

Privcap's Private Equity
ESG SUMMIT
2016

A recap of Privcap's first ESG event

Privcap/Report

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About Privcap

Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap offers communications services to market participants.

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David Snow
Co-founder & CEO,
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The Purpose Is Profit

This publication presents an overview of the intelligence that was shared at Privcap's Private Equity ESG Summit, which brought together limited partners, general partners, operating experts, investor-relations professionals, and advocates for environmental, social, and governance (ESG) objectives in investing.

I've headlined this letter "The Purpose Is Profit" as a deliberate departure from the oft-used "Profit With a Purpose" slogan one hears in ESG and impact investing circles. The wording change-up most accurately reflects the approach that U.S. advocates of ESG are taking, which is that the main reason to embrace ESG strategies and principles is because there is a strong business case to do it.

Paying attention to the "E" in ESG can clearly be shown to save money and prevent costly cleanups and PR disasters. The "S" and "G" components are softer, in that they lean more toward the benefits of reputation protection and customer outreach. But given the skepticism that some, particularly U.S., investment groups have shown toward "impact" investing and ESG, the profits-first advocacy model seems to be the best one, and was the one clearly put forward by the numerous experts who spoke at the ESG Summit.

One additional observation from the lead-up to the event: So many PE professionals that I spent time on the phone with planning the content for the summit urged that they not be presented as "ESG experts" but as fellow sojourners trying to figure out the right policies. One person who requested this low-key status was from a firm that has had an ESG platform in place for seven years.

Clearly there is more to learn about ESG, but the enthusiasm about it and clear evidence of progress shared at our summit indicates that expertise in these areas is clearly on the rise and sought after by those in private equity.

Enjoy the report,



David Snow
@SnowsNotes



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How ESG Impacts Investor Relations

The practice of quantifying ESG for investors is very much in the nascent stages, but poised to have a large impact in the coming years



Bronwyn Bailey
Vice President of Research and Investor Relations,
American Investment Council



Daniel Jacobs
Principal,
Clayton, Dubilier & Rice



Kate Ahern
Director, ESG and Communications,
Bain Capital



Esther Rombaut
Director of Investor Relations,
CVC Capital Partners

Bronwyn Bailey, American Investment Council: Daniel, how is Clayton, Dubilier & Rice implementing ESG?

Daniel Jacobs, CD&R: We have about 20 portfolio companies, and we try to look at ESG in the same way that we look at anything that might have impact on the long-term performance and value of our portfolio companies. It comes very naturally to help to frame up what we're trying to accomplish, and we try to do that in each company.

Bailey: How long have you been reporting on ESG to your LPs?

Jacobs: We established an ESG policy in 2009, and our reporting has incrementally improved ever since.

Kate Ahern, Bain Capital: We work with each of our companies on an individual level to understand what's material to their business when we're thinking about ESG. I think everyone would say that we've been doing reporting [to LPs] on various elements that are material forever ... and just in the last few years, starting to report on "Here's this in the ESG context, and here's why it matters."

Esther Rombaut, CVC Capital Partners: The perspective that we had, coming to ESG, [was] really thinking about it from a due diligence standpoint at the underwriting level before we got into a situation to think about what could be not only the financial impact, but the reputational impact of making a decision with poor ESG considerations.

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Bailey, Jacobs, Ahern, and Rombaut in a panel discussion

Bailey: What are your LPs asking you for in terms of reporting?

Jacobs: We found that there's certainly been a huge increase in the demand for information around ESG from our LPs. We raised [a fund] about four years ago, and about 25 percent of the capital that we raised was connected to some form of ESG inquiry. Fast-forward to today, we've at least doubled that. They really want to know our exposure and process for managing that.

Ahern: It's been interesting to see the different types of requests by geography. We've started to receive a lot more requests for information on governance and corruption and data security in Asia, for example, because it's become a real issue. We've received a lot more questions about diversity in the United States.

Rombaut: We saw it in [the Nordic countries], not surprisingly, and with the Dutch investors, and then we are starting to see some U.S. public pension plans having ESG-focused requests, as well as Asian sovereigns, which is a bit of a surprise based on historical experience with them. What's startling to me is ... our base of investors is about 300 LPs. I would say at least half of those have ESG-related questions, but primarily in the context of a fundraise.

Bailey: Do you know how the LPs are using information beyond due diligence?

Jacobs: In most cases it's a little bit hard to tell what they're using the information we're giving them for.

Ahern: We hear they're under increased pressure from many of their own investors, who are increasingly concerned about ESG issues.

Rombaut: We don't have a good feel for where the information goes. GPs are in a formulating phase of how ESG should be incorporated in our business, and I think the LPs are very much in that phase as well, and they're trying to get a sense of what are the best practices out there and how they want to calibrate their request going forward.

Bailey: Can you describe how you're collecting the information? How does it funnel back to the IR role?

Jacobs: We're very low-tech in this regard. The information that we're collecting from our portfolio companies really starts when we're making an investment, and we survey the CEO of the company, get a feel for their level of engagement around ESG.

Rombaut: We work with the management teams and some external consultants to try to create that

"We're learning as we go a little bit, and I think all of us feel like we're building the plane as we're flying it on ESG."

– Kate Ahern, Bain Capital

framework. We have very little by way of internal resources that can drive that, despite being a very large firm.

Bailey: Is there some information that's more relevant?

Rombaut: We are generalists. You can't have a given template that you just roll out to any business, because everything is pretty much different.

Bailey: Any challenges you've encountered collecting the information?

Jacobs: Giving advance notice helps a lot, and having someone at the top communicate to the whole organization that this is a priority.

Bailey: Do you think private equity will ever get really granular and really quantifiable around ESG?

Rombaut: I think we are at least four or five years away from having quantifiable data, and for us, that has to do with the diversity and the breadth of the portfolio.

Ahern: We're learning as we go a little bit, and I think all of us feel like we're building the plane as we're flying it on ESG.

Jacobs: We're in the early innings of a long game. But in the last few years, the industry has made tremendous progress—it's fantastic, but we're still early. ■

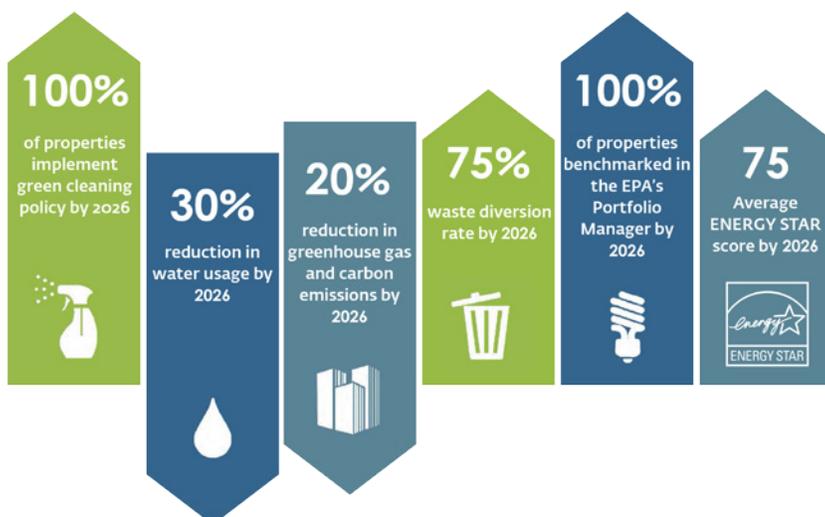
Colony's Plan to Win With Sustainable Real Estate

A conversation with Ryan McManus of Colony NorthStar

Few industries on earth have more of an impact on the environment than real estate. One of the biggest real estate investors in the world, Colony NorthStar, has a plan to decrease its own carbon footprint while driving real investment returns. At Privcap's Private Equity ESG Summit, the firm's head of sustainability, Ryan McManus, shared details of that plan.

With \$58B in assets under management and 500 employees, Colony NorthStar utilizes the EPA's Energy Star tool to track a series of performance indicators across its vast portfolio. The firm also uses the U.S. Green Building Council's LEED certification as an important marker of sustainable real estate.

And the firm is seeing results. In 2016, its first year of reporting, Colony was ranked second globally among real estate debt investors by GRESB (Global Real Estate Sustainability Benchmark), the industry standard for assessing sustainability in real estate.



Ryan McManus
Senior Vice President,
Colony NorthStar

Privcap: How new is the idea of sustainability within the real estate investment industry?

Ryan McManus, Colony NorthStar: Sustainability in real estate is not exactly new, but the formalization of the process and the emergence of building certifications have accelerated in the last 10 to 15 years. Fast-forward to today and there are over 15 billion square feet of LEED-certified buildings across the world, in every major marketplace. Reporting is becoming more standardized making it easier to measure sustainability performance of both properties and their parent companies alike.

What is your role at Colony NorthStar?

McManus: I oversee fund operations and investor reporting for the firm's private equity real estate funds, as well as the implementation of ESG initiatives throughout our portfolio. The two areas are complimentary. Knowing what is important to our investors has helped us shape a successful ESG program.

Colony NorthStar's ESG Goals

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What was behind Colony NorthStar's desire to formalize an ESG program?

McManus: First, sustainability is good business, and that's as clear for real estate as any other asset class. Reducing your energy and water consumption helps lower operating costs. It's also positive on the revenue side in terms of facilitating higher rental premiums for tenants who want to occupy green buildings. Additionally, energy efficient buildings have been proven to also have better terminal values and superior cap rates. These are among the many financial benefits we've experienced in our own portfolio.

Secondly, ESG is a critical component to any risk management program. We need to understand and monitor our environmental and regulatory risk.

And lastly, it's a matter of stewardship. Real estate accounts for an enormous amount of our global energy consumption and water consumption and waste output. In the U.S. alone, real estate accounts for around 40 percent of carbon emissions. That's more than the industrial sector, more than transportation, more than agriculture. So we've looked at that opportunity. If we can move the needle just a little bit, then we can have a great impact.

What is an example of a strategy that has cut costs and also had an ESG impact?

McManus: On the water side, last year we converted one of our very water-thirsty properties that had 64,000 square feet of lawn landscaping into mulch and drought-resistant vegetation. In California, this matters a great deal. That initiative is saving 1.6 million gallons of water a year, which is very important to our resources and to our bottom line.

Would you consider buying an energy-inefficient property and converting it into a more sustainable asset?

McManus: That's very much in play. Our ESG principles are not meant to be a barrier to investment; rather, we intend to identify risks and opportunities down the road. Through our active asset management plan and refurbishment and upgrading of the building facilities, we are making our properties more efficient. It takes a lot of human capital. It takes investment capital. But there is a positive return on that. ■

The Power of Standards



Dan Mistler
Senior Manager,
Climate Change and
Sustainability Services,
EY

Mistler explains why ESG benchmarking tools are becoming more widely used

“The identity of ESG is changing from something that felt fluffy to something that funds can really make money with. That progress has been about the ability to draw a business case between ESG interventions and business outcomes.

“One of the things that is needed is a bit more standardization, particularly with KPIs. There are some external frameworks being developed that a firm can take and build off of. For example, the Sustainability Accounting Standards Board, or SASB, is developing a great framework that is sector-specific. SASB guidance is really about understanding the materiality of the risks that the business may be facing, given the geography and the business sector it is in.

“In real estate, energy usage has been a recognized issue for much longer than in some of these other industries. The Energy Star program is a perfect example of that. Energy management is a great example of the easiest ESG initiative that you can have in a portfolio.”

Managing Portfolio Companies' ESG Efforts



Alan Kao
Principal and Global Service Line
Leader for Compliance, Strategy
and Transaction Services,
Ramboll Environ



Jackie Roberts
Chief Sustainability Officer,
The Carlyle Group



Elizabeth Seeger
Director, Public Affairs,
KKR



Lee Coker
ESG Officer,
Oak Hill Capital Partners

Four experts discuss how their firms instill ESG values into private equity investments

Alan Kao, Ramboll Environ: What sectors have you found to have the best opportunities for ESG impact, and in what sectors has ESG been more of a challenge?

Jackie Roberts, The Carlyle Group: There are certain sectors, like oil and gas and industrials, in geographies like developing countries, where investment professionals are very sensitized to these issues and they generally get a hard look in due diligence—whether it's looking at contingent environmental liabilities or labor issues in developing countries or operational risks. When I think about sectors where we can have an impact, we usually think about questions that start with, "Where is, what I call, private governance truly playing a role here?"

In a five-year hold period, we can look at where customer and competitor dynamics are changing the lay of the land. We look at this in terms of both the risks of falling behind new types of risks for that sector, and also where there are opportunities for developing new products or services. We see that a lot, for

example, in the consumer sector. When you have a large retailer, like Walmart, scoring on sustainability, [ESG efforts] are all driven by different supplier relationships and buyers driving changes.

I think that HR workforce strength issues are an area where our sector can play a major difference. For instance, our sector could have a big impact on gender diversity, racial diversity, health and safety.

Kao: How do you get your arms around a large portfolio? How do you prioritize?

Lee Coker, Oak Hill Capital Partners: When I was at EDF [Environmental Defense Fund] we partnered with Oak Hill Capital's portfolio to answer that question for the firm and for the private equity sector more broadly. We narrowed it down to three things. The first was considering the current state of the business. What stage of investment is the company in? What are the businesses top priorities and how could we tie in ESG initiatives into those activities? Another was, where the opportunity is, from an environmental or social impact perspective. The next was a check to ensure that improving the ESG profile would also create significant financial value.

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Kao, Roberts, Seeger, and Coker in discussion onstage

“Each time we’re thinking of an investment or particular industry, we’ll pull up the [ESG] guide and say, ‘Given the geography, are these questions relevant? If not, which ones should we add?’”

– Elizabeth Seeger, KKR

Elizabeth Seeger, KKR: At KKR we, early on in the process, developed a series of guidelines. Each time we’re thinking of an investment or particular industry, we’ll pull up the guide and say, “Given the geography, are these questions relevant? If not, which ones should we add?”

Roberts: I think the role of LPs in asking the hard questions about every company is certainly helpful in making sure [that], over time, this is disseminated throughout. The deal professionals have to continue developing this capacity and be trained to learn about [ESG] and see the value in being well-versed in the subject.

Kao: What are some specific examples of ESG strategies that you’ve successfully deployed?

Seeger: Two years ago, KKR Capstone hired a full-time energy engineer who works solely with KKR private equity portfolio companies and real estate portfolio companies to help them think through what is the business case for resource efficiency improvements, what vendors they can use, what are some of the best practices that others are applying. And so,

by providing this resource and guidance, we’re really able to drive more progress.

The other is the Responsible Sourcing Initiative, which we’ve been running with BSR as our partner since 2010. And in that case, we’ve been going to large numbers of portfolio companies, almost 30 companies, to help them assess what are their policies and procedures related to low-cost country sourcing.

Kao: Do any of your firms tie ESG factors to compensation or other incentives for the deal teams? And if not, do you think that that’s something that will be coming in the future?

Coker: Identification of ESG factors is integrated into the due diligence process and is included in Investment Committee memos. Deal teams are focused on these factors from the beginning of an investment to understand how these issues may impact the risk/return profile of the investment.

Seeger: In our case, compensation isn’t tied to any one particular KPI of any sort—ESG or not. It’s really evaluated on three criteria: commercial impact, living the firm values, and leading and managing people.

Kao: Have any of you been witness to losing a deal because you pressed a potential investment on ESG factors?

Roberts: No, but I think the reverse has been true, which is that we’ve had some deals come along, with a very strong ESG component, that have been highly sought after and we lost because it got bid up to a level that our deal teams felt like we couldn’t match it. ■

The Rise of ESG at KKR

In a keynote interview with Georges Dyer of the Intentional Endowments Network, the head of public affairs at KKR—also a veteran of the political scene—discusses the motivations behind KKR's embrace of ESG as a tool for value creation



Ken Mehlman

Member and Global Head of Public Affairs, KKR

Georges Dyer

Principal, Intentional Endowments Network

When Ken Mehlman joined KKR in 2008, he felt that the investment giant could be a better investor if it better understood the broader impact of its investments.

That feeling evolved into KKR's growing emphasis on ESG—environmental, social, and governance—issues in its investment process. "It was always something that was done, but it was done in a way I would describe as kind of a cottage-industry way," says Mehlman, whose career has included stints as Republican National Committee chairman and manager of George W. Bush's 2004 election campaign. "And our job was to take and build a systematic approach that could become essentially part of the KKR DNA."

Part of the solution involved placing ESG-related responsibilities within investment committees, Mehlman says, rather than as a separate function. "It's so important because, in my judgment, the risk is this can become just PR, greenwashing," he explains. "And the other risk is that it's something that someone views as someone else's job." In practice, the structure leads to accountability not only for the person on the investment committee responsible for ESG considerations, but also for the person who sourced the investment.

KKR's ESG strategy also involves being public and "explicit," says Mehlman. "If you're serious about something, you should talk about it, and you should challenge yourself to constantly improve how you do it."

When searching for strong financial performance and while mitigating non-financial risk, KKR's approach varies based on geography and industry. For instance, cybersecurity and sourcing are especially relevant in the retail industry, where there are often very long supply chains that include factories and operations in developing and emerging markets, he says. The firm also evaluates companies' "license to operate," says Mehlman. "Do you understand the countries where you're operating? Is the company welcome in those countries?"

Paying attention to the diversity of a company's employees is also crucial. "If you want to recruit the best people and you walk into the room and they all look like you and me, a lot of folks are going to say, 'I don't want to work there. What's going on there?'"

Mehlman explains that a number of KKR's portfolio companies are what KKR calls "solutions investments." He explained by using the example of milk and infant formula, along with other products in China that were tainted with melamine. A KKR team in China saw an opportunity to not only help solve the problem of food safety risk but also build a business. They partnered with a local Chinese entrepreneur, acquired a large number of dairies, and built a business that offered the same kinds of public health protections found in the U.S.

With several other large private equity firms allocating more manpower and thought to ESG issues in their investments, Mehlman says that KKR hopes the firms can continue to learn from one another. "We all constantly work to improve our work here." ■

The Day in Photos

Images from Privcap's inaugural ESG conference





How PE Can Get Past ESG Roadblocks

Although there's no set monetization or regulatory mandate for ESG, a pre-acquisition screening can uncover more about a company than PE might realize



Alan Kao
Principal and Global Service Line Leader for Compliance, Strategy & Transaction Services, Ramboll Environ



Adam Johnston
Principal and Due Diligence Practice Network Leader for the Americas, Ramboll Environ

There are two common roadblocks to implementing an environmental, social, and governance program at a private equity firm: no regulatory mandate or solid way to monetize results.

Although due diligence assessment of ESG matters is still in its early days, it is becoming clear that such assessments face several challenges that are not common to other areas of due diligence.

To help deal with these challenges, Ramboll Environ has developed an ESG screening process that can be used in due diligence of a potential portfolio company. “We had to develop processes that are efficient, yet still produce actionable results, while not being overly intrusive in the operations of a target company,” says Adam Johnston, a principal and due diligence practice network leader for the Americas at Ramboll Environ.

Ramboll Environ—a unit of the Danish global consulting engineering group Ramboll that is focused on creating livable and sustainable urban development solutions in cities around the world—is one place that companies or, increasingly, private equity firms turn to when they consciously want to take steps to meet investor demands to evaluate and improve on ESG performance of portfolio companies.

The level of access they generally get during the diligence process gives them the ability to look at ESG within a company in an efficient manner, says Alan Kao, a principal and global service line leader for compliance, strategy & transaction services.

Some of the things that might be looked at when evaluating a company's ESG performance are whether there are environmental management systems in place and the amount of greenhouse gas emissions, water use, or product-stewardship issues; on the social side, they look at the worker health and safety program and its performance, the resources dedicated to stakeholder and community

relations, and a human rights program if it's applicable.

Kao says that the ability to conduct an ESG screening of a target company depends on the circumstances of the due diligence process. “As a rule, we can learn a lot more during an exclusive deal than in an auction situation. In an auction, even if exclusivity is eventually given, the issues that you can explore during the diligence period are limited by the seller. It's not unusual to find ESG-related requests might be delayed. However, if we're able to visit the site or have a conference call with management, you can learn a lot about a company and where they stand on ESG issues.”

As an example, Kao points to a recent ESG screening on a pipeline construction deal. “From diligence, we recognized that engagement was low for certain stakeholder groups, and opposition to the project would be high. There was a strong likelihood that the schedule would be delayed due to litigation and public opposition. Our client went into this deal with an awareness of these issues and prepared for such potential opposition.”

If there is no formal ESG program in place, the first 100 days after acquisition is when there is the greatest propensity for a company to change and implement one, Johnston says. If there is a program, many times it's under-optimized. In some cases a company is capturing one type of ESG opportunity but not others.

Kao agrees and says that for those companies without a formal ESG program, they're looking at things like reducing water use and substituting raw materials with third-party waste by-products, because they make good business sense. “They're doing what we like to call ‘random acts of sustainability,’ but not under the umbrella of an overarching ESG program. That's what private equity can bring to companies—a formal approach to evaluating the risks and opportunities with respect to ESG.” ■

Investing to Mitigate Environmental Impact



Elizabeth Seeger
Director, Public Affairs,
KKR



Elliott Bouillion
President & CEO,
RES



Robert Antablin
Member & Head of Americas
Energy Private Equity,
KKR

Founded in Louisiana, Resource Environmental Solutions (RES) is dedicated to offsetting the environmental impacts that usually occur in large-scale infrastructure and commercial developmental projects such as roads, rail, pipelines, and manufacturing and power plants.

RES acts as a steward for sustainable development. The company has planted 11 million trees; it preserves and conserves habitats and restores streams and wetlands, among other ecological solutions. RES helps to streamline the permitting process, saving developers time and money by tapping a highly credible ecological team.

The company found an eager partner in KKR, which has several companies in its portfolio dedicated to providing solutions to ESG-related challenges and where consideration of these issues is core to its business plan.

At Privcap's Private Equity ESG Summit, KKR's Elizabeth Seeger sat down with Elliott Bouillion, CEO and President of RES, and KKR's Robert Antablin, who leads energy investment for the firm, for a conversation about the trends that are fueling RES's growth.

Elizabeth Seeger, KKR: Before KKR had the opportunity to invest in RES, what was the firm's view on the ecological services opportunity?

Robert Antablin, KKR: We are focused on ESG issues when we make investments. The energy sector, obviously, deploys large assets on sites, which have an impact. And so we spend a lot of time thinking about different ways in which

we can deliver better environmental performance. Ecological services are basically premised on facilitating economic development in a responsible way.

Anytime development happens in protected ecosystems, permits and mitigation strategies are required, and they need to be approved by the relevant regulatory bodies.

Roughly half of the demand in this market relates to mitigation that is required to facilitate new or [replacement] road and highway construction in the United States. And so there's a very, very robust demand outlook.

Seeger: Elliott, why did you think private equity would be a good partner to help your business grow?

Elliott Bouillion, RES: We were looking for a way to scale up our company for the future. We had spent almost eight years proving out our business model, and understanding how to manage and grow with new solutions and new geographies. To scale it up nationwide or serve our clients globally, we really had to reach out and find a partner. We spent about three years getting prepared to attract someone that could help us grow globally. Through an extensive process, we found that partner in KKR. We've leveraged KKR Capstone [consulting] resources for insights, guidance, and best practices. It's not all about capital—it's about people who can understand your business, people who help your business.

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The Business Case for ESG



Dan Mistler
Senior Manager,
Climate Change and
Sustainability Services,
EY

Mistler explains why businesses are now proactively building ESG strategies

“There is a sense in the business community that now ESG is evolving quickly into a hot issue. On the practitioner level, the ability to draw a business case for ESG is going to continue to get better.

“There are value-creation opportunities, and there are better stakeholder relations around having an ESG policy—looking at impacts and disclosing or reporting what they mean to your stakeholders. In the past, a lot of businesses did this on their back foot, because they were responding to stakeholder pressure. Now businesses are interested in ESG more, because they see that there can be a risk-management or value-creation opportunity.

“The identity of ESG is changing from something that felt fluffy before to something that businesses can really make money with. And that’s about the ability to draw a business case between interventions and business outcomes.

“One of the things that is needed is a bit more standardization, particularly with KPIs. The more agreement and standardization relevant to specific businesses, the better. Due diligence will be easier. From an analyst standpoint, they’ll know right away what to ask for.”

Seeger: Why would a big company think about hiring RES to do ecological work instead of hiring a team to do this internally?

Bouillion: Most of the big corporations we work for want to focus on their competencies. Regulation is changing every day, and it’s been that way for a long time. And the problem is, it’s not about just knowing federal regulation. It’s about understanding state and local regulations and how they are implemented. We have more experience about the transactions that are going on in the ground. The impact of developing a site in Louisiana is fundamentally different than the impact of developing a site in western Pennsylvania. Therefore, the type of mitigation that’s required is different. The methodology for determining impact is different. The regulator that you have to negotiate with is different. So it’s a complex, highly nuanced business that takes a team of professionals known for responsible environmental stewardship in all aspects of ecological solution delivery.

Seeger: What trends are you seeing that make you optimistic about the future growth of your business?

Bouillion: Take coastal restoration, for instance—we’re seeing a lot of capital set aside for this. Most of our coastal communities along the East Coast and the Gulf Coast have done a lot of planning over the last 10 years, and it’s now time to get projects in the ground. Our country has many infrastructure challenges, and there are a lot of new projects out there, including rail, bridges, roads, ports, and terminals. We’re planning to provide solutions in those areas as well.

Antablin: Another key area of focus is water quality. We have a number of issues with legacy infrastructure. One good example is the Chesapeake Bay, which receives storm water runoff containing the contaminating pollutants nitrogen and phosphorus from agricultural fertilizers. So there are opportunities to provide green infrastructure to essentially eliminate or create catch basin areas for storm water runoff before the nutrients are conveyed from urban areas. ■

Why ESG Is Important to LPs



Megan Bethke
Senior Portfolio Manager,
APG Asset Management US Inc.



Deborah Spalding
Chief Investment Officer of
Pension Fund Management,
Connecticut Office of the State Treasurer



Sondra Vitols
Senior Investment,
Research and Policy Officer,
North Carolina Retirement Systems



Peter Ellsworth
Director, Investor Program,
Ceres

Investors are spending time and energy petitioning their portfolio companies about adopting sustainable business practices in areas including energy efficiency and renewable energy, improved water management, better waste management, and many operational and fair-practice concerns up and down the supply chain. Four prominent LPs discuss how they work with their GPs on incorporating these ESG issues.

Peter Ellsworth, Ceres: Briefly, what formal or informal policies, or philosophies, does your organization have concerning ESG? And how do material ESG risk and opportunity factors get incorporated into your due diligence process for private equity?

Deborah Spalding, Connecticut Office of the State Treasurer: ESG and the questions to ask and the things to look for varies by industry, varies by GP. And so you have to have a commitment, but also recognize that it's implemented in different ways depending on the type of investor you're speaking with. We have had a commitment to ESG in the state for quite some time. In fact, statutorily, it is written into Connecticut law that we can consider ESG factors when making investments.

Candidly, our ESG program evolved out of the public markets. And so as we expanded ESG into private equity, we had to really rethink our approach. We have a formal ESG questionnaire that we ask all of our GPs to fill out. And we were finding that our GPs were not filling them out in a robust manner that we had expected. And we realized that we really had to rethink it and make it much more private-equity focused.

Megan Bethke, APG: APG implemented its responsible investment policy nearly a decade ago to ensure that our investments demonstrate social responsibility and integrity where

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we're seeking to enhance our risk-return profile by incorporating the non-financial elements into our investment process. And the Dutch pensioners and participants are attaching growing value to the knowledge that their money is being invested responsibly.

We're looking to invest in companies that pay sufficient attention to human rights, labor rights, environmental concerns, [and] corruption as some examples [of what] we take seriously. APG has a team of 13 professionals globally who sit on the responsible investments and governance side of the business. One professional spends much of her time on private equity and has helped lead ESG integration into APG's PE investment process.

Sondra Vitols, North Carolina Retirement Systems: We established our ESG policy—which is called our long-term stewardship policy—last September [2016]. And so we're building out the implementation of our due diligence process for our external managers. A lot of it leverages what we've done to date. A lot of it's around issues relating to governance, both for portfolio management companies and our own relationship to the GPs.

The outcome of this is really identifying particular risk areas that occur by industry that will have exposure within a private equity fund that we may anticipate making an investment. And then addressing how those risks are mitigated.

Ellsworth: When you periodically review with your GPs the legacy investments you have with them, how, if at all, do your updated understandings of material ESG risk and opportunity become part of that discussion?

Spalding: That's a very good question, because most of the heavy lifting happens at the due diligence to commit to

a GP. And then it's incumbent upon us to follow through. Most of the engagement that we do with legacy investments are in GPs that are far along in the program. And so we typically will reengage on issues, especially around governance, when we get to the tail end when we're trying to deal with the remaining dispositions of certain assets.

But I did want to reiterate that although we take ESG very seriously, it's a balancing act—where do you set the bar? Our goal is to make money. We've got to pay pension benefits, so that's our primary goal. And so we look at ESG within that context.

Bethke: APG has been making PE fund commitments on a direct basis for the past four years. We're starting to see our first re-ups, and we certainly engage on a regular basis with our GPs to stay abreast of any ESG risk or opportunities in their portfolio. We do it formally through our reporting requirements; we're expecting the GP to report at least annually on ESG. We're looking for reporting on a by-company basis in line with APG's ESG reporting template.

And as we get closer to the re-up, we'll reengage on some of the specific areas that we see for further improvement for the subsequent fund.

Vitols: For us, it's a review of what the projected performance was relative to what's been realized. And then also thinking about whether we've been compensated for the illiquidity premium inherent in this space. If the performance is lacking, [we're] seeing how that may relate to some material ESG factors that account for that lack of performance. And in certain cases, we are active in the secondary markets and will look to sell our shares.

North Carolina also tends to be part of an LPAC membership, the LP advisory boards, for our investments.

And we think a lot about how that board is structured, what our rights are, under what conditions we can exercise control and in some senses work cooperatively with other LPs if needed.

Ellsworth: If one of your peer LPs wanted guidance on incorporating ESG risks and opportunities into their own private equity strategy, what advice would you give?

Bethke: There are great resources available from UNPRI and American Investment Council. PRI recently released the new ESG DDQ. So there's a lot of existing literature, guidelines, best practices out there ... I've also found, from GPs and LPs who are looking to develop their ESG practice, just talking to your peers and learning about their specific processes really helps to further your own program and think about what's in the best interest of your constituents.

Vitols: There are a lot of ESG issues out there. Not all of them matter to investors, and not all of them necessarily matter to private equity. You need to get fairly granular and think about what's material by industry type. We spent a fair amount of time thinking through what the evidence was out there for incorporating various ESG issues by asset class and strategy, which is why we have this more granular approach about thinking what's material by asset class and by strategy.

Spalding: One of the biggest issues for LPs that are new to this is simply defining, for their program, what is ESG. And it's very broad, but we would all define it differently. And the other challenge is, [in] private equity, you're investing in very idiosyncratic investments. It's not like public equities, where you have benchmarks and screening tools. ■

Inside KKR's ESG Platform

Alisa Wood
Member, Client and
Partner Group,
KKR

Alisa Wood, who leads investor relations and product specialist functions for KKR, describes the rationale behind the firm's creation of an ESG platform, designed to conform to responsible investment principles as well as serve as a value-creation mechanism for portfolio companies

David Snow, Privcap: Can you talk about what KKR has done to date with regard to ESG and how you've sought to implement it into your business?

Alisa Wood, KKR: A number of years ago, as we always do, we were trying to figure out ways that we can add value and drive returns in our portfolio companies. What we really tried to do, across all of our industry groups around the world, is make ESG part of the framework, just like we would operational value creation in any of our businesses. So we built it in part of our operations team, and we have that team work with each of our deal teams in every single company we either looked at or actually went on to buy.

How can we add value by doing good things in our businesses? Things like the green portfolio—how can we reduce paper usage? How can we reduce water usage (depending on the company)? How can we grow jobs, which is part of that governance framework? It was that, at the end of the day, which really started some of the ESG trends you're starting to see across the GP community today.

It's been observed that the European institutional investors took an early interest in ESG, and that enthusiasm and those demands have slowly made their way over to the U.S. What have you seen?

Wood: The European investors were definitely on the cutting edge of this, and it was probably even more of the Dutch investors or Scandinavian investors that really led the charge on this. But today, we get asked the question regarding ESG—what we do, how it creates value in our portfolio—in almost every client meeting we're in. It's a page we have in every investor presentation, whether it be something we're marketing or something that's an update. It's in every diligence questionnaire we get. A number of the largest institutions in the world actually have their own ESG questionnaires.

Given that even U.S. LPs are now very interested in ESG, are you getting calls from friendly rival firms asking, "What is this, and what am I supposed to do?"

Wood: Yes, we get a lot of calls on that. At least in our view, it's not one size fits all. It can't be. The larger firms can take a different approach from some other firms. A lot of it has to do with resource allocation.

What I think has been unique (and we've seen this across the industry) is that the UNPRI principles are a good standard practice that, regardless of your size—small or large—you can use those as a guide or a framework. The next iteration may be the version 2.0 or version 3.0—how do we then drive that value in the portfolio? And that's where you really need more resources to do that.

Can you give an example of a type of information that you would track across portfolio companies, and any specialized type of information that you would track?

Wood: Depending on the type of business, we may be tracking carbon emissions. Or if it's an energy business, we may be tracking water usage. Or if the business has some type of fracking component, how do you track the waste of the water? Those are very tangible metrics that we are very focused on. More broadly, on the bigger ESG topics, [we track] things around employee growth, labor standards, and different practices we have. Those are all different parts that we track, depending on how specialized you are or the type of business you have. ■

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