from a risk-return perspective.”

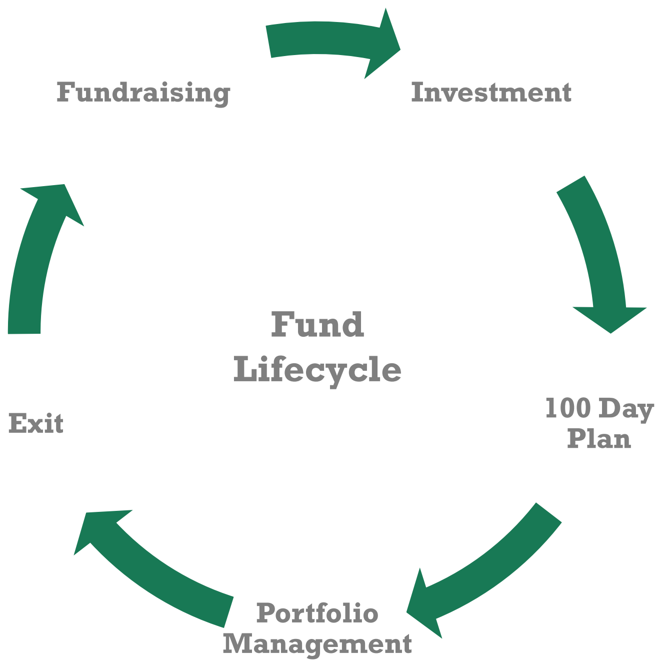
5. Recommendations and Next Steps

How can GP's continue to improve on their ESG journey? In this section, we identified 3 areas for improvement: Integration, Talent and Measurement.

1. Integration

Fig 5.1:

ESG should be integrated across the entire fund cycle



• **Due Diligence:** ESG considerations are embedded into investment process and evaluated alongside financial criteria. Investment team is trained in material ESG matters and is able to weed out risky investments and set out ESG value creation possibilities during due diligence

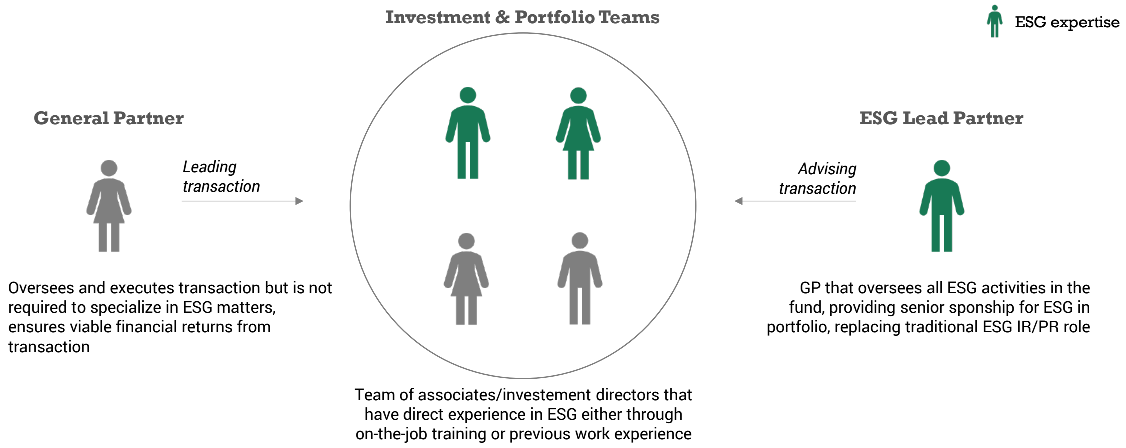
• **100 Day Plan:** ESG initiatives are included in the 100-day plan, with key priorities identified during the initial investment period, such as building up organizational and reporting capabilities within portfolio companies

• **Ongoing Portfolio Management:** Clear ESG metrics and targets are set so the fund can monitor financial and ESG value creation at the same time

• **Exit:** Possible multiple enhancement due to improved ESG profile leading to reduced risk and consumer interest in supporting companies deemed to be responsible/sustainable

• **Fundraising:** Attractive returns on assets due to positive ESG impact will improve the reputation of GP, allowing for more successful fundraising

2. Talent



For ESG to be meaningfully integrated into the fund's investment process, having the right talent and capability in place is crucial. We identified several best practices:

• **Hiring ESG professionals or specialists** helps to quickly level up the fund's knowledge in ESG. While some firms have also relied on external consultants for specific ESG knowledge during due diligence phases, it would be helpful for firms to bring this expertise in-house. Smaller funds may not be in a position to hire full-time ESG specialists and could rely on ESG training for existing team members.

• Moving towards **deeper integration of ESG into the investment teams** instead of having responsibilities for ESG handled by the investor relations or legal and compliance professionals

• Providing **continual training for investment professionals in ESG matters**. This is so they are fully equipped with the ESG lens when evaluating and managing investments.

• **Nominating a senior leader to oversee overall ESG efforts** across the fund and ensure ESG matters remain front and center of the leadership's agenda. It is also helpful to have a single point of contact to ensure consistency of the approach, measurement and target setting across the organization.

• **Creating "ESG ambassador" roles**, where junior investment professionals are given an additional focus on ESG issues and can become subject-matter experts in ESG matters within their teams.

3. Measurement & Metrics

KPIs for ESG and impact must be measurable and targeted for funds to create true impact at the portfolio level. To this end, GPs must have in place the right processes and systems to track, systemize, and target relevant ESG metrics.

As we gathered from our LP survey, LPs are struggling with several issues associated with ESG measurement:

• GPs **reporting in different formats, with different levels of granularity**. Some report data only at the fund level, with no information on portfolio companies.

• Many GPs **lack forward-looking ESG targets for portfolio companies**, resulting in a lack of accountability

• ESG data often **qualitative and is not a source of actionable insights** that allow for value creation

• Lack of a single contact point to **discuss ESG matters** in detail

To address this issue in the long-run, GPs will need to:

• **Standardize and harmonize metrics** across portfolio companies, starting from low-hanging fruit i.e., metrics that are relevant, easy to gather and can be audited by external parties

• **Cooperate with peers to set up comparable standards** (e.g., on relevant private equity industrial association level) that can be easily scaled up

• **Advance capabilities of internal reporting at portfolio companies** so they are ready to report ESG metrics together with financials

We believe there needs to be some standardization in terms of metrics across the industry because:

• LPs will benefit of having a few portfolio-level metrics that can be easily understood, compared, and benchmarked. LPs would have **limited upside from getting a multitude of asset-specific metrics that cannot be compared**, as is currently the case for some funds reporting metrics that portfolio companies have devised themselves.

• A simplified, common set of metrics would enable GPs not only to quickly implement the new standard but also give a coherent input to LPs and agree on clear targets for improvement.

• **GPs tracking a harmonized set of metrics can have much clearer view on overall portfolio performance and effectively address ESG levers** that can drive the highest impact and/or value.

• **GPs starting to create the discipline of tracking a small set of metrics across its portfolio would be in a better position to start tracking other metrics in the future.**

• Standardizing ESG metrics across funds in the industry will create a **common denominator for easy comparison**, similar to using commonly understood financial metrics such as EBITDA, Net Income and financial ratios.

For GPs looking to begin implementing a measurement and tracking system, we recommend:

• Metrics **should be relatively easy to measure**. Metrics that involve complex calculations, such as Scope 3 greenhouse gas emissions across the entire supply chain, would not be an appropriate metric for funds to begin tracking in the beginning.

• Metrics should be **measured in same (yearly) intervals on both the fund and portfolio level across all companies** to give clear insights how particular assets are performing.

• Metrics must be reported uniformly across the whole portfolio, because allowing portfolio companies **to choose certain metrics on a voluntary basis significantly reduces comparability and may lead to "greenwashing"** where only positive externalities are reported.

For funds currently not tracking any standardized metrics across the portfolio, we recommend the following 5 metrics to start, chosen for the relative availability of data and pertinence to ESG issues:

1. **Carbon emissions per $1m of revenue:** CO2 emissions across Scope 1 and 2 scaled by asset revenue give a clear grasp of asset carbon-intensity of primary operations.

2. **Gender diversity:** Gender diversity in terms of female to male employees allows for transparent comparison of gender balance across companies.

3. **Number of employees per $1m of revenue:** Number of employees scaled by revenue clearly points to possible job loss/creation across the entire portfolio.

4. **Number of employee injuries:** Measures job safety and general employee well-being.

5. **Number of data breaches:** Ensure data stored by GPs, LPs or portfolio companies is protected from third parties.

We recognize that the starting point differs for each GP, hence funds should **consider the materiality and relevance of their ESG approach to their portfolio companies and maintain a consistent dialogue with LPs on ESG matters**. In the long run, they should also build up internal capabilities to design a robust and forward-looking ESG approach that creates value for all stakeholders.

Implementation: Next Steps

We identified a 5-step journey for GPs to advance their ESG capabilities:

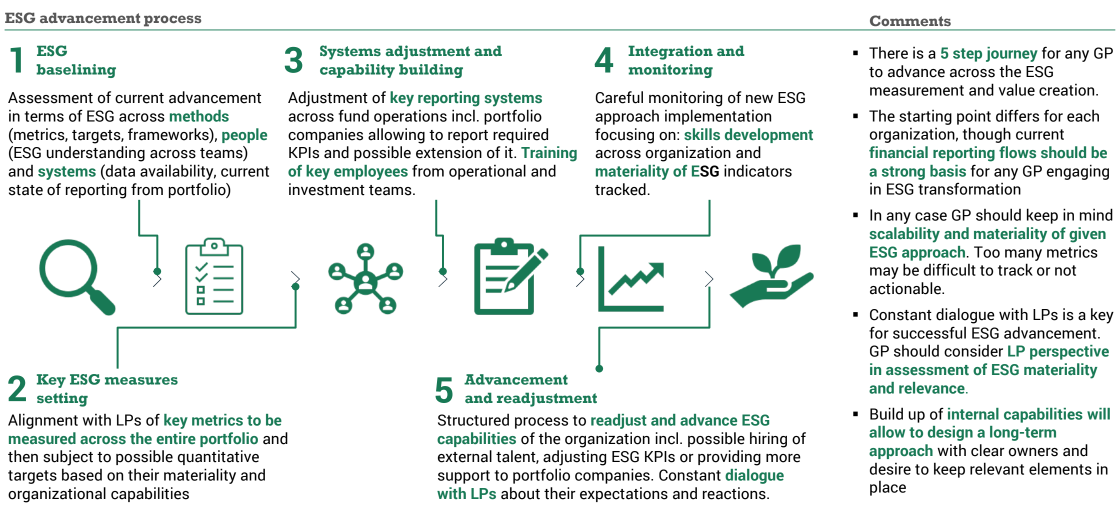
1. **ESG Baselining:** Assessment of current advancement in ESG across methods (metrics, targets, frameworks), people (ESG understanding across teams) and systems (data availability, current state of reporting from portfolio)

2. **Key ESG measures setting:** Alignment with LPs on key metrics to be measured across the entire portfolio, create quantitative targets based on materiality

3. **Systems adjustment and capability building:** Adjustment of key reporting systems across fund operations including portfolio companies required to report specific KPIs. Training of key employees from operational and investment teams

4. **Integration and monitoring:** Monitoring implementation of new ESG approach, focusing on skills development across organization and materiality of ESG indicators tracked

5. **Advancement and adjustment:** Structured process to advance ESG capabilities of the organization including possible hiring of external talent, adjusting ESG KPIs or providing more support to portfolio companies. Consistent dialogue with LPs about their expectations and feedback.



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