ERM's Global Environmental, Social and Governance (ESG) Survey of General Partners (GPs) and Limited Partners (LPs), 2016

ESG: The Multiplier Effect

ESG leaders have enhanced access to funds, margins and exit multiples

70%

of survey respondents have seen ESG issues materially impact their investments

5%

Only 5% of portfolio companies have realised the full sustainable value creation opportunities

95%

of survey respondents believe there is significant untapped value from ESG in their portfolio companies

The world's leading sustainability consultancy

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Foreword
Value Creation through ESG

Against the backdrop of a record nearly $4 trillion of assets under management (AUM) in Private Equity (PE), we have seen 195 countries pledge their commitment to the COP21 climate action pact, continued growth in the number of UN-backed PRI signatories and investors showing ever-increasing interest in the ESG performance of their underlying portfolios.

In this context, ERM set out to complete a survey of the Private Equity sector to investigate the impact of ESG issues on the value of their investments. The purpose was to identify enabling success factors, the extent to which there are significant untapped opportunities within portfolio companies, and the potential for unlocking such opportunities.

This report presents the results of the survey, which involved interviews with 60 General Partners (GPs) and Limited Partners (LPs) from 17 countries across the globe, representing approximately $1.3 trillion AUM*. The majority of firms interviewed are PRI signatories and as such ERM's survey findings provide insight into current ESG practices and ideas for realising value from many of the leading firms in the sector.

70% of the survey respondents told ERM that they have seen ESG have a material impact on their investments to date, either creating or eroding value. The respondents realising value from ESG tell us that there is a substantial prize to be attained by portfolio companies through robust ESG performance, whether this is enhanced margins in assets and services (40%), growth from new products and services (20%), positive contribution to the exit multiple (10%), or reputation enhancement (30%).

The survey responses indicate that 'unlocking-value' from ESG requires an increased maturity of programmes, which can fully address linkages between material issues and company strategy in a way that generates commercial benefits. To date a number of GPs and LPs have had success, enabled by firm senior management buy-in and inputs from ESG teams, in embedding processes at the firm level and an increasing number have started to engage with their portfolio companies to identify and report on ESG issues. However, only 5% of portfolio companies indicated they had accessed the full value creation opportunities and therefore there is a need for the engagement to be deeper and broader to capture significant value from such initiatives.

With over 95% of survey respondents confirming that there is significant untapped value from ESG within their portfolio companies, there is clear potential for further gains. However, as one survey respondent explained, 'it's all about the exit and value realisation but ESG does not consistently fit on that agenda'.

So what is next for ESG?

Many respondents noted that it would be a real game changer if LPs started to explicitly recognise good ESG performance in their investment decisions. It was very interesting to note that some GPs have already benefited from increased fundraising as a direct consequence of the outcomes of their robust ESG initiatives. Beyond LP recognition, the survey has identified three key actions that could 'move the needle' and unlock the significant untapped value identified by survey respondents. We hope that firms reading this survey find inspiration for ideas which create business value for them.

I would like to thank the GPs and LPs that took the time to participate in this survey and share their insights. We strongly believe that we are seeing evidence that ESG is adding material value in private equity investments; we are encouraged that this seems to be the tip of the iceberg. Significant value enhancement remains to be achieved through in-depth ESG engagement with individual companies, scaled across entire portfolios, and which is informed by an understanding of strategic ESG drivers that may impact the value and growth plans of companies looking ahead.

Keryn James
Global Director of Operations

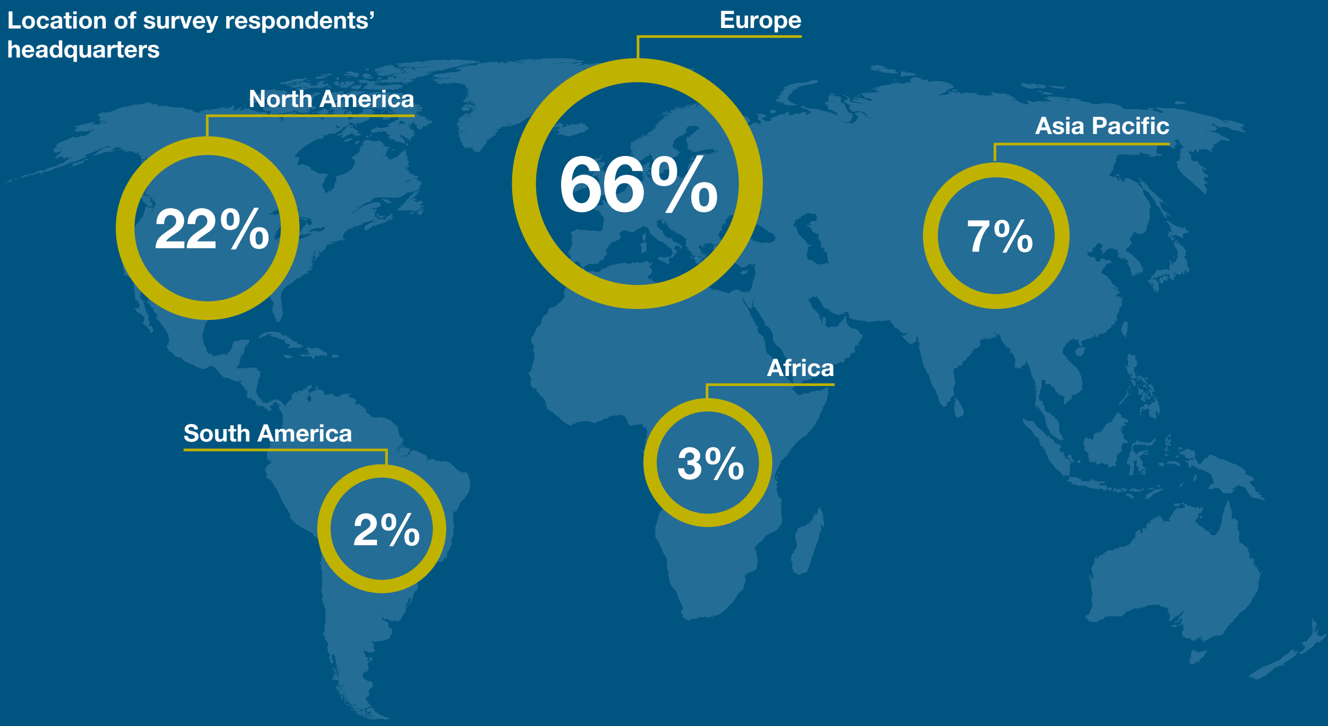
**for LPs this represents their private equity investments only*

Overview ↗ of Survey Respondents

60 General Partners and Limited Partners surveyed worldwide

70% Survey respondents are signatory to the PRI (Principles for Responsible Investment)

Location of survey respondents' headquarters



Survey respondents' Assets Under Management (AUM)

27 Large cap firms >$10B AUM

23 Mid cap firms $1-10B AUM

10 Small cap firms <$1B AUM

Survey respondents' geographical area of investment focus

Is **ESG** having a Material Impact?

70%

of survey respondents have seen ESG issues materially impact their investments. Respondents confirm that ESG is a contributory factor that can deliver enhancement in the value of their investments through positive impact to margins and multiples at exit, or erode value if not addressed appropriately.

"The gap is getting bigger between best in class and followers".

European LP

"Robust ESG management is a proxy for good business".

A North American large cap GP

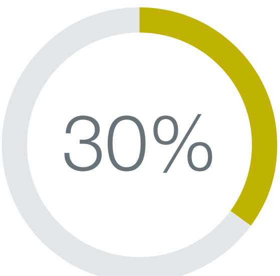
Value Protection

60%

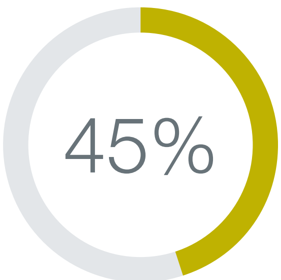
of the above ESG material impacts to date have come from protecting value.

It is perhaps not surprising that so far, the majority of the ESG benefits experienced by survey respondents have come from value protection. The ESG aspects of value protection tend to be easier to assess, and hence monitor and report, when compared to value enhancement aspects.

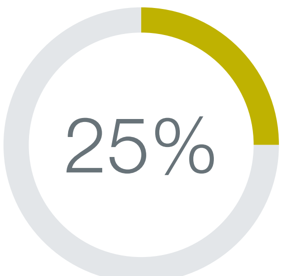
Respondents tell us that value protection has come from:



Reduction in Liabilities
For example health and safety claims, contamination



Proactive Risk Mitigation
For example reduce absenteeism and disruption costs



Licence to Operate
For example minimising community actions / protests

Value Enhancement

Of the 40% of material ESG impacts coming from value enhancement, respondents tell us that the breakdown is as follows:

Higher Exit Multiple

10%

Investors noted that for around 10% of portfolio companies experiencing commercial benefit from ESG, this has led to a positive contribution to the exit multiple. However, all survey respondents agreed that this impact was hard to measure, and was not generally quantified.

"ESG factors do impact multiples on exit certainly in some cases where there has been a revenue enhancement initiative with strong growth potential, but it is difficult to demonstrate what the actual contribution was as it is intertwined with other enhancement aspects"

European mid cap GP

Margin Enhancement

40%

Energy, water and waste reduction are the top three efficiency programme themes for physical assets (e.g. associated with manufacturing and retail portfolios) and services (e.g. logistics operations).

A North American large cap GP has achieved over $60M in operational savings across its portfolio of companies since programme inception. This has been achieved largely through no cost and low cost operational performance improvement tactics that did not require large amounts of capital.

$60M **Operational Saving since ESG inception**

Brand and Reputation

30%

Overall 30% of portfolio companies experienced commercial advantage from the uplift which ESG gave to their brand and reputation.

Although widely acknowledged as difficult to quantify, ERM heard from several respondents that the ESG impact on a portfolio company's brand and reputation had opened doors to new clients, as well as making companies more attractive to buyers at exit.

"The quality of management is reflected by good ESG management – this has an impact on the multiple you get for the value of the company".

Emerging market mid cap GP

"For this [portfolio] apparel company, ESG was a key part of its proposition, a case where the brand and revenues were both integrally linked to the ESG proposition of these products"

North American large cap GP

Growth

20%

Respondents noted that 20% of portfolio companies experienced value enhancement from growth in new products and services, including:

- A 'greener' or externally certified product, enabling the targeting of new customers or markets
- New clients and higher rental rates from sustainable retail and office space
- Demonstrating corporate social responsibility to government clients (especially in emerging markets)
- Delivering enhanced health and safety performance to gain blue-chip clients

"An industrial equipment portfolio company realised €200M+ in annual revenues from their eco product range (€50M+ revenue growth in less than 5 years). This is driven by the significant cost savings for customers from the increased energy efficiency of the eco product range, which is up to 50% more energy efficient than the traditional product lines"

European large cap GP

€50M+ **Revenue growth in less than 5 years**

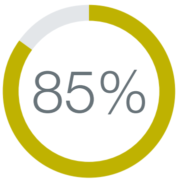
What is **Enabling** ESG **Success** in GPs?

"Investor pressure is the clear driver and the main reason why we initially embarked on the programme…"

European large cap GP

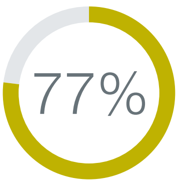
Recipe for Success

Survey respondents noted the following key factors that have enabled their ESG success to date.



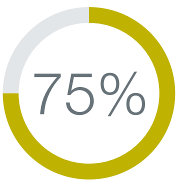
Senior management buy-in:

A large cap North American GP noted that: *"The ESG journey begins with Fund Senior Management buy-in, [which] sets the tone and is most critical"*. Another European based mid cap GP commented that: *"the number one priority for success is the tone from the top"*.



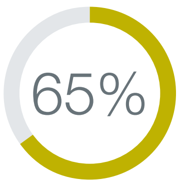
Input from ESG teams (internal/external):

A European mid market GP noted: *"Strong ESG management requires competent individuals who have operational experience as well as sufficient resources (either internal or external). Without sufficient firm-level resources the approach to ESG can lack consistency, breadth and scalability"*.



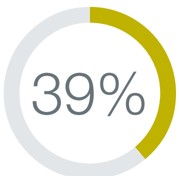
Integration of ESG in deal and operations teams:

"Our main success has come from buy-in from deal teams who sit on the board of companies, raising awareness internally through ESG training and highlighting some good ESG practices and success stories in the portfolio" European large cap GP.



Portfolio company management:

Proactively addressing ESG and recognising opportunities to do so. Whilst portfolio companies have addressed some opportunities, they have also managed to enhance the impact and breadth of their programmes through the support of the GPs.



Sharing of best practices between portfolio companies:

Respondents are finding synergies between their companies and sharing good practice and tools, for example through portfolio-wide share and learn seminars. However, it is a challenge to do so where assets are spread across different geographies, lack a similarity of operations or level of GP influence is low (i.e. in minority positions).

60%

of survey respondents cited enhanced firm-level ESG processes (including the development of in-house skills and resources) as an early success.

30%

of survey respondents cited technical ESG programmes in portfolio companies as an early success (such as portfolio wide energy efficiency and Anti-Bribery and Corruption initiatives).

16%

of survey respondents referenced product and service sustainability enhancements (percentage was higher amongst European GPs compared to others).

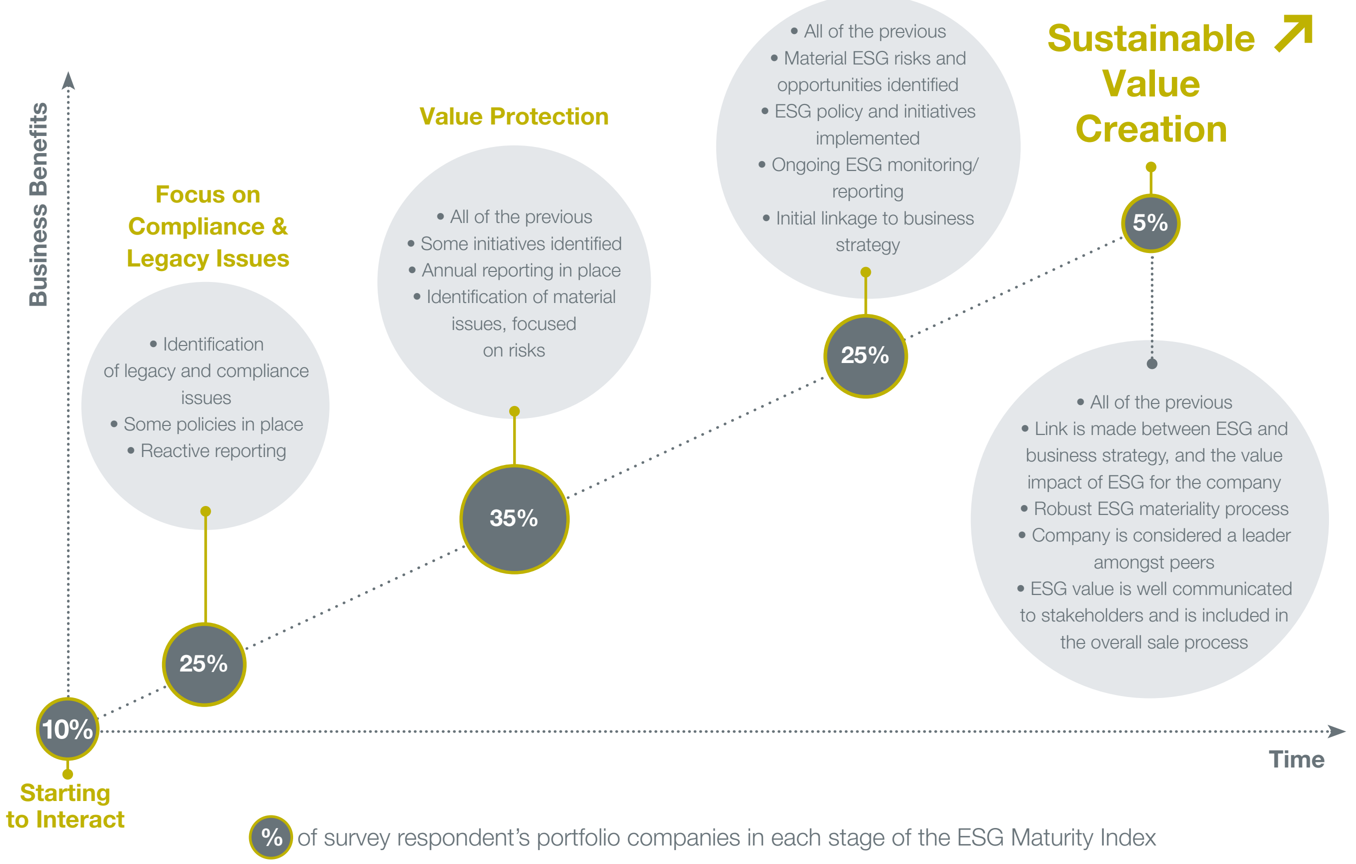
How is **Engagement** ↗ **Creating Value** in Companies?

ERM survey data shows that less than half of respondents have engaged with more than 50% of their portfolio companies.

The survey responses indicate that 'unlocking value' from ESG programmes is the result of an ever-evolving approach to ESG management that represents a journey towards sustainable value creation. To date GPs and LPs have worked hard to embed ESG processes at the firm level and an increasing number have engaged with their portfolio companies to identify risks and opportunities in response to strong senior leadership, peer GP-firm and investor pressure but there is a need for the engagement to be deeper to see significant value from such initiatives. Some firms have engaged portfolio-wide but perhaps only on specific topics, for example bribery and corruption issues or energy efficiency. Furthermore where engagement has taken place, more often than not there has not been a discussion on how material ESG issues may link to the company strategy and value plan. As the ESG Maturity Index below indicates, only 5% of respondents have accessed the full sustainable value creation opportunities.

The most significant ESG enhancement examples came from firms which have managed to deliver portfolio company programmes focusing on the material ESG issues and to leverage the opportunities identified across the majority of their portfolio. Furthermore, ERM noted that in the above examples, to achieve the full impact of the ESG programmes, these were linked to the companies' strategies, had board-level visibility and the business outcomes were well communicated to relevant stakeholders, including customers and staff.

ESG Maturity Index
(PE portfolio companies)



Unlocking Untapped Value: Where is the Opportunity?

95%

of respondents believe there is significant untapped value from ESG in their portfolio companies. This suggests that there remains plenty of scope to harness value in portfolio companies from the integration of ESG.

"Identification and raising awareness of why ESG matters, while stripping out jargon can be crucial with investment teams, especially to articulate how ESG may impact the exit process" .

North American large cap GP

Respondents told us that the untapped opportunities relate to:

Risk Management Improvements 91%

Return on Capital 85%

Growth 70%

Risk management improvements, such as:

- Reducing potential for business interruptions from significant incidents (health and safety)
- Enhancing supply chain management
- Protecting companies' social licence to operate

Return on capital, such as:

- Improving employee retention and/or satisfaction related to sustainability products
- Resource efficiency

New products and services growth, for example through:

- Developing sustainable products and services
- Improving and leveraging sustainability of existing products to reach new customers or markets
- Brand enhancement and customer satisfaction related to ESG

A number of firms stressed the importance of linking the deal team to the ESG agenda and encouraging collaboration in this area, to help bring to life the importance and value impact of material ESG issues for the relevant sector and portfolio company. *"ESG is here to stay and no longer a 'nice to do', but it needs to be done in a manner that generates real value and benefits for us and our investors"*, commented a European mid market GP.

Firms making minority investments may not exert significant influence over portfolio companies further down the track, but through completing a robust programme of ESG due diligence they can still ensure that early negotiations address the material 'red flag' ESG risks and opportunities.

Robust ESG Performance ↗ can Enhance Accessibility to Funds

25%

of survey respondents believe that successful ESG programmes in their portfolio companies can enhance the reputation of the GP itself, and subsequently boost their own ability to fund raise.

LPs have to a large extent driven the ESG agenda to date. The 2016 PRI report on progress shows that 44% of LP PRI signatories stipulate that GPs report on agreed ESG implementation activities in fund documentation, and that 41% ask for reporting on ESG-related company incidents. ERM's survey also suggests that LPs have the opportunity to do more. As a European large cap firm noted:

"Some LPs are driving the agenda, but this is a relatively small percentage, especially in the US. If there is broader recognition [by LPs] it will certainly drive change in greater adoption of better ESG performance".

Whilst there was recognition of an increased interest from LPs on ESG issues, respondents mentioned that engagement by many LPs is currently focused on compliance [with their requirements] and does not always include a discussion on effectiveness of ESG programmes and outcomes generated in underlying investments. However, respondents noted that a few LPs have started to look for evidence that ESG policy and practices are embedded throughout the investment lifecycle and are looking at the outcomes of such practices.

"Investors should be tough in setting a performance level expectation and then have the resources to follow through so that these expectations are met".

European LP

Where LPs can have such outcome-related conversations with their GPs and the data allows them to assess outperformance, this can drive ESG from a 'compliance stick' to a 'carrot' approach in terms of enhanced fundraising.

A large cap American firm reported LP feedback that the firm was awarded several hundred million more dollars during fundraising, compared to its GP peers. While all firms being considered for investment by this LP had ESG programmes in place, this GP had a very focused strategy, tools to track and measure performance improvement, and definitive financial achievements backed by facts and data.

http://2xjmlj8428u1a2k5o34l1m71.wpengine.netdna-cdn.com/wp-content/uploads/PRI-PE-Report-on-Progress-2016.pdf

Moving the Needle

In closing, when ERM asked investors what, beyond positive LP recognition and senior management buy-in, would really 'move the needle' the most to integrate ESG and unlock further value, the following answers stood out.

Identify

Respondents suggest having appropriate ESG capacity to engage with deal teams early-on in the investment process and to conduct holistic due diligence which identifies a full suite of material ESG opportunities and risks for the target business. Whilst it was recognised by some GPs that it is difficult for ESG issues to consistently fit into the 100/180 day planning process, others noted the benefits of being able to identify ESG value creation initiatives systematically at the onset of new investments, so that there is the maximum time available to reap the benefits during the hold period.

Engage & Monitor

Proactive engagement with portfolio companies at board level, and with operations team at GP level where these functions exist, ensures that business improvement initiatives are implemented and reported to address material ESG risks and opportunities, which support the companies' strategies. Further scalable opportunities may exist to drive successful pilot projects programmatically across the broader portfolio. Some respondents noted that they may consider putting appropriate incentives in place at senior management level to encourage such business improvement ESG programmes.

"Reporting can be a double-edged-sword; however, if scoped to add value and focus on the material ESG issues it can support in the realisation of performance improvements on the ground", commented a European large cap GP.

Communicate & Realise Value

As shown above, the survey data indicates that only a small minority of firms are currently at the point where they can articulate the value impact of ESG initiatives and improvements in their portfolio companies. The development of a robust methodology to link ESG with commercial impact will allow the GPs and their companies to credibly communicate with their stakeholders, including customers and employees, about how ESG performance improvements have resulted in successful business outcomes, attain a leadership position amongst its peers, and help them realise value at exit.

"ESG programmes need to prove their own value for them to receive continued support and attention of senior management at both firm and company level", noted a North American large cap GP.

"Focus [on material ESG issues] and leverage [across similar assets in the portfolio] results in significant value impacts", said a European mid market GP.

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We would like to thank and acknowledge the following GPs and LPs for their insights and time.

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+ ARDIAN
+ Arle Capital Partners
+ Armstrong Asset Management
+ Azulis Capital
+ Bain Capital
+ BC Partners
+ Blackstone
+ Bridgepoint
+ CapAsia
+ Capital Group Private Markets
+ Capvis
+ Carlyle
+ Céréa Capital
+ Cinven
+ Clayton Dubilier & Rice
+ Denham Capital Management LP
+ Development Partners International (DPI)
+ Emerging Capital Partners
+ EQT
+ eurazeo
+ GED Capital
+ Halder
+ HgCapital
+ IFM Investors
+ KKR
+ LGT
+ Lion Capital
+ Magnum Capital
+ MCH Private Equity
+ Nordic Capital
+ Norfund
+ Olympus Capital
+ OMERS
+ Ontario Teachers' Pension Plan (OTPP)
+ Partners Group AG
+ Permira
+ Phatisa Private Equity
+ Qualium
+ Swedfund
+ Terra Firma
+ TowerBrook Capital Partners
+ Triton
+ TPG
+ Vinci Partners
+ Warburg Pincus
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ERM
Sustainable Value Creation through ESG

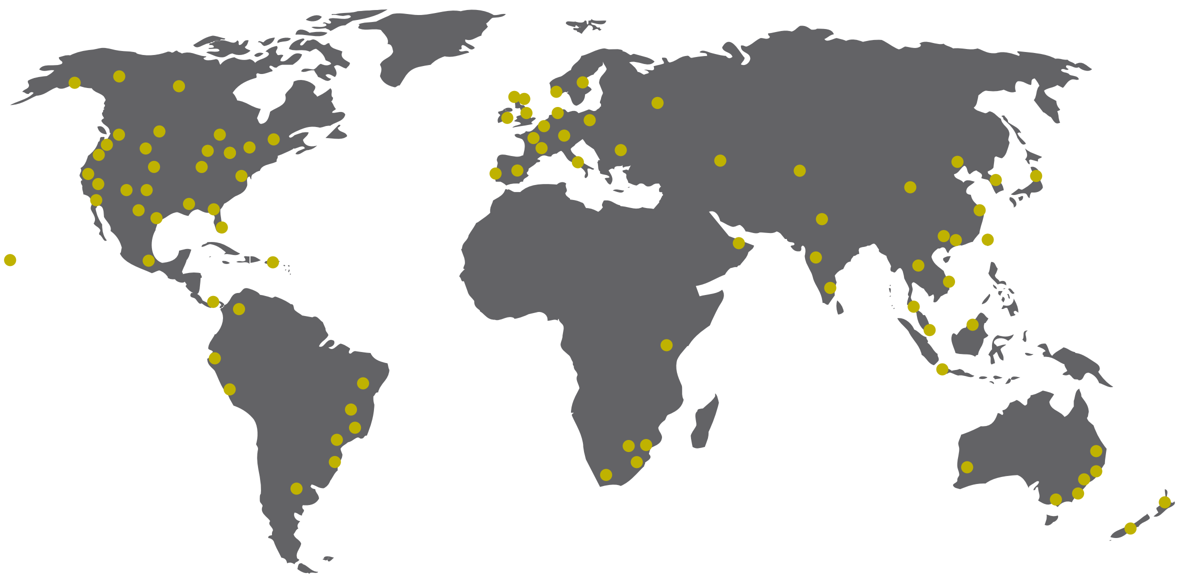
ERM is the global market leader in the provision of Environmental, Social and Governance (ESG) support to over 100 General Partners (GPs) and Limited Partners (LPs). We understand the Private Equity business model and value drivers, significance of fund raising and return on investment driven by earnings growth and enhancing the multiple.

Our team members have a unique blend of technical, GP, LP, lender and advisory backgrounds. We provide a holistic service offering covering full breadth of Private Equity ESG needs across the investment lifecycle. ERM undertakes more than 500 ESG projects annually for Private Equity firms and their companies.

Sustainability is at the heart of the services we provide and how we operate our business.

We have more than 160 offices in over 40 countries, employing more than 5,000 people who work on ESG projects around the world.

ERM's Global Locations



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