# Resilient Returns: Navigating PE in ESG and post COVID-19 world

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# Introduction

Today's world is rapidly evolving its perspective towards investments and financial institutions. Metrics used in the past such as EBITDA, Revenues or Enterprise Value remain significant, but an increased number of investors turn their heads towards more nuanced areas such as Environmental, Social and Governance (ESG) factors.

This **shift towards ESG metrics emerged as multiple investors acknowledge that they can play an integral role in risk mitigation and ensure healthy financial returns in the long-term**. Larry Fink, CEO of BlackRock, highlighted exactly this in his 2020-letter[i] to CEOs: "*sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors*". He added: "***a company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders***".

The **importance of non-financial factors in the investments is exacerbated by the current COVID-19 crisis**. A few months ago, a global pandemic was among the least possible scenarios for a near term financial crisis; reality struck, and the unfolding pandemic has become a challenge to both people and businesses globally. Over 16 million Americans filed for unemployment in the first weeks of crisis[ii] displaying the close connection between business and society. Furthermore, financial troubles of many companies left investors asking which areas were not covered sufficiently in the due diligence process.

The main purpose of this report is to **outline how non-financial factors such as ESG considerations can be incorporated by General Partners (GPs) to drive their risk-adjusted returns**. The report also provides a perspective on how GPs should act in the short-term to avoid pitfalls and leverage opportunities connected with the ongoing COVID-19 crisis.

**We take the perspective of the Limited Partners** (LPs), which may refer to e.g., asset managers, sovereign and endowment funds, family offices and high net-worth individuals. Given their indirect involvement with investments we view them as a source of independent insight on incorporating ESG factors and navigating through the current COVID-19 crisis.

Our conclusions are based on industry reports, relevant publications and a series of interviews with selected LPs for which we thank both Afinum and INSEAD. We hope that this report will serve as a good source of insight to advance the nature of investment activities.

# ESG

## Role of ESG in Private Equity

Ethical conduct, from the perspective of institutional investors and other LPs, was long synonymous to not breaking local regulation. This changed in 2005 with the publication of UNEP Finance Initiative working paper[iii] by Freshfields extending the definition of responsibility: *"Ethical conduct is more than not being crooked."*

Since then, the discussion on incorporation of Environmental, Social, and Governance (ESG) measures into the investment process and decision-making has moved center stage. Trend data from Google suggest that interest in the topic grew steadily until 2017, but only after did appetite for the topic clearly accelerate. As Bain[iv] captures it: ***"what changed in recent years is that vague discomfort about environmental and social issues has morphed into genuine alarm among investors and consumers."***

The importance of ESG is now acknowledged by all stakeholders from investors to final consumers. The additional, internal and external, pressure on LPs, most notably institutional investors and pension funds, is exemplified by the rapid number of signatories to the **UN's Principles for Responsible Investment (UNPRI)[v] from ~1,000 at the end of year 2014 to ~3,000 today**. LPs, led by the largest and most publicly visible institutional investors, will only increase their ESG targets in light of increased public scrutiny.

Whereas the impact of ESG focus by LPs was first visible in public assets, Private Equity is now following suit. **LPs increasingly demand GPs to implement ESG targets in both short- and long-term objectives to reduce risk of investments, discover new sources of growth, and increase resilience to changes in political and regulatory environment**. A number of GPs has even managed to transform its ESG approach to a competitive advantage, attracting oversubscription to new funds.[vi]

In addition to financial considerations and risk resilience, publicly visible LPs such as pension funds care about their public reputation. Increased awareness of ESG issues by the public comes with increased public scrutiny in the media. Reputation risk is an increasing challenge among LPs steering for a healthy return on their investment, extending today from public to private market investments.

**Academic literature[vii] (mostly in public markets) highlights the direct relationship between ESG management and improved returns**. Furthermore, LPs refer to ESG as a public responsibility, about acting morally right, while trying to minimize downside risk by having a quick glance at the 'obvious' ESG challenges a fund might face. Despite efforts to harmonize the overall ESG reporting landscape for Private Equity, monitoring ESG on a fund-by-fund basis remains for now a heterogeneous case-by-case process.

## Key themes for LPs in ESG space

Through our interviews, we identified **three key themes that are currently top of mind of LP investors**.

The first area of interest is the potential **harmonization of ESG frameworks**. As one LP put it: *"We need to ensure we have one framework to apply. It becomes increasingly difficult if everyone has their own – we would be grateful for an industry standard."* Asset managers pooling capital from institutional investors and other funds, will face a direct challenge once their different sources of capital start pushing for their individual perspective on the correct framework for assessing ESG in their investments. **The *soft* problem is increased monitoring costs by the LP due to non-overlapping ESG frameworks. The *hard* problem becomes direct conflict between ESG frameworks and standards from their investors**.

Practically, this lack of harmonization among frameworks could present LPs with painful trade-offs. To illustrate, one of our interviewed LPs is faced with strict exclusion restrictions for investments related to the consumption of alcohol. If, however, one of their other investors does not view this as a violation of their ESG-framework, then a clear trade-off presents itself between return and the 'right' ESG-principles.

The second key theme identified during our interviews with LPs is the **monitoring of ESG in 'bad weather'-times**. The recent Corona-crisis is a prime example, where LPs observe GPs putting existing ESG-frameworks second place in order to focus on the financial return of their investments. Quick decisions today, however, can have a long-lasting effect on a portfolio company and its compliance with ESG frameworks. The solution to this problem, as mentioned by multiple LPs, is to **enforce ESG-compliance from the most senior level at the GP**. Rather than making it a small part of the work package of all investment professionals at the PE fund, there should be one dedicated partner that is the 'ESG-partner': enforcing compliance with ESG in both *good* as well as *bad* weather times. This partner should be the challenger to make sure investment decisions are made in accordance with ESG objectives, even when times are tough. Seniority, from the perspective of LPs, is key here.

The third key theme identified during our interviews is the **balancing act between individual elements of ESG**: the prioritization between Environmental, Social, and Governance factors. Despite observed differences between LPs, most note that Governance is well-established among ESG-objectives, naturally flowing from the financial alignment between LP, GP, and portfolio company. The concern, and therefore **involvement of LPs, on Environmental and Social objectives is however determined by investment region**. European LPs note that Social considerations are well embedded among European GPs, but could be improved among US counterparts. These differences are most striking when intercontinental investments take place, and cultures can clash. At these moments, it becomes clear that ESG frameworks and the perceived importance of each aspect of ESG are not yet a global phenomenon.

## Achieving financial impact

**Fiduciary responsibility is a key concern for private equity investors**. To meet this objective, ESG can play one of two roles: risk-mitigation or value creation. In the first case, investors protect themselves from potential downside risk that can arise from improper governance (G) practices. Therefore, for years, private equity funds were particularly strong in putting right governance mechanisms in place. This view is clearly highlighted by TPG that names ESG as GES[viii] and states: "*Governance is a priority for TPG and, in fact, we believe "GES" instead of "ESG" is a more appropriate acronym*."[ix]

The latter case, **value creation by ESG, is still in a nascent state for many private equity investors**. The main question is how to implement ESG measures across the portfolio not only to achieve ESG targets, but also to create tangible financial returns. Successful strategies so far were able to create both an EBITDA increase (e.g., through improvement of energy efficiency of the assets) and multiple expansion (e.g., through IPOing a company that is perceived as less risky, hence more attractive to the public).

Luckily, ESG expectations and implications have matured and companies have started to implement ESG standards across their operations. This movement was supported by multiple NGOs and even more frameworks trying to point towards specific actions that need to be pursued in the ESG space. As pointed out in Larry Fink's letter to CEOs "*no framework is perfect*".

As a result, some frameworks became more common across organizations. These frameworks can be represented by: United Nations Principles for Responsible Investment, United Nations Sustainable Development Goals, Impact Management Project, GRI, IFC Principles, and Sustainability Accounting Standards Board. There are also frameworks that apply to specific geographies, such as The Walker Principles in the United Kingdom.

While all frameworks differ in their approach and proposed measures, it is important to note that some provide only a qualitative, binary approach, and many do not impose clear targets on investing entities. As a result many leading funds claim to be top performing on ESG standards, while referring to frameworks which standards they happen to meet.

There are three reasons for this phenomena: first, there is **limited recognition of one standard as a mandatory one**. Second, in many cases, **metrics reported can be chosen on a discretionary basis**. Third, measuring ESG can be hard and metrics **relevant to one asset can be insignificant to others**. Therefore, sustainability reports of leading private equity investors can be full of examples of impact achieved across a number of portfolio companies, with limited indication how these metrics were harmonized across the portfolio.

One of the examples can be drawn from Warburg Pincus' ESG Report (2019)[x]. The fund uses a comprehensive framework based on the United Nations Sustainable Development Goals, highlighting impact achieved by number of investments. From this report we learn that Ant Financial Services Group

users planted 100 million real trees across China, ~22% of Lemon Tree Hotels employees are physically or intellectually disabled or come from economically or socially marginalized groups, while Go-Jek contributed an estimated US$3 bn in added value to the Indonesian economy in 2018.

While all metrics above clearly point out positive actions from an ESG standpoint, it is difficult to pinpoint how these statistics are harmonized across the portfolio and what the overall impact of fund operations across the whole portfolio is. An example of such a harmonization can be drawn from Partners Group's Corporate Sustainability Report (2018), which outlines that its overall direct investment portfolio reduced 203 million kWh energy consumption, created 13,608 new jobs, and avoided 879,000 tons $CO_2$e emissions[xi].

Given the non-public character of private equity investors, it is difficult to judge which are performing better than others across ESG metrics (i.e., some publicly available ESG reports may purposefully not disclose all relevant information). On the other hand, it is easy to spot that the amount of disclosure varies dramatically across the funds.

Our discussions with **LPs teach that most of them consider ESG metrics to be, first and foremost, a tool for risk mitigation. Solutions such as RepRisk are leveraged by many of them** to ensure that investments in certain GPs will not result in significant reputational risk. The risk-focused approach of LPs is also driven by a clear uncertainty of data materiality and relevance.

Our interviewees indicate that a more quantitative approach towards ESG metrics is definitely on their mind, but currently there is no common quantifiable standard that is aligned with their principles and respected by all GPs they work with. Moreover, some of them indicate that **ESG metrics can be used to "greenwash[1]" a portfolio by cherry-picking examples that fit certain definition of ESG impact**. An example would be investment in a medical services company. Historically (pre-ESG), a GP would only report financial returns. Today, by greenwashing this same GP would (without taking additional actions) put the number of patients cured in its sustainability report and argue that the investment was not only financially beneficial but also met ESG goals.

As pointed out by Tim Macready, CIO of Christian Super (US$1.3 bn AUM Australian pension fund)" "***sharp growth in the impact market had heightened the likelihood of "greenwashing"*** *– where fund make unsubstantiated or misleading claims*." This claim is supported by Yvonne Bakkum (Dutch development bank FMO) stating: "*When the Sustainable Development Goals (SDGs) were launched, many people started to label their portfolios based on the SDGs and were very proud to communicate to the outside world how much they were already contributing*"[xii].

[1] Greenwashing – the process of engaging in marketing or PR activities to appear aligned with ESG

## Getting ahead: Right ESG talent

Today, **PE-investors operate in small teams**, comprised primarily of investment professionals that, depending on the fund size, vary from one-digit to three-digit numbers. The path of most professionals is strikingly similar – with a well-regarded university degree and investment banking experience.

Lately, more and more funds started to open to former consultant who brought more operational skills to complement financial acumen of former investment bankers. This shift became apparent once GPs acknowledged that operational improvements are becoming more and more important in today's very competitive landscape of private equity investments.

Additionally, **private equity funds across the world focused its hiring strategies on promoting diversity**, attracting more women and minorities and cooperating with an NGOs such as Level 20[xiii] to promote gender diversity across European private equity funds. By diversification of their workforce, private equity investors strengthened their profile to leverage and identify more value creation opportunities. Given the rise of ESG importance the main question is whether current talent in private equity funds is strong enough to leverage all ESG opportunities both in terms of risk mitigation and value creation.

Our discussion with **LPs indicates that GPs need to advance their talent to improve funds ESG performance**. They stress that ESG needs to be implemented across the whole investment period, starting from due diligence, through portfolio holding to the exit. Moreover, LPs highlight that ESG skills need to be clearly understood by the investment team rather than provided on ad-hoc basis by a separate unit.

There are two ways to achieve the ESG implementation goal: **provide more on-the-job training for investment professionals with no ESG background, or recruit professionals** (still possibly from investment banking or consulting background) who already possess relevant ESG experience. A clear sponsorship from senior leadership is required to ensure that ESG considerations are thoughtfully integrated across investment period. In this model, **transactions can be carried out by fund partners working with ESG-trained associates and supported by another partner nominated to oversee fund ESG operations**. The GP can then ensure that ESG initiatives are properly leveraged and harmonized across the whole portfolio.

**Deep integration of ESG skills into investment teams would have two benefits: proper leverage of ESG opportunities, and the clear alignment of ESG goals with financial targets**. Given the fiduciary responsibility of private equity investors it is important to ensure that ESG actions do not compromise financial performance and this issue can be evaluated by properly skilled investment teams. Finally, a deep integration of skills may result in lowering the risk of a culture shock for the organization that could occur if a separate ESG unit, monitoring the work of investment and operational teams, would be created.

## Getting ahead: Right metrics

Having the right metrics in place to measure ESG-compliance and performance as an LP plays a significant role. During our interviews we observed a wide variance of frameworks used by LPs and GPs to measure performance on ESG KPIs.

Most LPs measure ESG compliance with their internal frameworks and standards by GPs at three distinct moments. The first occurs when the decision is made to invest in the fund being raised by the GP. The second is a periodic review that takes place typically once every year. The third is when a fund is closed and the GP is looking to raise a follow-up fund. Scrutiny of ESG-compliance by LPs is therefore often not a continuous process.

**The lack of an existing track record makes the ESG review of a new fund an opaque exercise**. To LPs existing tools, such as the questions included in ILPA DD Questionnaire[xiv] can support this effort. Additionally, it is common practice for **LPs to solicit the services of outside consultants to benchmark expected ESG performance of a new fund**, focused on fund strategy, targets, and employee background.

LPs, constrained in time and resources to manage their holdings, have historically spend significantly less time reviewing ESG factors for their Alternative Investments portfolio compared to other assets classes such as Equities and Fixed Income.[xv] A detailed periodic review by LPs of their investments into funds is therefore often limited to an annual exercise, for example as a key topic to be discussed during an annual onsite visit – though there are of course funds that opt for a more frequent approach.

This internal review takes various approaches. **Some LPs employ an internally developed rating system, to see how well the GP does on ESG measures. Other LPs adopt the ESG criteria set by one of their dominant investors**. LPs expect their GPs to proactively provide at least some metrics on their ESG targets; during our interviews however it was interesting to observe that LPs generally refrained from sharing specific metrics but instead preferred to talk in more abstract terms on measurement.

The main objective of an annual review is to spot clear deviations of the employed ESG framework and the related business risk; these issues can then be escalated to the responsible GP and acted upon. An example of such an annual review is the exercise conducted by one interviewed LP who reviews all portfolio companies every year versus a list of 17 defined criteria; including e.g. labor conditions among suppliers. If these are in line with ESG-targets the box colors green, and else it colors yellow. All uncertainties are then followed up by the LP with the GP.

Interviewed **LPs strive for an objective, fact-based approach to evaluate their investment portfolio and the investment portfolio of their GPs**. They mention the ambition to increase the quantitative metrics used in ESG evaluations, but admit that currently most work is conducted from a qualitative angle. As one LP put it: *"We have so many investments that it is very difficult to find consistent reporting."*

This lack of consistent reporting, and lack of consistent expectations by LPs can confront GPs with a clear challenge: how do we report our ESG performance? PwC (2019)[xvi] observed a clear upward trend in the use of consistent KPIs, as 91% of respondents to their annual Responsible Investment in 2019 claimed to have a policy in place or in development, which is up from 80% in 2013.

PwC also found that GPs (52%) are more likely to use KPIs than LPs (30%). All LPs we interviewed mentioned ESG as an important consideration in their investment decision, but we observe it remains difficult to distinguish intentions from clear reporting KPIs leading to actionable behavior by the LP. Whereas GPs initially incorporated ESG-frameworks under LP-pressure, they now seem to be ahead.

General advice on getting the right metrics in place revolves around two elements: consistency and granularity.[xvii] Consistency will allow for clear comparison between investments. When quantitative insight is missing a qualitative approach can work well. Granularity in KPIs and metrics ensures that industrial and geographic peculiarities are considered. **Based on the nature of a specific investment, alignment with ESG-frameworks can vary materially**.

# COVID-19

## COVID-19 situation overview

COVID-19 was diagnosed first in late 2019. The virus originated in Wuhan, China, most probably carried by pangolins in one of the local wet markets. The virus spread in Hubei province in January 2020 resulting in a lockdown in China. **In the following months the virus spread globally infecting ~2 million people (confirmed cases) and contributing to deaths of ~100,000 as of mid-April 2020**. The initial outbreak in China contributed to a significant shock to its economy, causing the government to impose a stringent lockdowns of society across the country. While the situation appeared to stabilize in China, other outbreaks were recorded first in Western Europe and then the USA which became the new COVID-19 pandemic epicenter in March 2020.

**Rapid spread of the virus resulted in lockdowned economies across the world, including India, the USA, France, and Italy**. Administrative orders urging people to stay at home and refrain from non-essential activities and occupations resulted in a deep economic downturn primarily affecting consumer-centric businesses such as travel, hospitality, retail and food. Moreover, border and movement restrictions impaired operations of other branches of the economy. **All of these factors contributed to a surge of unemployment (e.g., in first few weeks of the pandemic, 16 million Americans filed for unemployment) and significantly impaired consumer confidence**. Furthermore the time horizon of COVID-19 remains unclear, due to the rapid spread of the virus, limited testing capacity, and uncertainty over a possible vaccination.

**The speed and shape of recovery became a topic of discussion**. While previous pandemics such as SARS or the Spanish Flu witnessed V-shape recoveries (fast recoveries to previous economic levels), the reality for COVID-19 could be different, resulting in either a U- or L-shape recovery; not to mention the possible second wave of COVID-19 outbreak after the initial wave is stabilized across North America and Western Europe. Furthermore, there remains the risk of a rapid spread of COVID-19 in poorer countries in Africa, the Americas, or Asia Key to harness the current crisis is the speed and feasibility of drug/vaccine development that would safeguard society from health issues. Another scenario is possible virus mutation to less lethal and milder form that would discontinue current disruptions.

The COVID-19 crisis hit PE through two channels: (1) **many portfolio companies have been affected by lower liquidity and operational constraints**, and (2) **investment horizons become uncertain** by lack of a clear timeline of the pandemic. On the other side, the rapid fall of market indexes created also opportunities for tactical investments in stable and solvent public companies.

Given this rapidly changing global pandemic situation, COVID-19 proves to be a difficult time for PE-investors to assign resources and focus between supporting operations of portfolio companies and executing timely investments in attractive assets. Additionally, GPs need to consider **how global business can evolve after the outbreak is contained** both from the business (e.g., increased role of teleworking) and political perspective (e.g., limited movement of goods and people across the borders).

## Impact of COVID on ESG

The current crisis is sparking a **debate whether ESG issues are unnecessary given that firms are facing both operational and financial problems** or whether the current crisis needs corporates to reconsider their values and purpose fundamentally. Most interviewed LPs concur that in the long-term ESG principles will continue to play a prominent role in investment decisions. **In the short-term, Limited Partners and General Partners seem to be more concerned about how to keep supply chains intact, how to shore up liquidity, and how to shield off the portfolio from any larger losses**.

> *"ESG will be here to stay" – Managing Director of Large Asset Manager*

A recent study by BCG [xvii] among 150 investors found that about 91% of respondents wanted companies to focus on their operations and "prioritize building key business capabilities to create advantage, drive future growth, and be better positioned to bounce back, even if it means lowering EPS guidance or delivering below consensus estimates". Only 56% of investors wanted companies to "continue to fully pursue their ESG agenda and priorities as they navigate the crisis, even if it means guiding to lower EPS or delivering below consensus". This is coherent with interview findings in which some LPs expressed that in the short-term the focus of management decision making will not be on ESG topics. Rather, these topics will be focused on in the mid- and long-term.

**LPs still expect their GPs to consider ESG practices and sustainability issues in their responses to the current crisis**. Case studies in dealing with the Covid-19 crisis in an ESG-compliant fashion highlight three key areas: 1) creating transparency and awareness from a governance level, 2) looking after employees and stakeholders from a social and health level, and 3) serving the wider community to conquer the current economic crisis.

First, from a governance perspective, **Limited Partners expect sufficient transparency from their General Partners on the general performance of the portfolio and further disclosures on risk management** and mitigation strategies. In addition to financial data, some Limited Partners are adding further information to their communication such as on risk management and general preparedness relevant to their board and public stakeholders. Furthermore, Limited Partners can use further disclosures to model different scenarios, introduce provisions, and adjust valuations of portfolios accordingly. General Partners can provide great value in this time of uncertainty by providing transparency and information. At the same time, LPs expressed that with market conditions changing almost daily, the amount of communication received by GPs to be overwhelming at times. In times of such uncertainty, GPs should try to balance transparency with overcommunication. In addition, Limited Partners expressed the desire to have one contact person at the General Partner for ESG issues to ensure that this aspect is not lost in times of pressure.

Second, **to avoid large social costs on employees that are made redundant because of plant or store closures, General Partners can use schemes like Germany's Kurzarbeit program in which workers are still employed with the government subsidizing part of their wage**. These measures can create a win-win for companies and employees by avoiding increased unemployment as well as avoiding costs to re-hire former employees. Given the harsh measures on the workforce, management can also opt to receive a reduced salary package or forfeit its bonus payment altogether to send a message that they are equally affected and stand with the organization in such a crisis. Douglas, which is Europe's market leader in perfume retail stores and owned by CVC, applied for the Kurzarbeit program for its workforce given the closures of its retail stores while its management agreed to a cut of its compensation as well [xviii].

> *"Exec. compensation changes are not enforced by LPs but good firms do it themselves - it's a test to see if they focus on short-term profits or long-term gins" – Managing Director of Investment Firm*

For employees that are kept, Private Equity firms will need to ensure that these employees will be able to continue working while being able to prioritize their health and well-being. Many firms are investing in digital remote working and conferencing solutions for their workforce to ensure that both operations and workforce remain functional. Part of these changes in the way of working are expected to stay beyond the current pandemic and will potentially reduce office space usages and operating costs.

Third, **Private Equity firms can directly contribute to the fight against Covid-19 by leveraging the expertise in their portfolio companies that specialize in diagnostics or pharmaceuticals**. EQT-owned Certara, launched a Covid-19 Pharmacology Resource Center to help advance the therapeutics for Covid-19. Together with the Bill & Melinda Gates Foundation connects experts to accelerate efforts in the fight against Covid-19. Simultaneously, LPs point out that some GPs consider merely owning a healthcare company as an ESG-initiative and use it as a marketing machine to create goodwill among the general public during the current COVID-19 crisis.

## Impact of COVID on investment assessment

The current COVID-19 crisis is **impacting the business world and the Private Equity industry to a degree not seen since the recession in 1930** according to the IMF [XX]. As for its impact on investment assessments, we foresee three areas that are especially impacted by the current crisis and that PE funds will need to pay special attention to: 1) portfolio improvements, 2) direct transactions, and 3) secondaries.

Portfolio and operational improvements have been a key driver of value creation for PE funds in recent years. LPs mentioned that the current environment produces especially relevant data which will reveal the GPs that handle crises well. **To continue to capture value and drive investor returns, funds will need to derive key learnings from the current crisis and adapt their operations accordingly**. These key learnings include managing operational risk and prioritizing portfolio support.

Private Equity firms will need to **identify operational risks along their supply chain**. General Partners will need to create visibility to cater to the significant changes in customer demand that result from the current crisis. In addition, the risk exposure of the supply chain especially with regards to production, distribution, and logistics should be assessed not only considering the short-term impact of the crisis but also considering long-term changes in supply chain trends including potential diversified, decentralized as well as shorter and less dependent operations. Supplier risk and dependencies should be identified to reduce overall dependency and potentially shorten the supply chain.

Additionally, GPs will need to **adjust their portfolio management approach. General Partners will need to analyze their portfolio and identify companies that need urgent support**. For these companies, General Partners will need to shift their resources including liquidity, operating support, or critical relationships with other organizations to ensure the performance of these firms. Likewise, such a prioritization exercise will reassure management teams that they will get the support they need when necessary.

Secondly, regarding direct transactions, **once portfolios have been shored off, the current crisis will provide buying opportunities** for investors that are courageous enough to get back into the markets early. To be able to close deals in the current environment, PE funds will need to learn the right lessons from the crisis and adapt their direct investing approach accordingly.

> *"In 2009 and 2010, there were amazing deals and we did not have the guts to do them. We learned from this and continue to make deals in the nearby future"*
> *– MD from large Asset Manager*

Given the market turmoil, financial performance for most firms have collapsed. One investor mentioned that the current crisis cost its fund the equivalent of the last two years' profits. Given these developments and the uncertainty about the shape of the recovery, **precise valuations are paramount**,

yet expectations on valuations diverge for buy- and sell-side: sell-side investors are reluctant to sell firms given the steep drop in equity values, while buy-side investors are hoping for bargain purchases. Accurately modelling the impact of the crisis, the recovery from it, and the long-term effects to derive a sensible valuation will be paramount for buyers to get back into the market early and buy some companies at more reasonable prices. Given the recent market movements, David Mussafer, CEO of Advent International, claims that now there is an *"opportunity for us to get involved with some of the most incredible businesses on the planet that heretofore might not have been interested, or needed capital, or sought a partner"* [xix].

In addition, the COVID-19 crisis reminds Private Equity funds to **incorporate further crisis scenario modelling in their due diligence process** in order to assess a target's susceptibility to potential disruption. These scenario modelling exercises should include both operational disruption as well as financial stress caused by high debt levels and low liquidity. Being able to assess the implications of such disruptions will enable Private Equity funds to identify the companies that are most likely to survive such crisis and succeed in the long term. Although credit markets tightened up, comparing the current crisis to the situation during the global financial crisis, when leveraged loan issuance sank by up to 80% shows that there is still sufficient liquidity in the financial system. Understanding how the crisis affects different industries, how to model these effects, and how to adjust valuations will enable funds to tap this liquidity and purchase good firms at reasonable prices.

> *"Compared to 2008, I feel we are still in a better shape as there is still liquidity in the system as economic activity will rebound quickly after lockdowns are lifted"*
> *– Investor from Large Asset Manager*

Furthermore, the current crisis poses both a **demand and a supply shock to many industries**, causing some firms to go bankrupt while others will thrive in the long term. Hence, it is paramount for Private Equity firms to leverage their industry expertise in order to tell the winners from the losers for a given industry. Limited Partners will be looking for this industry expertise in their GPs in order to place bets on how the industry will develop and which companies will use the current crisis as an opportunity.

Lastly, regarding secondaries, some Limited Partners (e.g., pension funds with hard cap on allocation) will see a drop of their public equity portfolio value with no direct adjustment of their alternative investment allocation. As some funds will need to divest some stakes in GPs to adjust its portfolio exposure, some investors are expecting to **participate in lucrative secondaries**. The extent of this trend is controversial with some LPs claiming that the degree of this effect will depend on the frequency of GPs reporting adjustments in valuations and the frequency of LPs to rebalance their portfolio. At the same time, liquidity requirements for many LPs will force them to sell stakes in GPs to other LPs. These new buying LPs will choose from the GPs that are coping well, learn the right lessons, and adjust their investment approach after the crisis.

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# Resilient Returns Navigating PE in ESG and post COVID-19 world

April 2020

David Kukulies, Bas van Marle, Bartek Walentynski

# Executive summary

## ESG

- Awareness on **ESG in PE is a growing trend** moving from "Ethical conduct is more than not being crooked." in 2008 to "What changed in recent years is that vague discomfort about environmental and social issues has morphed into genuine alarm among investors and consumers."
- To tackle ESG issues **multiple frameworks** have been developed such as UN PRI, UN SDG, SASB, Impact Management Project
- Similarly, **AUM labeled as impact ones observed double-digit growth** in recent years (26.3% 2015-19 CAGR) driven by emergence of >1bn impact funds
- There are 3 key themes for LPs in ESG space today:
  - **Harmonization of ESG frameworks**
  - **Monitoring ESG in 'bad weather'-times**
  - **Balancing act between individual elements of ESG**
- Successful execution of ESG levers can **positively contribute to value creation and investment IRR**, our initial estimate suggests that >0.2x invested equity can be returned through ESG inititatives
- **Right talent in place is crucial** to ensure full alignment between ESG aspirations and financial returns
- **Consistency and granularity are key** to overcome wide variance in metrics to measure ESG performance in the PE-industry. Today only selected GPs exhibit comprehensive frameworks that measure entire portfolio performance

## COVID-19

- COVID-19 emerged in late 2019 in China and followed by rise of cases in Europe and North America was declared a **global pandemic in March 2020**
- All **cases of previous pandemics indicate that V type of global markets (quick) recovery** is the most plausible scenario once COVID-19 is contained
- Although **investors seem to prioritize operations over ESG** in the current crisis, GPs will have measures to **put ESG at the centers of their crisis response**
- The **impact of COVID-19** on investments in general will be felt in three areas: **portfolio improvement, direct transactions, and secondaries**
  - During last financial crisis **GPs with dedicated value creation teams realized higher returns** (~30%) and were able to raise more capital afterwards
  - During last financial crisis **GPs with higher acquisition appetite realized higher returns** (~25%) and were able to raise more capital afterwards
  - Once recalculated **net asset value of private equity assets can face double-digit drop** though possibly lower than public equities

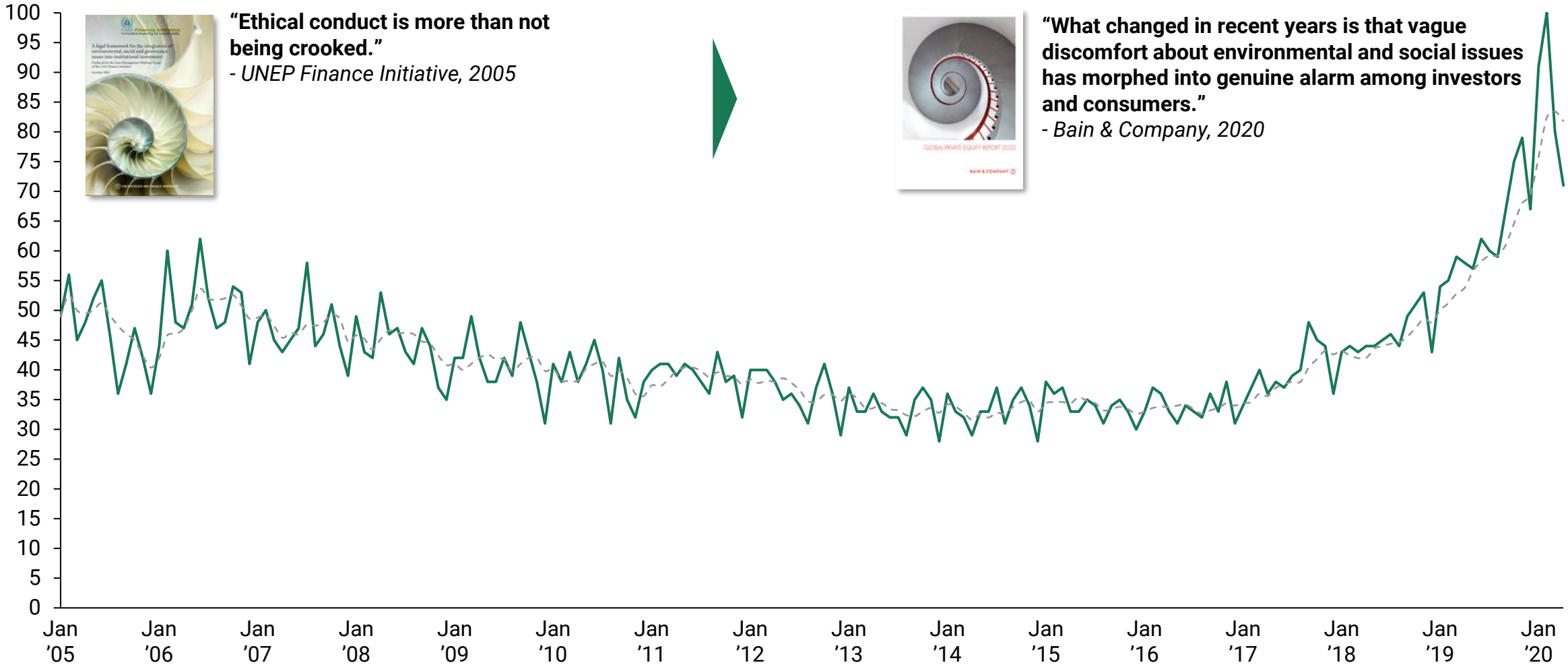
Source: team analysis

I. ESG

II. COVID-19

# Awareness on ESG in PE is a growing trend

Indexed Google searches for 'ESG' relative to total Google searches that day




Source: Google Trends data; UNEP Finance Initiative (2005); Bain & Company Global Private Equity Report (2020)

# To tackle ESG issues multiple frameworks have been developed

SUSTAINABLE DEVELOPMENT GOALS

UN GLOBAL COMPACT

PRI Principles for Responsible Investment

IMPACT MANAGEMENT PROJECT

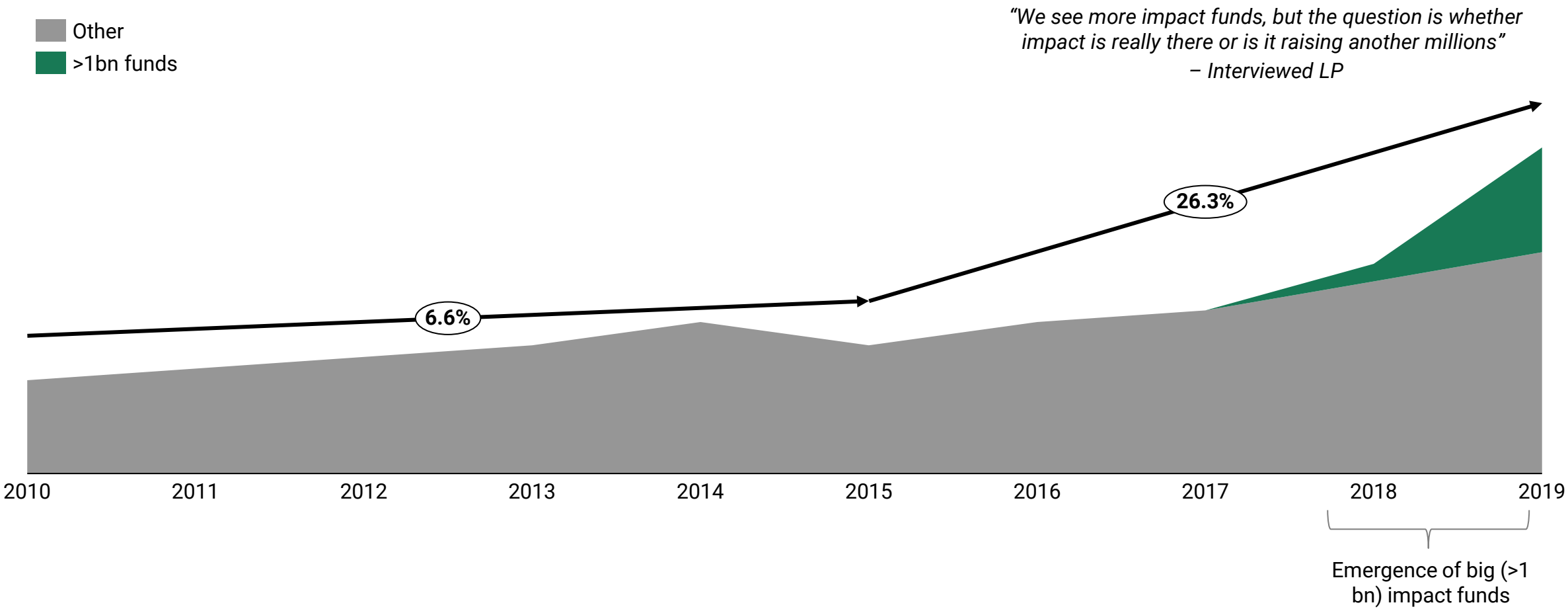
SUSTAINABILITY ACCOUNTING STANDARDS BOARD SASB

GRI Empowering Sustainable Decisions

Source: press search

# Similarly, the amount of assets under management labeled as impact ones observed double-digit growth in recent years

## Dedicated impact PE/VC funds, bn AUM




Source: Bain & Co., Preqin, team analysis

# There are 3 key themes for LPs in ESG space today

## 1 Harmonization of ESG frameworks

**"We need to ensure we have one framework to apply. It becomes increasingly difficult if everyone has their own; we would be grateful for an industry standard."**
*- MD of Limited Partner*

## 2 Monitoring ESG in 'bad weather'-times

**"Enforce ESG-compliance from the most senior level at the GP"**
**-** *MD of Limited Partner*

## 3 Balancing act between individual elements of ESG

**"Differences are most striking when intercontinental investments take place, and cultures can clash"**
*- LP interviews*

Source: LP team interviews

# Successful implementation of ESG can help GPs in boosting their financial returns from investments

## ESG risk mitigation

Traditional approach towards ESG is based on qualitative assessment and exclusions to **eliminate investments that exhibit too much risk** for an investor.

Typically, qualitative ESG risk assessment is conducted based on **standardized checklist** that enables to quickly asses and compare risk areas between different companies.

The purpose of such an approach is twofold:

- **Downside protection**: elimination of investments that e.g., due to poor governance can incur financial losses through corruption, bribery or other illegal activities
- **Reputation protection**: elimination of investments that by character are not aligned by the investor profile, e.g., companies that are producing tobacco products may be excluded from investments by some investors

In both scenario ESG plays a key role to minimize potential losses of the investor (financial and/or reputational)

## ESG value creation

Advanced approach towards ESG is based on **quantitiave assessments of ESG metrics** and **implementation of operational improvements** that can improve long-term value of the business.

ESG value creation can be done **on the portfolio company level** (where all initiatives are designed bottom-up). Alternatively GP can undertake **harmonized set of actions** across all portfolio companies.

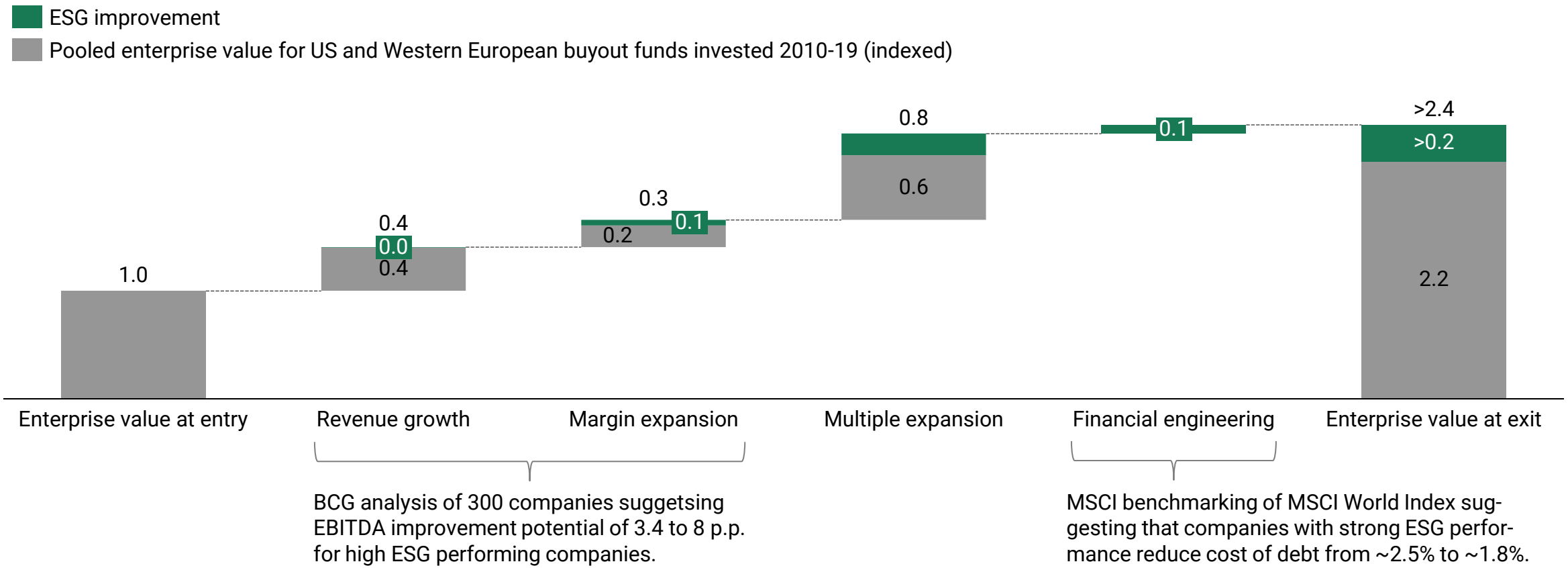
The value creation can come from four sources:

- **EBITDA improvement**: operational initiatives that improve financial performance e.g., procurement of renewable energy may be not only beneficial from ESG standpoint but result in lower energy bill
- **Revenue improvement**: in case of consumer-centric assets sustai-nable profile can increase customer volume or enable to raise prices
- **Multiple expansion**: companies regarding as ESG-compliant can be viewed more posititvely (e.g., by carrying less risk) by potential investors; particularly relevant in case of potential exit through IPO
- **Financial engineering**: pursue of ESG initiatives can unlock GPs opportunity to use *green bonds* in the LBO financial structure

Source: LP interviews, press search, team analysis

# Successful execution of ESG levers can positively contribute to value creation and investment IRR

## ESG returns enhancement, estimate

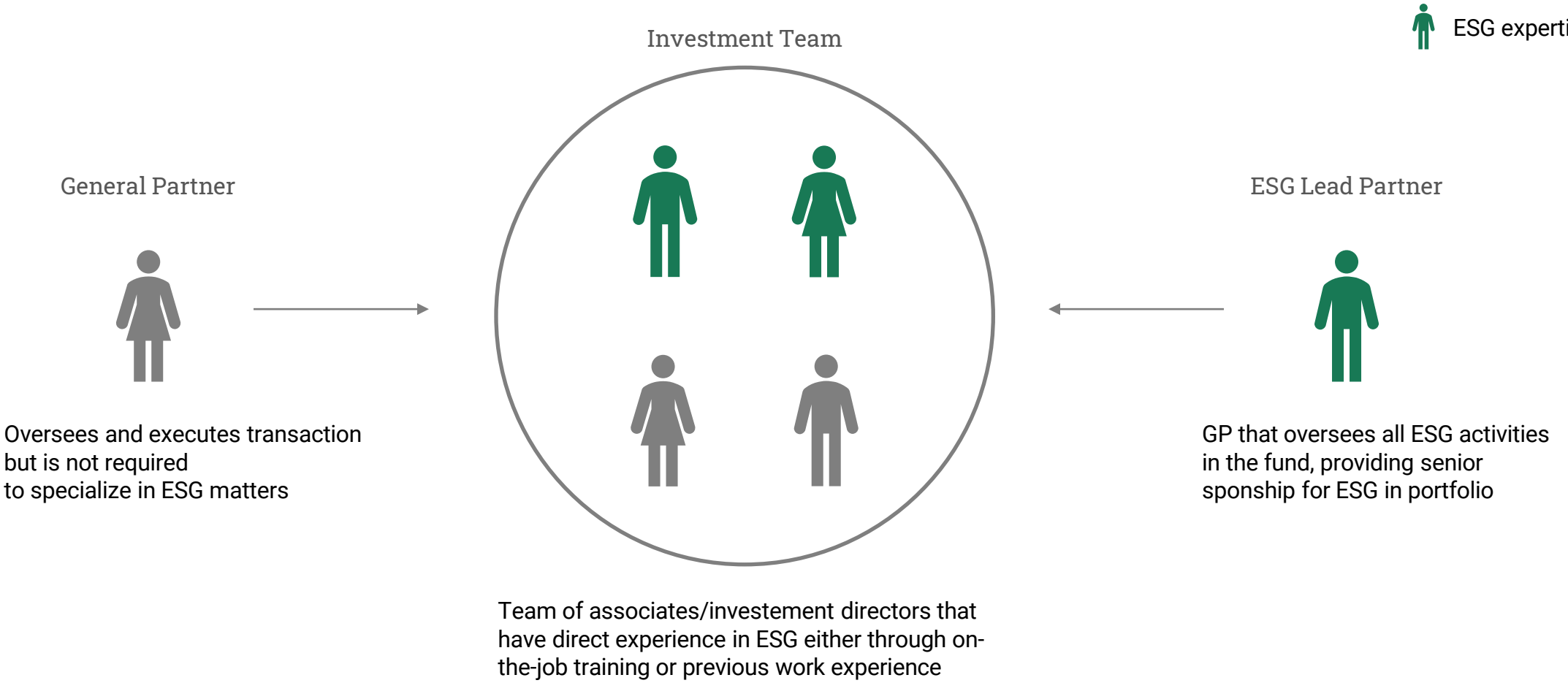



Assuming GPs can achieve half of the potential for cost of debt decrease (at 5% interest rate) i.e., 0.35 p.p. decrease in cost of debt. Assuming 90% EBITDA improvement is attributed to cost reduction and 10% to revenue generation with average EBITDA margin of 20%. Assuming positive impact on multiple expansion for ESG compliant companies.

Source: Bain & Co., MSCI, BCG, FT, UN PRI, press search, team analysis

# Right talent in place is crucial to ensure full alignment between ESG aspirations and financial returns

## Potential ESG investment team structure




Source: LP interviews, press search, team analysis

# Consistency and Granularity are key to overcome wide variance in metrics to measure ESG performance in the PE-industry

## LPs face several challenges when measuring ESG performance by GPs…

- Lacking existing track record makes the ESG review of a new fund difficult
- Measuring ESG performance at discrete intervals (e.g. annual review) instead of continuously
- Facing time and resource constraints leads to less scrutiny of ESG in Alternative investments portfolio compared to other asset classes
- Observing ESG compliance in a portfolio of investments by the GP can obscure individual cases

## …but solutions to overcome opaque process exist

- Solicit services of outside advisor to benchmark expected ESG performance of a new fund
- Develop internally consistent rating system or adopt the framework set by a competitor
- Strive for objective, fact-based approach to evaluate investment portfolio; when quantitative insight is missing a qualitative approach can work well
- Create clear escalation cadence when issues with ESG performance are observed

**Consistency allows for comparison between investments.**
**Granularity in metrics ensures that industrial and geographic peculiarities are considered.**

Source: Investor interviews: RBC global asset management report (2019); PWC responsible investment survey (2019)

# Today only selected GPs exhibit comprehensive frameworks that measure entire portfolio performance

## Many GPs focus their reporting on several ESG case studies…

*Employing disabled workers*

One billion people, or 15% of the world's population, experience some form of disability, and prevalence is higher for developing countries. Working age persons with disabilities and those from socially disadvantaged groups experience significantly higher unemployment rates.

**Lemon Tree Hotels** is India's fastest growing chain of mid-market business and leisure hotels and the third largest hotel chain by owned and leased rooms. Lemon Tree has prioritized hiring persons with disabilities since 2007. This initiative began with an initial focus on speech- and hearing-impaired employees, and evolved to include programs for employees with down syndrome, autism, and victims disfigured in acid throwing attacks. Lemon Tree has found that in many cases, these employees are more productive, with higher retention rates, in a hospitality sector that typically has high employee attrition. Notably, these p

lemon tree HOTELS

~22% of the company's employees are physically or intellectually DISABLED or come from economically or socially MARGINALIZED GROUPS

**Sequoia Logistica e Transportes S.A.** is a vertically integrated contract logistics operator in Brazil providing warehousing, fulfillment, and last-mile delivery services to mission-critical high value-added products. The company currently operates 5 distribution centers with a total storage and handling area of over 80,000 square meters. Sequoia has been successful i linking team engagement, productivity, and business success to diversity and support to local communities. Sequoia's Seeds apprenticeship program identifies young people from disadvantaged backgrounds and provides them with job training or professional opportunities. The company's Inclusion Program is supported by senior leadership to offe opportunities for people with disabilities, including hearing visual, and physical impairments. The company developed corporate policies and partnerships for hiring, improving working conditions, deploying sensitivity training sessions, and integrating mentoring initiatives with performance evaluation and retention programs. In 2018, the program's first year, the company hired over 80 employees with disabi

*Incentivizing green consumer behavior*

As the Chinese population faces adverse air quality in their everyday lives, the government and private sector are increasingly committed to encouraging more environmentally sustainable behavior.

**Ant Financial Services Group**, an Alibaba-affiliated company, focused on a core platform that offers basic mobile payment services and a growing range of financial services, including SME lending, money market, and wealth products. In August 2016, in collaboration with UN Environment, Ant Financial initiated the Ant Forest program through Alipay: the world's first, largescale pilot in greening citizens' consumption behavior through the use of mobile payment platforms, big data and social media. Through Ant Forest, users can collect "green energy points" through low-carbon

蚂蚁金服 ANT FINANCIAL

AS OF APRIL 2019, 500 MILLION Alipay users planted

100 million real trees across China

*Improving livelihoods through technology*

**GO-JEK** is the leading multi-category, on-demand mobile e-commerce marketplace in Indonesia. The company focuses on its three core values: speed, innovation, and social impact. Its platform enables transportation, logistics, payments, food delivery, and other on-demand services to millions of customers. GO-JEK connects its 25 million monthly users with over 300,000 motorcycle and car driver partners, 100,000 food merchants and 7,000 service providers. Drivers enjoy health benefits, insurance, safety training, and access to microfinance loans. Small and medium-sized businesses operating in Indonesia typically see a dramatic increase in sales once they are registered on GO-JEK's platform. The company's activities in the payments space have promoted financial inclusion and enabled more individuals to access numerous financial services such as obtaining insurance and mortgages. Using technology as a means of social impact, GO-JEK has created jobs, improved livelihoods, and aided micro-entrepreneurs.

GO-JEK

GO-JEK CONTRIBUTED AN ESTIMATED $3 billion in added value TO THE INDONESIAN ECONOMY IN 2018 through earnings made by its drivers, talent partners, and small-medium enterprise merchants

(University of Indonesia study, 2018)

## …while selected ones use comprehesive portfolio framework

PROGRESS REPORT

Responsible investment | Governance & risk | Financial performance | Human capital | Business ethics | Environment

ESG integration

| Traditional | Negative screening / SRI | Responsible investment / ESG integration | Impact investing | | Philanthropy |
|---|---|---|---|---|---|
| | | | Market-rate | Concessionary | |
| Limited or no focus on ESG factors | Excluding investments based on harmful products, services or practices | Focus on creating and protecting value through consideration of ESG factors | Focus on one or a cluster of issue areas, where social or environmental need creates a commercial growth opportunity for market-rate returns | Focus on one or a cluster of issue areas, where social or environmental need requires some financial trade-off | Focus on one or a cluster of issue areas, where social or environmental need requires 100% financial trade-off |

Our approach

As one of the largest private markets investment managers globally, we are fully committed to investing our clients' capital in a responsible manner. We systematically integrate ESG factors, alongside commercial and financial factors, into our investment due diligence and ownership. We believe this approach not only protects, but also creates, value for our clients and their more than 200 million beneficiaries.

Read about our approach to ESG Integration across investment strategies in our Responsible Investment Policy and Methodology

ESG highlights of Partners Group's direct investment portfolio

| Impact achieved | | | Equivalent to |
|---|---|---|---|
| 203 million kWh energy consumption | REDUCED | | 61,000,000 liters of gasoline being consumed |
| 2.6 million liters fuel | SAVED | | 1,146 passenger vehicles driven for one year |
| 879,000 metric tons CO2e CO2 emissions | AVOIDED | = | 436,000 tons of coal being burned |
| 5,097 tons waste | RECYCLED | | waste generated by almost 7,000 Swiss residents in a year |
| 13,608 new jobs | CREATED | | 7.6% job growth rate |

Note: data from our annual ESG KPI Survey. Once a year, Partners Group surveys its direct lead and joint-lead investments on key aspects of their ESG performance. We use the data from this review to understand the collective impact of our portfolio on society and the environment, assess the overall ESG maturity of each investment and identify priority areas for engagement.

12 | Partners Group

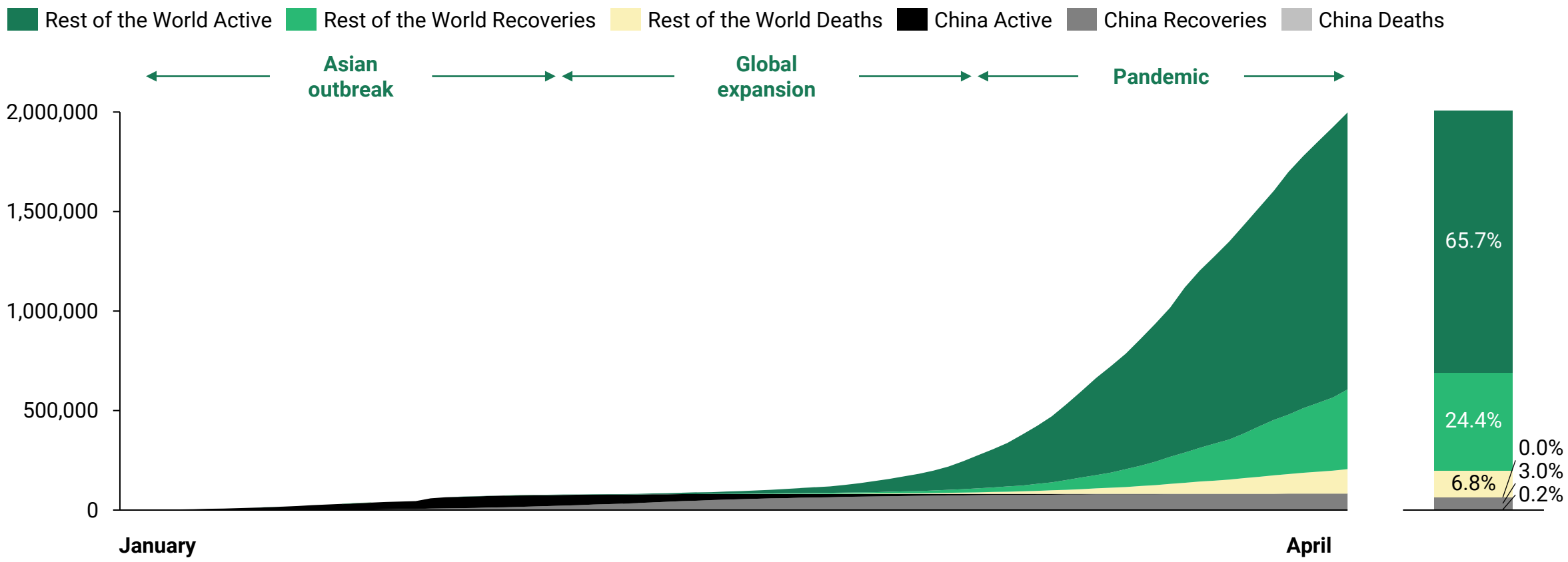
Source: Warbug Pincus, Partners Group annual sustainability reports

I. ESG

II. COVID-19

# COVID-19 emerged in late 2019 in China and followed by rise of cases in Europe and North America was declared a global pandemic in March 2020

Number of COVID-19 total cases

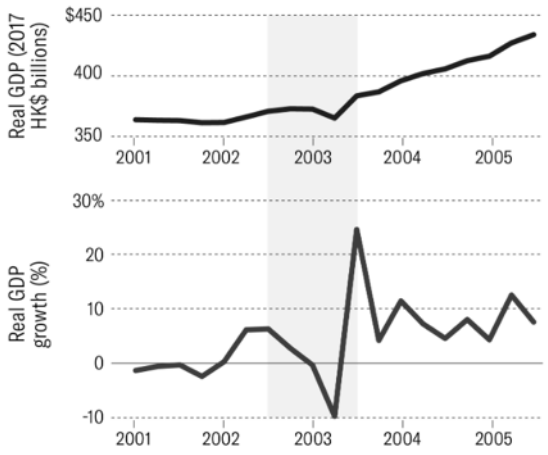



**While number of cases in China peaked cases worldwide experience exponential growth**

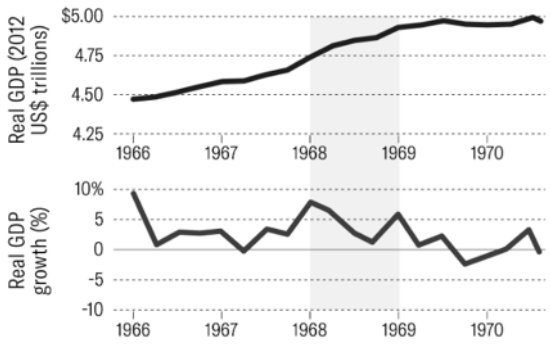
Source: Worldometers

# All cases of previous pandemics indicate that V type of global markets (quick) recovery is the most plausible scenario once COVID-19 is contained

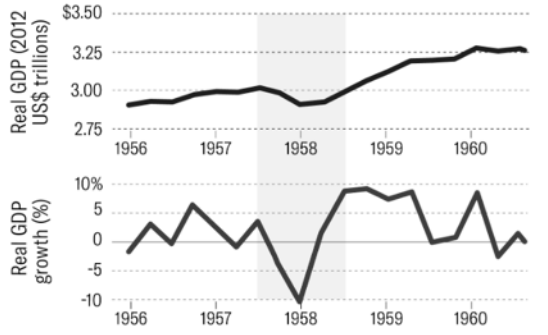
## 2002 SARS



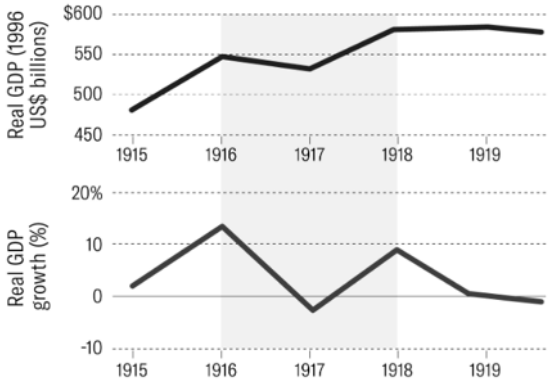

## 1968 H3N2 „Hong Kong" flu




## 1958 H2N2 „Asian" flu




## 1918 Spanish flu




## Comments

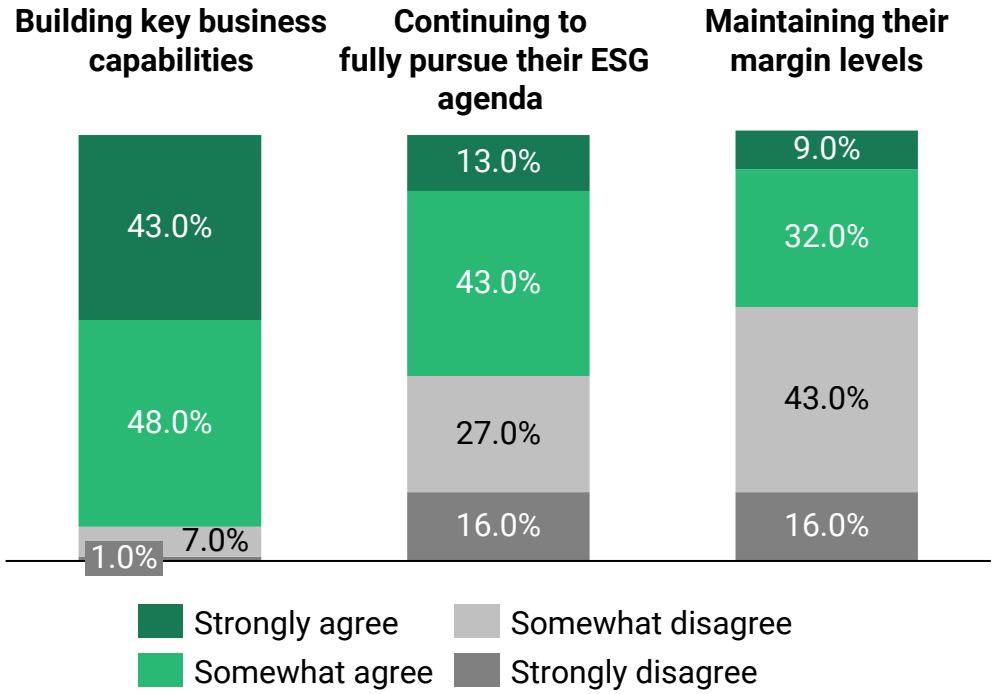
- All previous pandemic cases indicate that **market rebound follows „V" pattern once outbreak is contained**. This scenario exhibits **„classic" real economy shock** in which growth eventually rebounds.
- The other scenarios could take form of „U" or „L":
  - **„U" shock** would indicate resume of previous growth but with clear permanent loss in output. In this case, possible de-globalization and slower flow of goods and people may trigger the scenario.
  - **„L" shock** would mean that there is a significant structural damage in place through long-term disruption of e.g., labor market, capital formation and productivity function.
- The **impact on the economy** can be transmitted both through supply and demand side channels:
  - **Indirect hit to customer confidence**: as household wealth contracts, saving goes up, consumption falls. May be particulatly strong in advanced economies with households exposed to equities (e.g., US).
  - **Direct hit to customer confidence**: COVID-19 may have direct effect on customer confidence by keeping many self-isolated at homes and pessimistic about long-term
  - **Supply-side shock**: possible gaps in production and labor scarcity may significantly impact supply-side in case of quarantine. However, this shock is expected to be more short-lived than demand ones.
- The path can deviate given past bull market and expectation of moving to recession period where **market correction** would be anyways expected

Source: BCG, HBR, U.S. Census Bureau, BEA, CDC, Census and Statistics Department

# Although investors seem to prioritize operations over ESG in the current crisis, PE funds will have measures to put ESG at the centers of their crisis response

## Issue Prioritization in COVID-19 Crisis

It is important for healthy companies to prioritize …




*"Some ESG efforts won't be focus of attention now"*
*– Executive of Investment Firm*

*"ESG will be here to stay"*
*– MD of Asset Management Firm*

## Crisis Response with ESG Considerations

**Governance**

- Create transparency of financial performance for LPs
- Provide further risk management disclosures
- Keep one senior point of contact for ESG matters

**Workforce**

- Invest in remote working and distancing measures
- Use short-time work schemes to avoid lay-offs
- Consider lowering executive compensation and bonuses

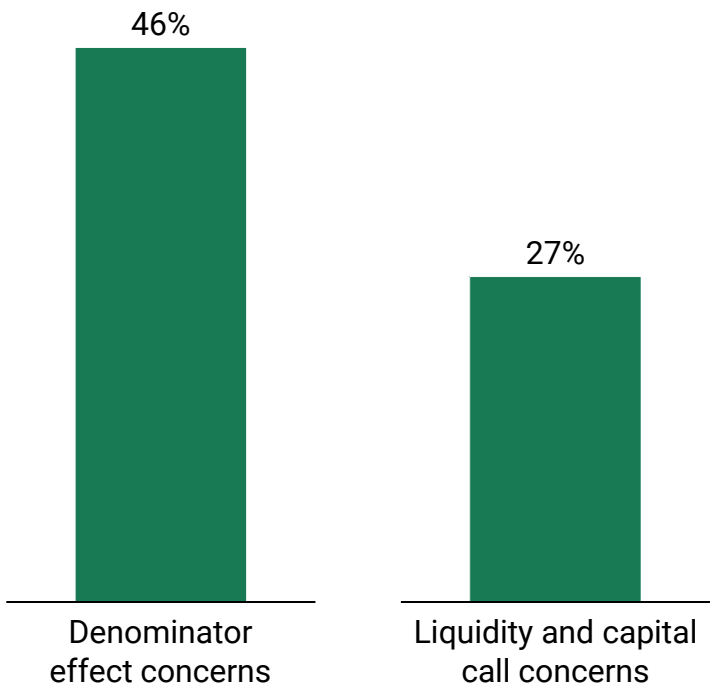
**Society**

- Donate money to help combat the pandemic
- Leverage portfolio firms to research vaccine
- Avoid greenwashing via mere healthcare investments

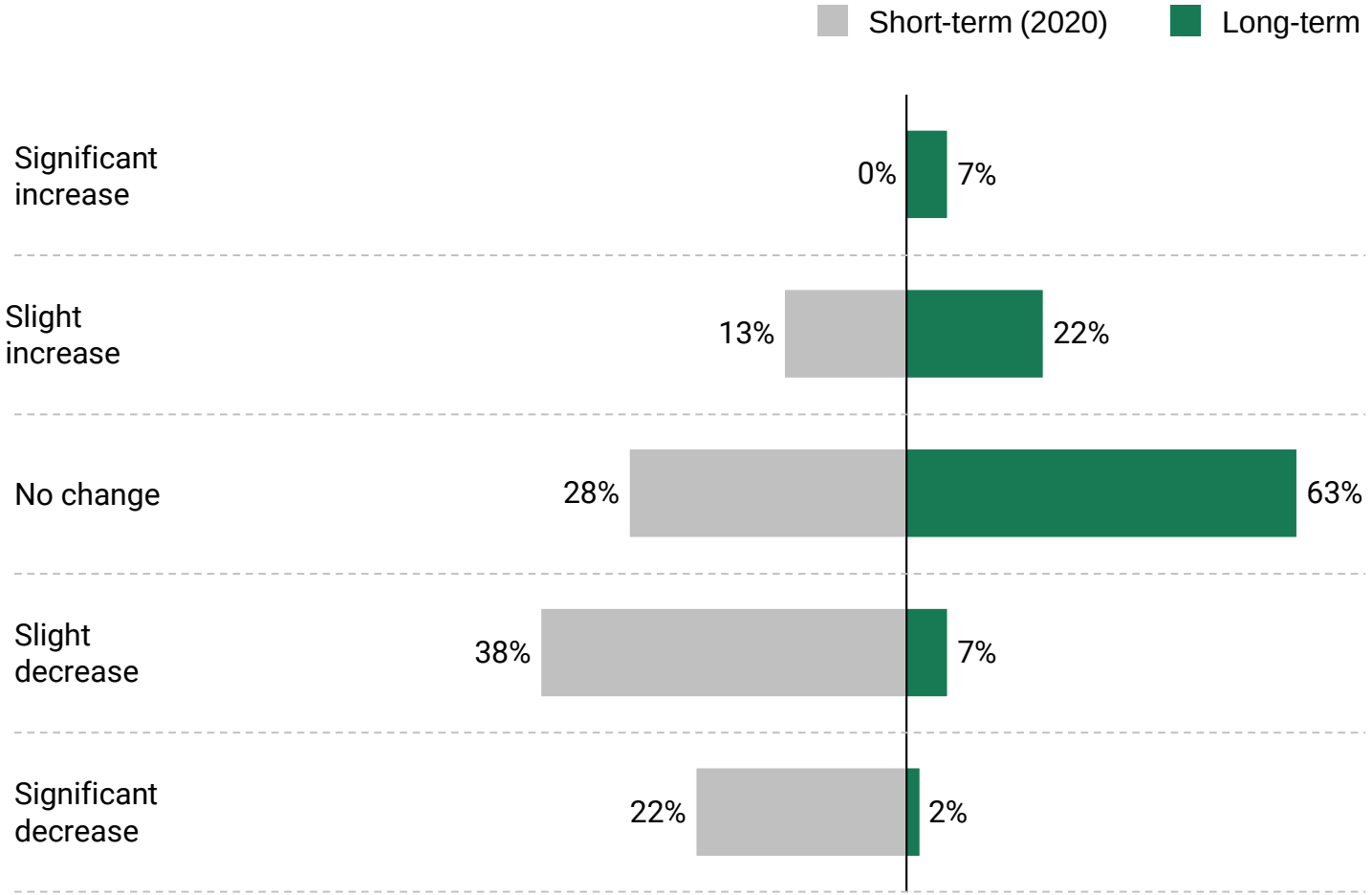
Note: Survey with 150 respondents.
Source: BCG COVID-19 Investor Pulse Check, April 2020, Investor Interviews, McKinsey & Company, Financial Times, Bain & Co.

# Despite short-term concerns, investors indicate long-term intention to increase their alternative investment portfolio

## Short-term 2020 investor concerns arise from COVID-19, % that agree




## COVID-19 Investor view on 2020 planned commitments versus long-term investment strategy in Alternative investments portfolio




Source: Preqin COVID-19 Investor Survey, April 2020

# The impact of COVID-19 on investments in general will be felt in three areas: portfolio improvement, direct transactions, and secondaries

## 1 Portfolio Improvements

As operations continue to be key driver of value, LPs will look for funds that derive learnings from the current crisis:

- **Operational risk** including:
  - Disruptions in production, distribution and logistics
  - Shift towards decentralized, diversified supply chains
  - Changing customer demand and sales channels
- **Prioritizing portfolio support** incl. analysing firms that need urgent support and allocating resources to it

## 2 Direct Transactions

The current crisis will provide buying opportunities for funds that adjust their investment approach accordingly:

- **Scenario modelling** and rightly assessing risks of such downturns during the due diligence phase
- **Valuations** including assessing the short-term and long-term impact of the crisis on firms' business models
- **Industry expertise** and knowing what differentiates winners and losers in an industry after the crisis

## 3 Secondaries

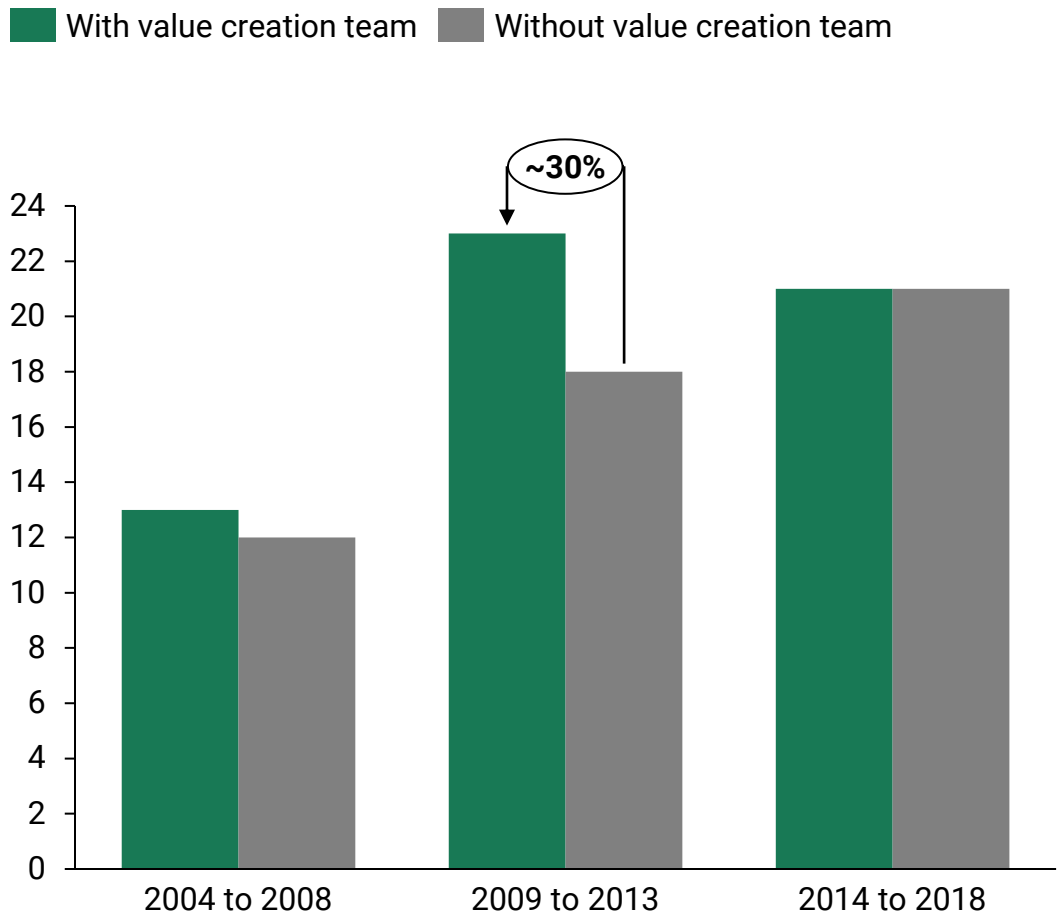
Seleced LPs face liquidity need and may require portfolio rebalancing due to drop of public equities:

- **Possible secondaries** opportunities for Limited Partners that are not bound by hard cap portfolio allocation rules
- **Vintage year diversification** will still require LPs to invest in 2020 despite and because of drop in valuations
- **Best learners and adapters** among the PE funds will be able to convince LPs to invest further in their funds

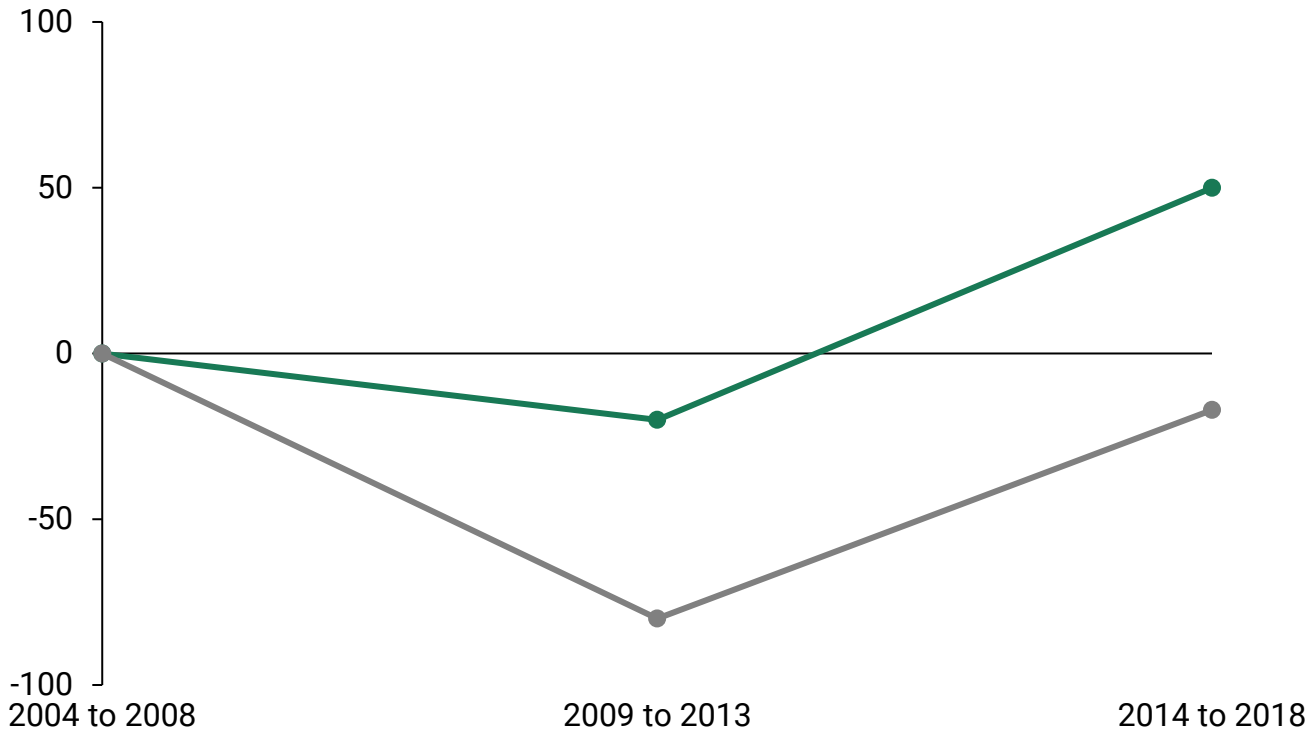
Source: BCG COVID-19 Investor Pulse Check, April 2020, Investor Interviews, McKinsey & Company, Financial Times, Bain & Co.

# 1 During last financial crisis GPs with dedicated value creation teams realized higher returns and were able to raise more capital afterwards

Average IRR, %



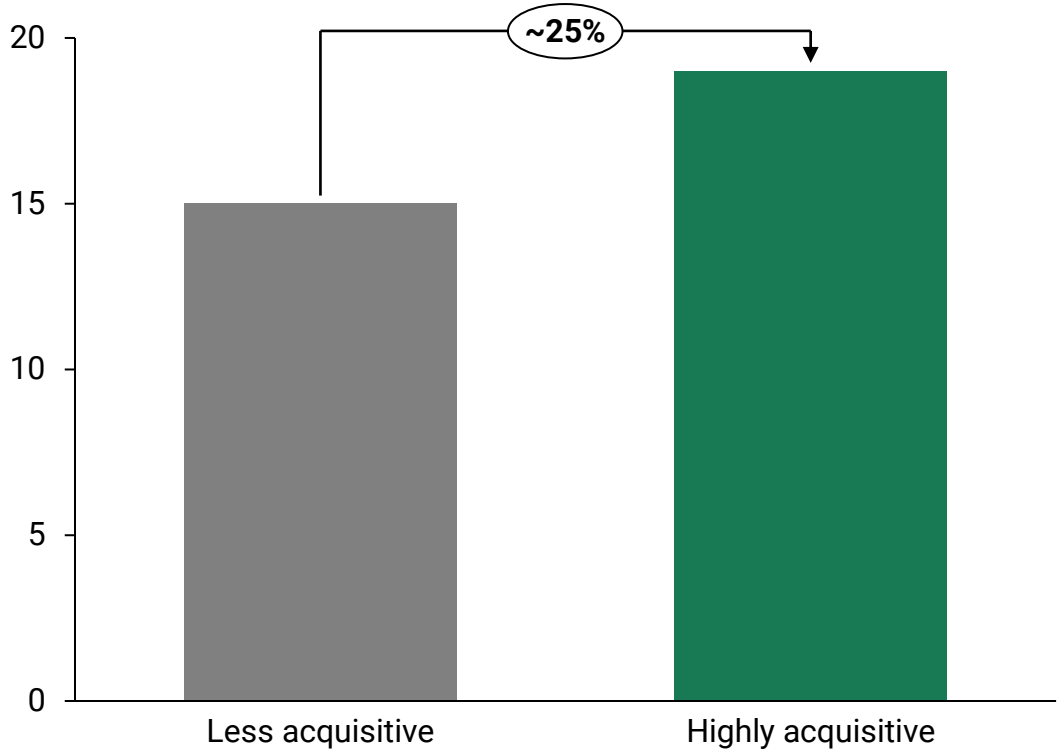

Average fund size (indexed), % change vs. 2004-8



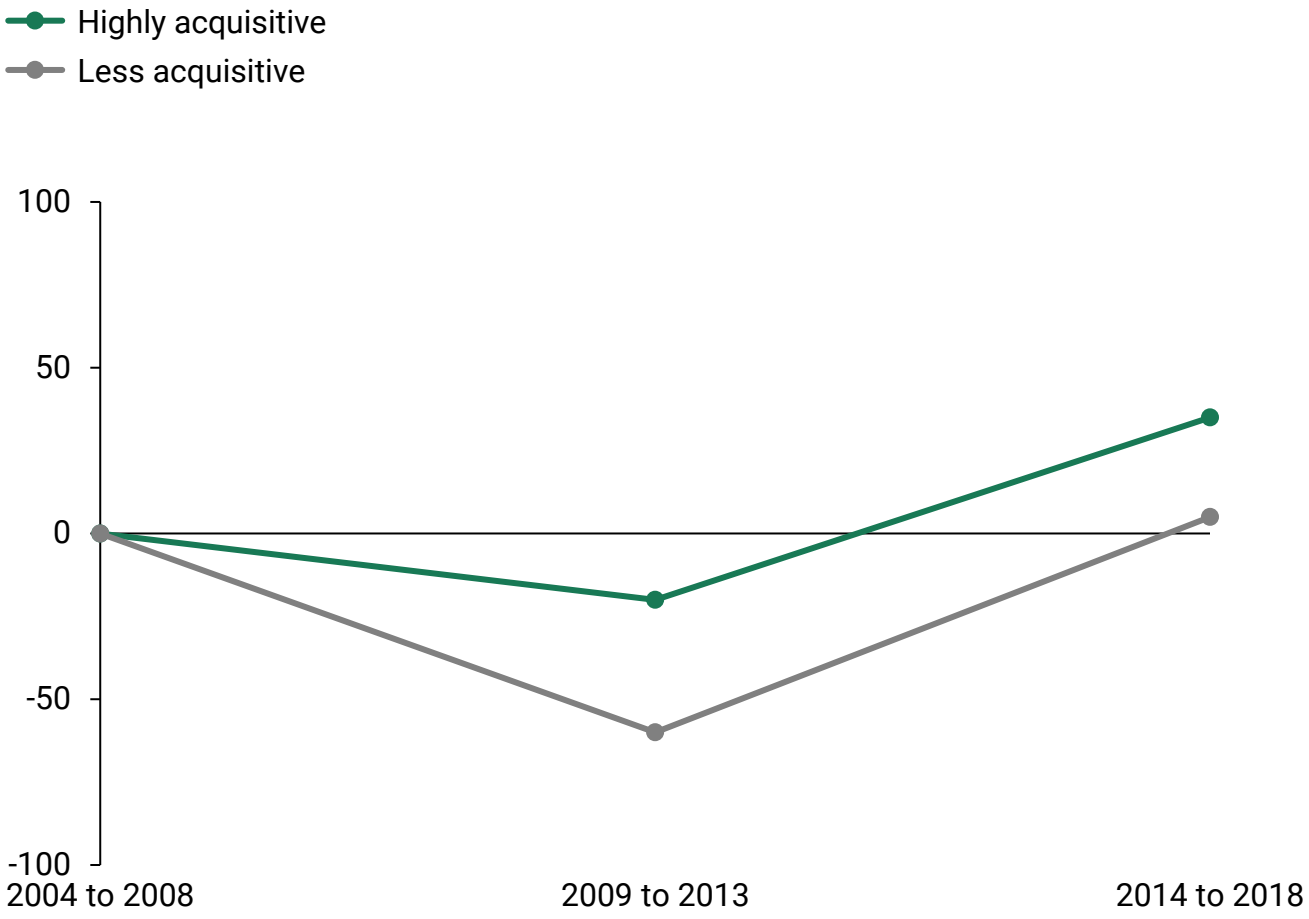

Source: McKinsey & Company, Preqin, team analysis

# 2 During last financial crisis GPs with higher acquisition appetite realized higher returns and were able to raise more capital afterwards

Average IRR, % 2009-13



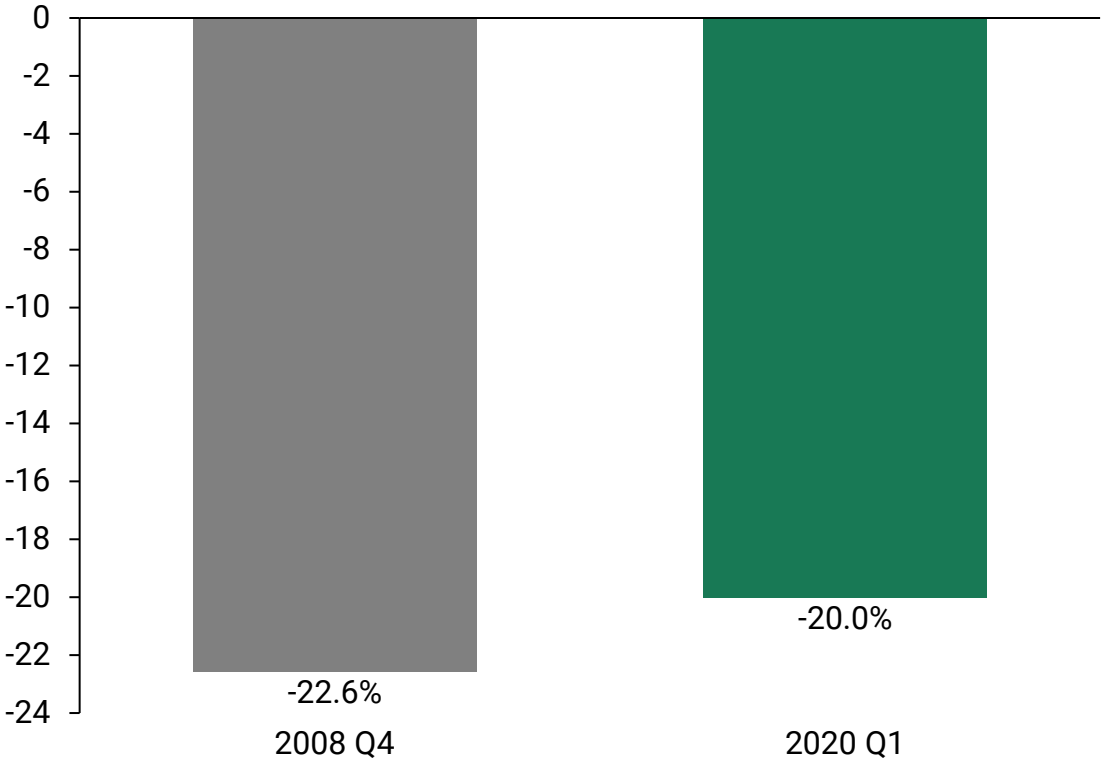

Average fund size (indexed), % change vs. 2004-8



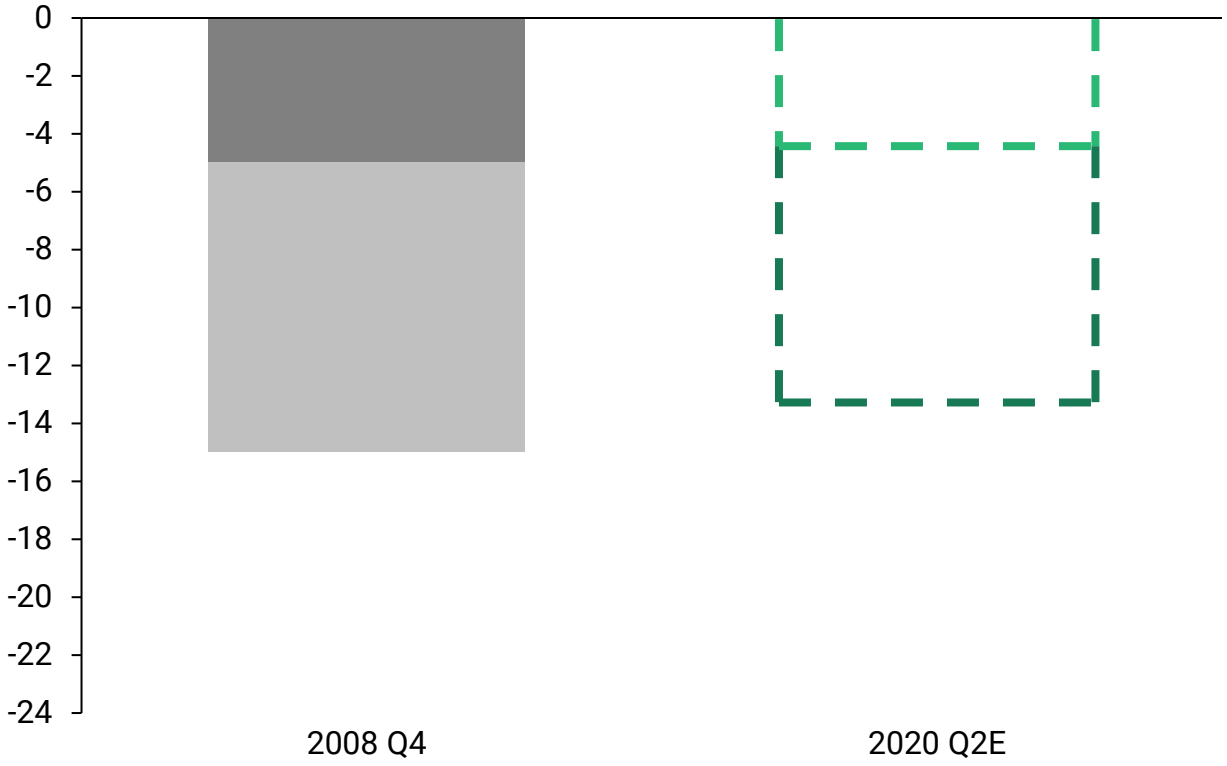

Source: McKinsey & Company, Preqin, team analysis

# 3 Once recalculated net asset value of private equity assets can face double-digit drop though possibly lower than public equities

Public equity index value, S&P500 quarterly change




Private equity NAV, quarterly change




Source: Bain & Co., S&P 500, press search, team analysis