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The impact of development mandates (ESG) on private equity fund performance

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A research project submitted to the Gordon Institute of Business Science, University of Pretoria, in partial fulfilment of the requirements for the degree of Master of Business Administration.

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Abstract

The major theme of this research has been to understand the impact of ESG requirements, or development mandates, on the performance of private equity funds.

Semi-structured interviews were undertaken with participants from private equity funds, investors and advisory firms. The research interviews included a number of broad themes: the effect of ESG requirements on private equity fund returns, obstacles to the realisation of ESG objectives, availability of suitable data, the effect of ESG on investment choices, monitoring of ESG performance, and key indicators and methods to evaluate ESG.

The key research findings of the study include: ESG has a positive effect on private equity fund performance, in terms of risk management and improved valuation at exit; in terms of ESG, governance still receives the greatest attention and focus; two areas that hamper the achievement of ESG objectives are the lack of skills and resources, and the weakness of regulatory frameworks in emerging markets.

Based on the research findings, recommendations have been made to further improve the impact that ESG objectives can have on fund performance. These include: development of suitable standards and management systems; integration of ESG into risk and business management processes; and improved tracking and quantification of ESG development impact.

Keywords

Responsible investment, responsible private equity, ESG

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Declaration

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other University. I further declare that I have obtained the necessary authorisation and consent to carry out this research.

_____ _____

Full Name Signature

_____

Date

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1 Chapter 1: Introduction

1.1 Research title

The impact of development mandates (ESG) on private equity fund performance.

1.2 Background to the problem

There is growing awareness of non-financial factors in the corporate environment and the effect of these on corporate performance, referred to as ESG, which refers to environment, social and governance. Environment encapsulates elements such as resource management, pollution prevention, emissions management and environmental reporting. Social refers to elements such as workplace diversity, health and safety, product safety and quality, and community relations. Governance focuses on elements such as executive compensation, board structure and accountability, and corporate reporting and disclosure. Related to this growing awareness, responsible investment and the inclusion of environmental, social and governance (ESG) requirements, are receiving greater attention and consideration across various types of investments, which are commonly referred to as asset classes[1]. This has been in part due to the efforts by the United Nations (UN), as it defined the Principles for Responsible Investment (PRI) with the assistance of the investment community. The principles were defined in recognition of the fact that ESG factors have an impact on the performance of investments and therefore require both consideration and management during the investment process.

It is within this context that this study aims to explore the impact of ESG requirements, or development mandates on the performance of private equity funds. The reference to ESG is used to refer to development mandates, as this is the term that is included in the related literature. ESG requirements place additional demands on the private equity funds, and possibly have an impact on the returns that can be provided to investors. The basis for this study has been the move towards Responsible Investing (RI) and recognition of the necessity to create “sustainable, stable and inclusive

[1] Asset class refers to a group of investments or securities that have similar characteristics, which exhibit similar characteristics and are governed by the same regulations and laws. Source: Investopedia (http://www.investopedia.com/terms/a/assetclasses.asp#axzz2BSlYu1bs)

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markets that are good for business, investment, peace, security and development" (Kell, 2009, p. 7).

Within this context of responsible investment, and a greater focus on ESG, emerging and developing markets are receiving greater attention as investment destinations. Access to finance and the development of capital markets within these markets remains a challenge for the private sector. This has meant that private equity funds or Development Finance Institutions [2](DFIs) have the opportunity to provide the necessary capital within markets where access to traditional sources of funds, such as bank loans, isn't available. The nature of these markets means that the impact of financing activities in emerging and developing markets provides an opportunity to meet specific development goals, and these markets present attractive investment opportunities. However, development requirements may be incongruous to the achievement of suitable returns for investors, but are a prevalent aspect of investment in emerging markets. The nature of development requirements or ESG factors, mean that investment or capital may be diverted to areas within a business, which aren't driven by financial outcomes. Private equity activity within South Africa and the sub-Saharan Africa region, as with other emerging markets, has seen growth over the past few years.

The investment proposition that private equity funds provide is the possibility of achieving abnormal financial returns for investors. However the increasing focus on ESG factors and the requirements of investors place additional demands on the fund managers and may have an impact on this. This is due to the exclusion of certain industries, such as gambling or tobacco, and may result in additional costs being incurred through the investment process, as issues, which are typically non-financial in nature, have to be addressed. The exclusion of industries is typically based on social or ethical concerns. In cases where DFIs invest in a private equity fund, it places additional requirements on fund managers in terms of reporting and management of specific ESG objectives. Joly (2010, p.23) argues "the next frontier in RI effectiveness will be if and when the large private equity funds take charge of progress on the environmental agenda of the companies in their portfolios". However, these varying objectives mean that funds will need to monitor and present concrete strategies for ESG, in addition to fundamental business management strategies. In certain instances this will be a requirement in order to attract required investment from DFIs or IFIs

[2] Development Finance Institutions (DFIs) are government-controlled institutions that invest in sustainable private sector projects with the twofold objective of spurring development in developing countries while themselves remaining financially viable. Source: Dalberg (2009)

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(International Finance Institutions), and are in line with the United Nations Principles for Responsible Investment (UNPRI).

However, effective management of these investments requires that there is suitable information available for the risk assessment of the investments being made, and that the relevant ESG objectives are being addressed. Bassen and Kovacs (2008, p.184) state that this type of information "delivers additional relevant information, allowing more differentiated investment judgements by enabling investors to better assess risks and opportunities".

The approach adopted to explore these topics, is to review current literature that is related to the private equity industry, development finance and ESG; thereafter, through the use of interviews, engage with participants in the industry to determine the current themes emerging in this area. The intention of this study is to develop a greater understanding of factors that influence the achievement of ESG objectives, and any possible effect this may have on private equity fund performance.

1.2.1 Private Equity

"The term private equity is generally used to refer to the investment and management assistance provided by specialist private equity firms funded by wealthy individuals and institutional investors" (Heed, 2010, p. 26).

According to Demaria (2010) private equity provides an investor with the prospect of financing the improvement of private companies and realises the financial return from their success in the future. The investment period is over a short term, not usually exceeding ten years. The typical objective is to maximise the return to investors upon exit, which would result in the sale of the business or possible listing via an initial public offering (IPO). A private equity deal progresses through various steps as depicted below:

Figure 1. Steps from contact to conclusion of private equity investment (Demaria, 2010)

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The fund that is formed is a combination of the equity, which can be invested by the relevant fund manager. This equity is typically provided in stages, the majority of the available equity is via commitments from the relevant investors. The fund represents a limited partnership that is formed between the general partner and multiple limited partners, where the general partner is usually the private equity firm that manages the fund. A general partner is "[responsible for] managing the business of the partnership and is liable for all debts and obligations of the partnership" (Heed, 2010, p.29). The role of the limited partners is to provide the capital that can be used to invest in respective businesses.

1.3 Problem statement

Research conducted by Del Bosco and Misani (2011) focused on the Responsible Private Equity (RPE), which they state is an emerging asset class. They highlight that the strength of this emerging asset class is the ability to exploit business opportunities, while achieving positive social and environmental outcomes. Kumar (2008, p. 131) argues that the nature of private equity investments makes it suitable for the integration of sustainability factors while still being able to generate suitable returns. The challenge in both cases, relates to the ability and commitment of the relevant fund managers to incorporate sustainability or development objectives in their investment strategy and processes.

It would therefore be important to understand the impact of development mandates or ESG on investment performance, and in doing so, to determine the prevailing obstacles and challenges with regard to ESG, that remain within the private equity industry.

1.4 Purpose of study

The purpose of this study is to determine whether the incorporation of development mandates or ESG requirements, has an effect on private equity fund performance.

The objectives of this study will be to address the following:

- To develop a greater understanding of the relationship between the development requirements of investors, and the overall fund performance.

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- To determine the role of ESG requirements during the selection process of private equity funds for investment.
- To determine if the imposing of environmental, social and political requirements on funds affect the overall performance.

1.5 Research scope

This research seeks to gain an improved understanding of the perceptions of participants within the private equity industry, specifically those with an exposure to the African continent. This research does not therefore focus on the values or metrics of specific private equity funds.

The focus of this study will be private equity fund managers, investors and related advisory services that operate on the African continent. The fund managers and investors that have been included have been selected due to the varied nature of their investment strategies; the only common factor amongst the participants being their exposure to emerging markets and at least one investment in Africa.

1.6 Report layout

The structure of the rest of this research report is as follows:

- Chapter 2 reviews the relevant literature;
- Chapter 3 will articulate the research hypotheses to be tested, which are based on the reviewed literature;
- Chapter 4 describes and justifies the research methodology adopted to test the various hypotheses;
- Chapter 5 presents the results of the study;
- Chapter 6 provides a discussion and interpretation of the results observed in chapter 5;
- Chapter 7 provides a summary of the major findings and provides recommendations. It will also offer ideas on areas for possible future research.

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2 Chapter 2: Literature Review

2.1 Introduction

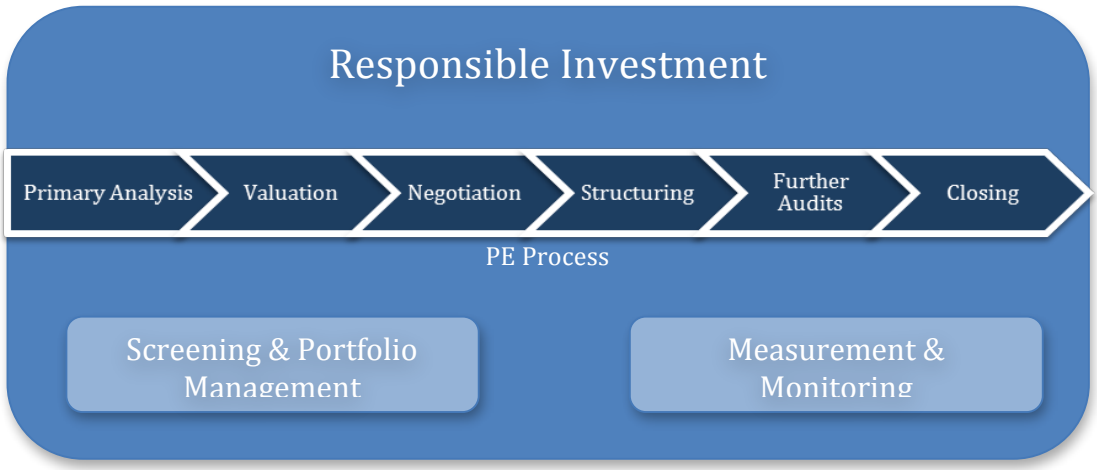
The literature review will explore current research and thinking around the challenges of evaluating and making investments along ESG requirements within the private equity industry. ESG requirements are rooted in principles of Responsible Investment (RI); literature around this will be considered as many of the principles are transferable and form the basis of ESG requirements.

Theory related to the structure and nature of the private equity sector will be reviewed, in order to determine the suitability of this sector as an avenue to achieve ESG requirements. A further aspect, which will be explored, relates to the role various stakeholders play and how they can influence the achievement of ESG requirements. The intention is to highlight any possible shortcomings or frameworks that could be adopted to evaluate the performance of private equity investments.

As part of this review, the role of DFIs and IFIs is explored. Within the developing and emerging markets, these institutions are seen as a key source of funding and viewed as an important catalyst of economic development. DFIs and IFIs will be referred to as Development Finance Institutions (DFIs) for this literature review.

2.1.1 Framework

Figure 2. Private Equity in the context of Responsible Investment



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The primary context that is used for the literature review is responsible investment. It was felt that the principles that governed this form of investment would guide and determine the impact on private equity fund performance, when meeting ESG objectives.

Screening and portfolio management, in the context of responsible investment, requires the consideration of specific elements such as screening approach, exclusions and investment strategies. Similarly the measurement and monitoring of the investment process is guided and informed by the principles of responsible investment. Attention is paid to the use of management systems and the current challenges in effectively measuring and monitoring non-financial indicators.

Finally, the literature covers the role of private equity within this context and the concept of responsible private equity is explored. Particular attention has been paid to the role of limited partners during this process.

2.2 Responsible Investment

From the literature that has been reviewed, it appears that the definition of Responsible Investment (RI) has been through many changes and has been referred to in numerous ways. In certain cases it was referred to as ethical investments or sustainable investments, or in other cases Socially Responsible Investment (SRI). Benson, Brailsford and Humphrey (2006, p.337) stated that the philosophy behind SRI relates to investment decisions being based on financial and non-financial considerations, and that the non-financial considerations relate to “ethical, environmental and moral concerns”. Research conducted by Eccles and Viviers (2011) focused on the various terms and descriptions related to investment practices that integrate ESG considerations. Eccles and Viviers (2011) conclude that the definition for RI is those investment practices that integrate the consideration of ESG, the primary objective being to deliver “higher-risk-adjusted financial returns”.

For the purposes of this paper the definition as outlined by Eccles and Viviers (2011) will be adopted, as it is a broad definition of RI and the aim of this paper is to understand the impact of ESG on the private equity sector.

Joly (2010, p.18) added to the definition of RI, stating that it “represents the voluntary non-governmental approach by the financial community to reforming itself”. This was

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outlined in the UNPRI, whereby principles have been outlined which express a number of possible actions that could be undertaken by institutional investors. The work done by UNPRI has led to an increased focus on RI practices. Eccles (2011) indicates that by 2009 there has been a rapid growth in the number of signatories to the UNPRI and that by this stage approximately a quarter of global assets had been placed behind a RI initiative.

Although this has shown an increased commitment to RI practices, there have been arguments made to the contrary. Lydenberg and Sinclair (2009, p.52) argued that most institutional investors don't incorporate social and environmental factors into their decision-making. Arguments made by Joly (2011) highlighted areas where RI has failed, namely the inability of RI managers to foresee or react to the financial crisis, and the fact that portfolios of RI and non-RI funds are similar in composition. Previous work by Joly (2010, p.22) also indicated that conflicts of interest within the investment environment and "career survival instincts of professionals" responsible for ESG are further hampering efforts with regards to RI. Lydenberg and Sinclair (2009, p.58) highlighted that the "rules of the game" will only have changed when either the legal definitions of fiduciary duties or a change in the culture of capital management takes place. Changes that result in fiduciaries acting based on an understanding of the impact that their investment decisions have on society, and the relevance of this to various stakeholders. These arguments present a number of cases where the incorporation of RI practices or consideration of ESG may actually be a secondary consideration during the investment process.

In support for the incorporation of RI practices and reasons why firms may look to incorporate ESG objectives, alternative views have been presented. Cumming and Johan (2007, p.397) highlighted possible reasons that could lead to a greater focus on socially responsible investment practices. The first reason was the fact that companies with an international or multinational presence tend to face "public scrutiny with regard to their socially responsible investment policies". The second reason was due to the perspectives of institutional investors, who in a recent survey viewed long-term returns from socially responsible investments as favourable. Benson *et al.,* (2006, p.338) argued a similar point, but also added that investors could be attracted to RI as their "personal values are consistent with the underlying philosophy of the relevant fund". A slightly different view is provided by Renneboog, Ter Horst and Zhang (2008, p.1726), who stated that the growth in SRI assets is anticipated based on the greater focus on

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issues such as global warming, emissions trading and corporate governance, which are receiving greater consideration from governments and investors.

2.2.1 Environment, Social & Governance (ESG) Factors

As mentioned above a key aspect of RI is to consider the role of non-financial objectives, ESG factors, during the investment process. Cumming and Johan (2007, p.397) provided further support for this argument, highlighting that an effective SRI programme should aim to deliver the best possible return for stakeholders, "at an acceptable risk, with the idea of combining social, moral, legal, and environmental concerns". The argument by Cumming and Sofia (2007) described an important aspect of the responsible investment paradigm, that the pursuit of ESG objectives should not introduce undue risk into the investment process.

An alternative view provided by Bassen and Kovacs (2008, p.184) argued that there wasn't "conclusive evidence which could universally either confirm or refute a direct causal link between good environmental, social or governance performance and a firm's financial performance". However, they elaborated further that it provided an indication of the risks and opportunities that are faced by a company, and "[allow] enhanced security selection and risk management". This would be particularly important from both from an investor and an asset management perspective. Investors would seek the most appropriate funds or asset classes for investment, and asset managers would aim to construct the best possible portfolio. In both the cases the driver would be to achieve the best possible returns, at an acceptable level of risk.

The level of risk to manage would occur at various stages, namely the investment stage, management of the portfolio, and upon exit to limit the impact of any possible legacy concerns. According to a report by UNEP FI (2006, p.12) the following are some of reasons that investors and asset managers should incorporate ESG issues into the investment decision-making process:

- It would improve the management of risks "through identification of material, but often overlooked, investment issues".
- It provides an opportunity to increase profits; this is based on the impact that the inclusion of ESG issues can have on company valuations. This has a direct impact on equity valuations and portfolio construction.

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- Asset managers can take advantage of a growing market by incorporating ESG issues into the investment management process.

For asset managers this increased focus on ESG has an impact on the investment process, and in particular the due diligence process that has to be followed. The due diligence[3] process would be used to highlight any potential risks or existing liabilities within a company, which could be financial or legal in nature. According to Dowse (2009, p.660), an ESG due diligence is conducted at the same time as the traditional due diligence, such as financial and legal. Dowse (2009) argued that this process could highlight opportunities, which could inform the valuation process. An important point that was raised is the fact that it is necessary to assess the importance of the ESG issues to the transaction and the future of the relevant company, and to use this to determine the amount that should be spent on the due diligence process.

From an investor perspective, this is particularly important when selecting an asset class or asset manager to achieve development goals or incorporation of ESG objectives. Through the evaluation of key indicators, it would be possible for investors to effectively manage their risk while still achieving their desired objectives. In the case of DFIs there is a clear requirement with regard to ESG; however, there is also a firm requirement for financial return. The UNEP FI and PRI (2011, p.10) highlight possible steps to be included during the due diligence process, some examples are as follows:

- Include questions on ESG integration and/or portfolio company risk management.
- Provide a general partner with a statement explaining its PRI commitments and responsible investment policy, and request information on how the general partner plans to address these commitments within the fund.

However, a theme that has recurred through some sources of literature is the lack of available information and standardised approaches for monitoring and reporting of asset performance. According to Heed (2010, p.36) “there have been efforts made by relevant trade associations to standardise this, but it has proven to have little effect in

[3] Due diligence is an investigation or audit of a potential investment. Due diligence serves to confirm all material facts in regards to a sale. Source: Investopedia (http://www.investopedia.com/terms/d/duediligence.asp#ixzz2BTBWbu00)

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practice". This is similar to the view of Bassen and Kovacs (2008, p.185) who highlighted the lack of "standardised definitions and disclosure" as one of the challenges in providing ESG information. This could negatively impact the due diligence process during asset selection, and the monitoring during post-investment stages.

In addition this poses a significant challenge when evaluating the relevant investments to be made, as there isn't a standard approach for comparative purposes. However, the provision of this information through a standardised approach would provide "significant advantages for an investment community overwhelmed with information" and would highlight actual issues that financial indicators may conceal (Bassen and Kovacs, 2008, p.191).

2.2.2 Development Finance Institutions (DFIs)

According to Dickinson (unknown, p.1), DFIs "occupy an intermediary space between public aid and private investment", and "their mission lies in servicing the investment shortfalls of developing countries and bridging the gap between commercial investment and state development aid". This implied that while they are focused on achieving development goals, the intention is to achieve a financial return as well. Although they fulfil many different roles within financial markets, it is their role as limited partners within the private equity industry that this research is concerned with.

Examples of the institutions that have been referred to as DFIs in this paper are as follows:

- African Development Bank
- Asian Development Bank
- International Finance Corporation (World Bank)
- Development Bank of South Africa
- Norfund

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DFIs are typically funded by governments and have specific mandates that have to be met through investments and disbursement of funds. Although the funding sources of the various institutions may differ, the mandates are quite similar and are closely aligned with ESG factors. Therefore this is a key aspect of the investment selection and performance measurement of the institutions (Dalberg, 2009, p. 8).

2.3 Screening & Portfolio Management

Based on the work by Benson *et al.,* (2006) and Cumming and Johan (2007) successful responsible investment programmes should aim to earn the best possible risk-adjusted returns for stakeholders while incorporating ESG objectives. In pursuit of this, there are a number of strategies that can be adopted by investors and asset managers alike. This section will provide a brief description of these strategies, to provide some context to the decision process during the asset selection or portfolio construction.

The diagram (Figure 3) below provides a summary of RI strategies that can be adopted. This approach, if followed by investors and asset managers, can ensure that the investments made are aligned with the overall mandate. This is particularly in the case of DFIs, which have a clear mandate and aim to achieve this through the investment in various projects and funds. In the case of private equity, the UNEP FI and PRI (2011, p.10) describes the investor or limited partner as a “passive partner in the management of a fund”, and this would imply that shareholder activism or cause-based investing would be less suitable to private equity when compared to other asset classes. This does however raise the issue of influence that limited partners, such as DFIs, have on fund managers. In cases where DFIs place substantial investments in a private equity fund, it is anticipated that they would have significant influence over the mandate of the relevant fund even though they play a passive role in the management of the fund.

From the strategies that have been outlined below, it is the screening strategies that would be most suitable during the asset selection or portfolio construction stages. Investors or fund managers tend to have an exclusion list, which is applied, which typically indicates the business or industries that should be avoided. However these strategies would depend on relevant non-financial data, in order to ensure an effective screening process. According to the UNEP FI and PRI (2011, p.10) “a LP should

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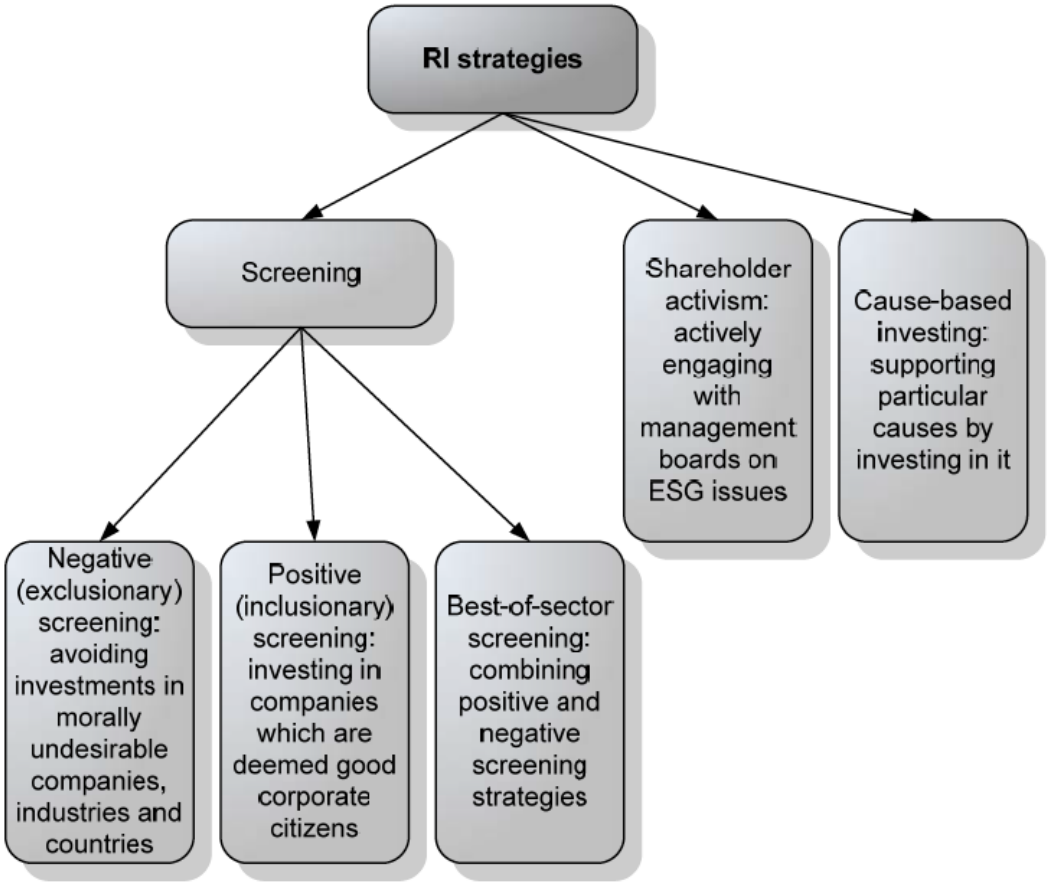
assess the degree to which a GP has the policies, systems and resources needed to integrate ESG considerations into its investment decisions and ownership activities". In the same way the strategies outlined below relate to the selection of companies to invest in, it provides investors with a suitable framework during the assessment of the asset manager prior to investment.

Figure 3. Prominent RI Strategies (Viviers, Bosch, Smit & Buijs, 2009, p.4)



In terms of screening, Renneboog *et al.* (2008, p.1728) identified negative screening as the "oldest and most basic SRI strategy", and this is based on the exclusion of investments or industries based on a set of criteria related to social, environmental and ethical criteria. Positive screening is based on criteria which identifies an investment that meets superior standards, with the focus typically being on corporate governance, labour relations, sustainability and cultural diversity. The third strategy is defined, as an "integrated approach" comprised of the criteria found in negative and positive

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screening approaches, and referred to as the "triple bottom line". Renneboog *et al.* (2008, p.1734) presented two possible arguments in favour of using screening processes. Firstly, the social and environmental performance could provide an indicator of managerial quality, and secondly, these could reduce the possibility of costs incurred through environmental or corporate social crises. This was identified by Lee, Humphrey, Benson and Ahn (2010, p.352) as an indicator of Corporate Social Performance (CSP). Lee *et al.* (2010) argue that the loss of diversification through screening can be countered by CSP i.e. firms which demonstrate characteristics of better management, will offer improved performance. This is similar to the argument by Barnett and Salomon (2006, p.1103), that the limitation that screening places on the portfolio of a fund, is offset as the financial performance of the selected firms tends to be equal or higher than those which are excluded.

Although Lee *et al.* (2010, p.368) argued that the use of screens can provide an indicator for better CSP, they conclude that in the case of highly screened funds there is a negative impact on risk-adjusted performance. This wasn't specifically related to private equity funds, but this conclusion does provide consideration for both limited partners and fund managers, when using ESG factors to inform screening and selection processes.

2.4 Measurement & Monitoring

There are a number of approaches and methodologies which are applied to the measurement of sustainability. As investors aim to make investments via asset managers that have objectives aligned with their own, the lack of information is a challenge. This particularly the case for private equity funds, as the disclosure policies due limit the available information. As the focus on ESG requirements increases amongst investors, it will become more important for fund managers to demonstrate there expertise and success in this area. Koellner, Weber, Fenchel and Scholtz (2005, p.55) argued that investors are overloaded with information and data, which is increasing the demand for methods and standards tailored towards investor needs. Due to the complexity of ESG factors, this presents asset managers with a challenge.

Bassen and Kovacs (2008, p.185) argued that there are numerous challenges with regard to the provision of ESG information. This is particularly the case, as ESG measures are typically non-financial and shortcomings such as a lack of consistent or

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standardise definitions exist. Cunha Callado and Fensterseifer (2011, p.44) supported this, stating that there are few approaches that integrate economic, environmental and social dimensions; instead most instruments tend to examine the dimensions separately. This, in turn, is likely to generate further overhead for asset managers in order to meet the reporting requirements for various investors.

Amaeshi and Grayson (2009) provided guidance to help improve the measurement of portfolio performance, and stated that an effective management system is required that should meet specific requirements. Firstly, that sustainability performance must be clearly defined. Secondly, there should be an effort to ensure that the indicators that are used, are accurate. It is then necessary to develop a clear hierarchy of objectives, which can then be broken down into subordinate objectives to be achieved. The problem with the requirement around accuracy, is the fact the non-financial measures are quite often qualitative in nature and therefore quite subjective.

2.4.1 Driver outcome model

The work that has been conducted by Koellner *et al.* (2005) is based on a model, to be used for the management of sustainability objectives. A key concept that has been defined is a means-end network, which allows the definition of relationships between the drivers and the desired outcomes.

With regard to fund and portfolio management, the model would represent the relationships between business processes and the “performance of these processes in terms of sustainability”. A key assumption of this model is that business processes are drivers of financial and non-financial performance, and it avoids the inclusion of external drivers, such as natural disasters or market development, which can’t be influenced by fund managers. Koellner *et al.* (2005, p.55)

2.4.2 Development indicators and standards

In an attempt to manage and monitor the progress of ESG requirements, an approach has been defined which includes the provision of standards and measurements that are to be applied. According to Amaeshi and Grayson, (2009, p.17) the management systems remained one of the key challenges to “mainstreaming [of] ESG issues”.

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One of the approaches that has been defined and used pervasively within the investment industry is the performance standards that have been provided by the International Finance Corporation, which is a global development institution and a member of the World Bank Group. A comprehensive set of standards have been developed by the IFC that cover the following aspects:

Table 1. IFC Performance Standards

Standard	Description
Performance standard 1	Assessment and Management of Environmental and Social Risks and Impacts
Performance standard 2	Labour and Working Conditions
Performance standard 3	Resource Efficiency and Pollution Prevention
Performance standard 4	Community Health, Safety, and Security
Performance standard 5	Land Acquisition and Involuntary Resettlement
Performance standard 6	Biodiversity Conservation and Sustainable Management of Living Natural Resources
Performance standard 7	Indigenous Peoples
Performance standard 8	Cultural Heritage

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Although these standards provide a comprehensive list of considerations, it is performance standard 1 that is the basis for all the assessments. Performance standards 2 through 8 provide detailed assessments for areas that require specific consideration. More detail has been provided in Appendix B, that provides further explanation of the performance standards.

As highlighted by the number of standards, the management of ESG is complex and it is within this context that the Emerging Markets Private Equity Association (EMPEA) has provided a library of development indicators that can be used to measure the development impact of private equity funds. The aim was to provide a framework and tool that could assist fund managers with the complexity surrounding ESG. The various indicators are related to environmental, social or governance measures, and the complete set of indicators is listed in Appendix A. The library was developed through the contribution of various development finance institutions. In this case the EMPEA library has been used as an illustration of a framework that is available, and is one of many that has been developed. Other sources include EIRIS[4], MCSI[5] and UNPRI, which provide additional guidance and frameworks that can be used.

The following extract from the EMPEA library has been used purely for illustration purposes, to demonstrate the type of indicators that are being proposed. This has been broken down into core indicators, for annual reporting, and additional indicators that can be used at the discretion of the fund managers. The following has been derived from the Library of Development Indicators for Private Equity Funds.

Table 2. Development Indicators (EMPEA)

	Development Indicator	**Format**	**Definition**
1	**Core DI**		
1.1	IRR - internal rate of return	Numerical + basic calculation hypotheses	The rate of discount for which the present value of the net revenue stream becomes zero, or at which the present value of the revenue stream is equal to the present value of the cost stream. It can be compared with the opportunity cost of

[4] EIRIS is a provider of research into corporate environmental, social and governance performance. (http://www.eiris.org/)
[5] MCSI is a provider of investment decision support tools. (http://www.msci.com/)

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	Development Indicator	Format	Definition
			capital
1.2	Employment (indirect) at investee companies	Numerical + Qualitative (if necessary)	(i) Number of jobs existing and sustained in investee companies(ii) net employment creation in the year of reporting (if possible by gender & type)
1.3	Compliance with IFI Environmental and Social Standards	Yes/No	A clear statement that the project complies with international environmental and social standards and the specific requirements of the involved IFIs (which should be part of the normal contractual requirements).
1.4	Compliance with Core Labour Standards	Yes/No	A clear statement that the project complies with International Labour Organisation (ILO) Core Labour Standards and relevant national commitments
2	**Optional DI (Examples)**		
	Technology Transfer	Numerical or Qualitative	Expenses in technology or a qualitative judgement in terms of the sharing of knowledge impact and facilities as a result of the realised project.
	Training	Numerical + Qualitative (if necessary)	The training budget associated (directly or indirectly) with this investment and the number of people receiving training, and type of training provided. (Or - average hours of training per year by employee & category of employee)
	Environmental Management Certificates	Names	Reporting of any environmental management certificate (e.g. ISO, EMAS, generation of carbon credits, etc).
	Outreach Transparency & Accountability	Qualitative	Interaction with shareholders & stakeholders about risks & opportunities

Bassen and Kovacs (2008, p.182) outlined the relevance of a standard list of indicators. They stated that financial reporting doesn't represent a complete picture to

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assess a company's value or management performance. However, it does highlight the challenges presented for the effective management and monitoring of ESG requirements.

Although the library of indicators is not a definitive list of what should be used, it does provide some indication of what can be measured to aid in the assessment of development impact. This would be particularly important during the post-investment stage, particularly for the limited partner who plays a passive role. However, the constant reporting and monitoring of this information could prove onerous on the part of the general partner, and it is perhaps a subset that should be agreed upfront during the due diligence process.

2.4.3 Challenges

Although there has been progress in the toolkits or methodologies available, there are some prevailing challenges that are highlighted below. Ultimately these could reduce the ability of asset managers to integrate and manage ESG objectives.

Cunha Callado and Fensterseifer (2011, p.44) argued that the discussion around the use of sustainability or development indicators is quite new and therefore there is a general lack of agreement around the approach or methodology to be adopted. Furthermore, there is also a lack of consistency amongst the methodologies that have been adopted. Amaeshi and Grayson (2009, p.14) found that this was consistently identified, and was a major barrier to the provision of high quality information in these areas. In addition, they found that by addressing this, it would make it more likely for the financial community to take these issues seriously.

In addition to the lack of standards or consistent approaches to the incorporation of ESG, further challenges are presented. Cadman (2011a, p.21) identified further challenges related to the integration of social and environmental values. This was due to the lack of a consistent set of values or principles, against which corporate actions could be measured. According to Amaeshi and Grayson (2009, p.16) this was partly caused by data inconsistencies, due to varying policy focuses in different regions, levels of integration within the value chain and the diverse nature of companies within portfolios.

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Koellner *et al.* (2005, p.55) stated that the approaches and tools defined for financial data are well developed versus the less developed indicators, which are used for non-financial data. This, according to Koellner *et al.* (2005), limited the ability for fund managers to develop non-financial performance standards, and reduces their ability to report on this to investors. Amaeshi and Grayson (2009, p.16) have highlighted that there is inconsistency amongst the approaches that have been adopted by analysts and rating agencies, which further compounds the challenge. Cunha Callado and Fensterseifer (2011, p.52) concluded that there is a lack of agreement amongst academics and practitioners with regard to the best approaches to be adopted with regard to the measurement of sustainability indicators. Furthermore, in spite of the progress in the development of proposed models, a consistent measurement approach has not been established. Ultimately in order to make ESG a mainstream component of the investment process, a critical component would be the development of a consistent methodology for the measurement of ESG indicators. As highlighted by Amaeshi and Grayson (2009) this would improve the consideration from the financial community and help support investor requirements.

2.5 Private Equity

“The term private equity is generally used to refer to the investment and management assistance provided by specialist private equity firms funded by wealthy individuals and institutional investors” (Heed, 2010, p.26).

According to Demaria (2010) private equity provides an investor with the prospect of financing the improvement of private companies and realises the financial return from their success in the future. The investment period is over a short-term, not usually exceeding ten years. The typical objective is to maximise the return to investors upon exit, which would result in the sale of the business or possible listing via an initial public offering (IPO). The fund that is formed is a combination of the equity, which can be invested by the relevant fund manager. This equity is typically provided in stages, the majority of the available equity is via commitments from the relevant investors.

The fund represents a limited partnership that is formed between the general partner and multiple limited partners, where the general partner is usually the private equity firm that manages the fund. A general partner is “[responsible for] managing the

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business of the partnership and is liable for all debts and obligations of the partnership" (Heed, 2010, p.29).

The role of the limited partners is to provide the capital that can be used to invest in respective businesses. Heed (2010, p.29) states that provided the "LPs do not participate in the management of the partnership, the liability for the LPs will be limited to the amount contributed". According to Kumar (2008, p.129) the investors in private equity funds include institutional investors, sovereign wealth funds and wealthy individuals. This is expanded further to include that although the investors share in the risks and rewards, they however have "no day-to-day say in the management".

2.5.1 Nature of private equity

Private equity has been criticised for the approach it takes in order to generate the returns for investors, and there are opposing views of the nature and performance of private equity firms. Wright, Gilligan and Amess (2009, p.3) highlighted one view that the returns that are generated are "[not] achieved by value creation within the operations of the investee companies, but by value appropriation from other stakeholders". They stated that this is one of the current debates around private equity, "the importance of value appropriation versus value creation" (Wright *et al.*, 2009, p.4). In support of this view Morrell and Clark (2010, p.257) stated that although private equity is able to provide impressive returns, this tends to generate wealth only for their partners and the benefits are limited to certain groups in society.

It is these views of the private equity industry that would challenge the use of these investments as a suitable vehicle to achieve development goals. Wright et al., (2009, p.3) expanded on this argument by stating that private equity is often accused of the following:

- Asset stripping[6];
- Instigating restructuring within firms that negatively impacts on employment and employee remuneration;

[6] The process of buying an undervalued company with the intent to sell off its assets for a profit. The individual assets of the company, such as its equipment and property, may be more valuable than the company as a whole due to such factors as poor management or poor economic conditions. Source: Investopedia (http://www.investopedia.com/terms/a/assetstripping.asp#ixzz2BTF3FcsW)

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- Use of leverage and offshore holding companies reduces tax charges, which accounts for the financial performance of the investments.

However, there are opposing views in the defence of private equity. An alternative view is that private equity funds are an effective means to provide finance within challenging economic environments. According to Banerjee, (2008, p.161) there is "evidence [that] suggests private equity is playing a significant role in the development of global capital markets". According to Klier, Welge and Harrigan (2009, p.7) there have been changes in the sector, with private equity firms having embraced changes in the marketplace, adapting their management model. They indicated that this resulted in the private equity firms improving their operational ability, and increasing their involvement in the portfolio businesses. Kumar (2008, p.129) also highlighted private equity as a growing and dynamic asset class, with one of its attributes being the provision of experienced management to portfolio companies. A related view, is highlighted by Morrell and Clark (2010, p.252) that is based on the findings of the Walker report. This was a review of the industry in the United Kingdom, which states that the key advantage of private equity is the "alignment of interest" that is achieved between owners and managers.

It is perhaps within the emerging economies that private equity firms can provide the greatest impact, especially based on the positive nature that has been described above. Considering the limited financial resources within emerging economies, it presents private equity firms with a unique opportunity to provide the required finance. Banerjee (2008, p.162) supported this argument, and stated "the private equity market is an important source of funds for start-up firms, private middle-market firms, firms in financial distress and public firms seeking buyout firms". However, in addition to the funding that is provided, further benefit could also be derived from the quality and experience of the management that is provided to portfolio businesses.

2.5.1.1 Forms of private equity

Added to the opposing views of private equity, there is the complexity that is introduced through the various forms that private equity can take and this may contribute to the negative criticism of the sector. This is demonstrated in the following diagram. Morrell and Clark (2010, p.251) expanded on this further, highlighting that the

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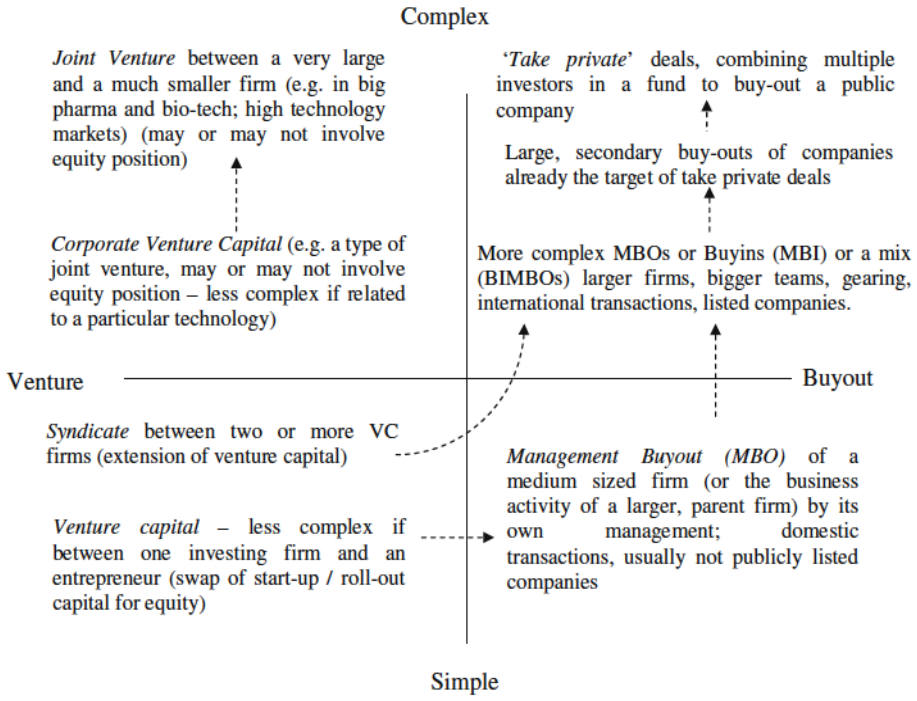
"structure of private equity firms varies in terms of transparency, governance arrangements, taxation and source of investment capital" which leads to the complexity within the industry.

Figure 4. Typology of Private Equity (Morrell and Clark, 2010, p.251)



2.5.2 Responsible Private Equity (RPE)

Waddell (2011) outlined the meaning of Responsible Private Equity (RPE) as use of the private equity asset class as a means to pursue responsible investment objectives and that it can be identified through the finance made available and the criteria, which is applied to investment decisions. Although there have been initiatives to further this agenda, one of the catalysts within the private equity sector was the agreement reached on a set of ESG guidelines between UNPRI and the Private Equity Council. Kell (2009, p.7) stated that there are common objectives between the UN and the financial sector, and that there is a "shared desire to create sustainable, stable and inclusive markets". If we consider the conclusion by Eccles and Viviers (2011) with regard to RI, it can be inferred that the incorporation of ESG factors would not be an altruistic exercise, and in the case of the private equity sector, the objective of general partners would be to deliver the best possible return for limited partners.

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There are certain factors that have been increasing the focus on ESG within the private equity industry, and its not purely driven by guidelines such as those contained in the UNPRI. In a survey that was conducted by Pricewaterhouse Coopers International Limited (Nissan, Case, Koopman, and Paul, 2012, p.2) it was noted that the key drivers for responsible investment practices by private equity funds, relate to "risk management and investor concern". The survey also revealed that investor expectations with regards to ESG are expected to increase, and that to remain competitive during the fundraising stages the management of ESG factors will be important points of differentiation and "to secure and maximise their access to capital" (Nissan, Case, Koopman, and Paul, 2012, p.2).

However it is unlikely that private equity funds would focus on ESG, if it weren't possible to derive any benefit, as this would be detrimental to any returns that could be generated. Protti-Alvarez (2010, p.13) argued that the focus from fund managers on ESG are not only driven by investor expectations, and that if they are able to generate profitable returns from the operational improvements then that could also influence the increased attention to ESG issues. In terms of risk management, considerations of ESG issues are also playing a role in the investment evaluation process. Protti-Alvarez (2010, p.13) noted that if fund managers pay attention to ESG issues "[it] can help avoid getting bad deals presented to them, and avoid getting four months into a due diligence process only to see the deal fall through".

The model that is applied by private equity funds has been identified as beneficial in the pursuit of ESG objectives, and provides a suitable investment vehicle for investors concerned with ESG issues. According to "The guide for Limited Partners" that was produced by the United Nations, the nature of private equity investments allowed the general partners to actively participate within the overall company management. This "stewardship-based style of investment" combined with the long-term investment horizon, means that responsible investment should be "seen as a natural step for private equity investors" (UNEP FI and PRI, 2011, p.4). The nature of private equity means that the general partner has a far greater role in the running of the business. According to the British Private Equity and Venture Capital Association (Ellis, 2011, p. 4), due to the active ownership model of private equity investments it is in a position to positively influence the management of ESG issues. This is similar to the view of Joly (2009, p.23) who stated that engagement is required for effective RI and that a "private equity investor is an owner that has the authority and capacity to act as an active owner".

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The efforts by the UNPRI have been credited with the renewed focus on ESG within the investment industry. The principles that have been outlined by the UN could be described as an evolution of responsible investments initiatives, with the goal of incorporating ESG factors into all aspects of an investment portfolio. The aim being to "maximise long-term investment objectives" and simultaneously "align the investment community with larger societal goals" (Kell, 2009, p.4). According to Kell (2009, p. 2) the guidelines that were outlined were recognition of the fact that management of ESG factors were "material to business and asset performance". In the context of private equity, this provides both an opportunity and a challenge, and requires incorporation into the overall investment approach and the portfolio management strategies that should be adopted.

Investments that are driven by ESG objectives and development mandates as a key objective are showing positive signs. In a report by the IFC (2007, p.1) it states "97% of projects with satisfactory or excellent financial performance also have high development impact ratings". This supports the notion that RI strategies can yield suitable financial results, and that a focus on development impact doesn't have to hinder the overall returns that are achieved. Although this view is limited to the investments by the IFC, it does provide some insight into the relationship between financial performance and development impact. This is evident from the statement by the IFC (2007, p.2) that in cases where "financial performance is unsatisfactory" the "environmental and social performance has suffered".

These various factors that have been outlined, do indicate that the private equity industry has a part to play in the achievement of development objectives. However, ESG requirements are only a part of the overall objectives that general partners need to consider while managing their investments. It is unlikely that fund managers would pursue development objectives at the expense of financial performance.

2.5.3 Role of Limited Partners

According to McCarthy and Alvarez (2006, p.14) limited partners are being more demanding on private equity firms, after increasing investments. This is due to the nature of the limited partnership, where the investors take a more passive role within the partnership structure and have less influence over the management of their investments. Kumar (2008, p.130) highlighted a similar characteristic of the limited

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partnership, stating that the limited partners share in the "risks and rewards of the companies in which their funds are invested" but they have no direct influence over the management of the portfolio companies.

Limited partners have an important role to play in shaping the behaviour of private equity funds, and are becoming more demanding of fund managers. It is anticipated that this will extend to responsible investment and the achievement of ESG objectives. According to Andrykowsky and Barbary (2011, p.17) limited partners are placing increasing requirements on fund managers "to mitigate risk and maximise returns" and are increasingly evaluating track records and consistency in returns of fund managers. With regard to responsible investment, Gorte (2008, p.31) argued that investors are becoming a stronger force in driving sustainability requirements, further highlighting the fact that many of the funds were shaped through the requirements of investors, which forced them to apply certain mandates. According to Kumar (2008, p.133) there is a "growing appetite" amongst limited partners to use ESG analysis to improve risk management of their investments.

2.5.3.1 The role of DFIs

Development funds have grown into significant investors in private equity funds, and their role continues to grow in emerging markets. Settel, Chowdhury and Orr (2009, p.60) stated that DFIs tend to focus on the "growth equity model, which seeks to invest in industries that drive innovation and economic growth and create new jobs and opportunities for their respective economies". Andrykowsky and Barbary (2011, p.15) noted that in sub-Saharan Africa, DFIs play a significant role as limited partners and their findings suggest that they provide more than half of the limited partner investment in the region.

Although the requirement of various DFIs may vary, according to Settel *et al.,* (2009, p.64-67), the three most important factors for investing in private equity funds are as follows:

- Developing financial markets;
- Supporting infrastructure development;
- Promoting growth in small and medium enterprises.

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Dalberg (2009, p.iii) described DFIs as “additional and catalytic”. They are additional, as they tend to invest in sectors that would not typically receive funding from the private sector; they also provide expertise and support through this investment process as well. The catalytic nature is due to the ability of DFIs to partner with other investors, and provide an indication of areas that provide “sustainable investment opportunities”. The implication of this is that, as much as DFIs may view private equity investments as a vehicle to achieve development objectives, private equity funds would benefit substantially by having a DFI as a limited partner. The investment in a fund would be an indicator to the market, and would encourage participation from other investors.

One of the drivers for investment in private equity funds by DFIs is the possible multiplier effect of the original investment. The research by Settel *et al.,* (2009, p.63) indicated “more than five times the amount of capital committed by the MDFI will be mobilized through other institutional investors” as this provides the “international community's seal of approval”. Although this specifically relates to a Multilateral Development Finance Institution, it is assumed that this would apply to DFIs and IFIs as well. A further benefit is that this “enhances the prestige of a fund, gives it credibility, and indicates good governance and positive developmental significance” (Settel *et al.,* 2009, p.63).

Dickinson (unknown, p.2) highlights the fact that a DFI’s involvement can serve to “mitigate risk, serving as a public guarantee in countries and sectors where private sector actors would be unwilling to operate alone”. This would be particularly important in emerging countries, in which capital markets don’t exist and there is a general lack of funding available.

Related to the multiplication factor that is discussed above, the investment by DFIs also points to a lower level of risk for potential lenders. Therefore the inclusion of debt in the overall financing of the fund can increase the multiplication factor, and therefore the presence of DFIs can be viewed as a mechanism to “mobilize even larger amounts of capital—both debt and equity” (Settel *et al.,* 2009, p.63).

In order to effectively meet their development mandates DFIs look for opportunities to invest in a number of small and medium enterprises (SMEs). By using private equity funds as a vehicle to achieve this, ensures the effective distribution of funds. Settel *et al.,* (2009, p.66) indicate that a challenge for DFIs relates to “overseeing many direct

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equity investments in SMEs [which] would be tactically difficult" due to "requirement for their operational and strategic involvement".

There are a number of benefits that accrue to the general partners if they include a significant DFI as a limited partner however, it is clear that this investment comes with clear preconditions. Therefore it would be even more important for general partners to demonstrate a strategy and capability of implementing ESG requirements. Hence it also places clear requirements on a general partner to have a suitable reporting strategy, which will ensure that it can communicate its alignment to ESG requirements and permit monitoring of its impact post-investment.

2.5.4 Performance of private equity

In the paper by Wright *et al.,* (2009, p.3) there are factors outlined which contribute to the performance of private equity firms. Firstly, access to information that is more complete, which is in part to the due diligence process and current trading information on the portfolio companies. Secondly, the firms take board seats and place specific contractual limitations on management of the business. This is a similar view taken by Barber and Goold (2007, p.60), who stated that the private equity firms are able to put "strong, highly motivated executive teams together". The research by Bloom, Sadun and Van Reenen (2009, p.13) concluded that when private equity-backed firms are compared to other ownership models such government-owned or privately-owned, the private equity-backed firms on average display significantly better management practices.

Van Niekerk and Krige (2009, p.4) highlighted that the alignment of the interests between owners and management is vital to general partners, and that the incentives for general partners to behave like owners are key to the attractiveness of private equity investments. Work conducted by Cressy, Munari and Malipiero (2007, p.667) arrived at a different conclusion, stating that possibly the "skill in investment selection and financial engineering techniques" has a greater impact than managerial incentives. In addition it was found that operating profitability of companies backed by private equity was 4.5% higher than non-buyout firms and that industry specialisation resulted in a further 8.5% improvement in profitability.

In terms of RI practices, Barnett and Salomon (2006, p.1117) identified the screening process that is employed, as a contributor to performance. It is argued that the through

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the employment of social screens, it is possible to remove under-performing businesses from the portfolio. Lee *et al.,* (2010, p352) supported this argument, stating that investing in businesses that display "strong corporate social performance" can mitigate any loss in diversification of the portfolio. This is due to the more effective management, which should provide enhanced performance.

The work by Barnett and Salomon (2006, p.1118) also concluded that funds that were screened using community relations as a basis, demonstrated a stronger financial performance. However, they found that the financial benefits were not necessarily justified by the costs associated with meeting SRI screening requirements by improving equal employment opportunities, diversity or improving environmental performance.

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3 Chapter 3: Research Questions

The objective of this research is to further understand the impact that ESG requirements or development mandates could have on private equity fund performance. The following research questions were the basis for exploring this objective, through which the various responses will be analysed and used to approach a conclusion.

3.1 Research Question 1

What impact does ESG objectives have on expected returns for private equity funds?

The aim of this question was to evaluate the perceptions of participants, with regard to the perceived impact and role of ESG in achieving suitable returns. Furthermore it sought to determine the effect ESG requirements have on the performance of portfolio businesses, and the necessary trade-offs that exist when incorporating ESG requirements in the investment process.

3.2 Research Question 2

What role does ESG play in the investment management process?

The aim of this question was to highlight and evaluate the approaches that have been adopted to include ESG into the investment process. In addition this question was used to highlight the impact that ESG requirements have on the portfolio management.

3.3 Research Question 3

What impact does ESG have on the valuation and selection process?

This question sought to understand the approaches that are adopted by participants in the private equity industry, during the valuation and selection processes. Furthermore it attempted to evaluate the perception of participants with regard to the role of ESG in the valuation and selection processes.

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3.4 Research Question 4

What factors contribute to the achievement of ESG objectives?

This question sought to understand the major obstacles or processes that contribute to the achievement of ESG requirements. The aim is to evaluate the perceived obstacles and the critical factors that participants have to consider with regard to ESG.

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4 Chapter 4: Research Methodology

4.1 Research design

The research design was qualitative and exploratory in nature. According to Smith, Bekker and Cheater (2011, p.41) qualitative research methods "are ideal for exploring topics where little is known, making sense of complex situations, gaining new insights into phenomena, constructing themes to explain phenomena, and ultimately fostering a deep understanding of the phenomena".

Although the topics covered by this research aren't entirely new, concepts and the research questions required further investigation. As this study was qualitative, it was based on semi-structured interviews conducted with participants from the private equity sector.

The semi-structured interview approach was selected due to the exploratory nature of the research. Its suitability was identified based on the following from Saunders and Lewis (2012, p.151), which states that these types of interviews are suitable when:

- The researcher may be unsure of the answers that will be provided;
- The questions to be asked are complicated;
- The order of questions to be asked may need to be varied, or the actual questions may require modification.

4.2 Population

The population of this study was limited to general partners, limited partners and advisory firms that are focused on investment within emerging markets. In the case of limited partners, they were either development finance institutions, international finance institutions or institutional investors. The advisory firms are those which provide specific services to the private equity industry.

4.3 Sampling & unit of analysis

This study focused on the decisions and processes which participants in the private equity industry implement to realise development mandates. A non-probability

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sampling technique was utilised, more specifically purposive sampling was adopted. Saunders and Lewis (2012, p.138), state that this approach permits the researcher to use “their judgement to actively choose those who will be best be able to help answer the research question”.

The variety of purposive sampling was of the critical case variety. This was based on the varieties identified by Saunders and Lewis (2012, p.139), as the chosen sample would be critical to the achievement of development mandates and the objectives of the research will most likely be relevant to the chosen sample. The total number of participants was 15, and they were interviewed individually.

The unit of analysis studied was the decisions, perceptions and experience of private equity sector participants, who have facilitated the implementation and monitoring of development mandates during the investment process. The scope of the research was limited to private equity sector participants who have actively participated in the investment process specifically related to development mandates and the achievement of ESG requirements. The scope was limited due to the following reasons:

- relevance – the participants are actively engaged within the private equity sector, and are key to the realisation of development mandates.
- consistency – a common set of objectives and goals were prevalent amongst the participants.

4.4 Research instrument

4.4.1 Data collection

Semi-structured interviews were conducted with participants across multiple organisations. The questions were based on the research objectives that have been defined, and content of the literature review. The respondents were contacted via both email and telephone to set up time for the interviews. The interviews were conducted either in person by the researcher or via telephone, and recorded via an audio device. This was used in conjunction with interview notes to summarise key points and transcribe the full interview. The interviews were approximately an hour each with the 15 participants interviewed.

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The measuring instrument used to collect data was the interview schedule, the basis of which was the contents of the literature review. In addition, the research questions led to the list of topics and open-ended questions, which were used to compile the interview schedule. Saunders and Lewis (2012, p.151) indicate that the chosen interview type also permits flexibility, whereby topics or questions can be omitted or added based on the relevance to the participant.

4.4.2 Pre-testing

A pilot phase was used to test the effectiveness of the interview questions and topics to extract the information required. The pilot phase involved trial runs with two representative respondents. This phase allowed the researcher to determine if the participants experienced any difficulty or misunderstood the interview questions and instructions.

This also allowed the researcher to determine if there was consistency in the understanding amongst participants, and highlighted any ambiguity in the questions that were asked. Changes or suggestions from participants were incorporated into the design of the final interview schedule.

4.4.3 Data analysis

Saunders and Lewis (2012, p.152), state that the use of semi-structured interviews provide data which can be used to “either explore what is happening and gain new insights or describe what is happening and identify general patterns”. For the purposes of this study the aim of the data analysis was to identify the key patterns and themes that emerge from the various responses.

Narrative analysis was utilised to analyse the data. Narrative analysis permitted the evaluation of the participant’s perspective, and allowed the determination and analysis of specific themes.

Generic steps were followed during the data analysis stage. The following analysis stages were adapted from Pope, Ziebland and Mays (2000, p.116):

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- Familiarisation - immersion in the raw data with the intention of extracting key ideas and themes.

- Identifying a thematic framework - identifying all the key elements or details within the data, which can be used to examine and reference the data. This stage will result in a detailed index of the data, grouping it to assist with further retrieval and exploration.

- Indexing - applying the thematic framework or index systematically to all the data. This will have to be done multiple times, in order to refine and index all the data correctly.

- Charting – develop charts of the data, linking the data to the relevant part of the thematic framework. This will involve creating summaries of the responses to aid with classification according to the framework.

- Mapping and interpretation – the charts will be used to define emerging concepts and to find links between the various themes. This is done based on the original research objectives and questions, extracting the relevant themes that have emerged from the data.

The analysis of the data was conducted through the use of an application called Dedoose, which permitted the coding of data and the linking of data to emerging themes. The process that was followed was to review all interview transcripts and to develop a general understanding of the content. High-level themes were then defined, which were used for analysis of the data. Through this process, further sub-themes emerged and permitted more detailed analysis of the data. Finally the themes and sub-themes were consolidated to remove any redundancy and mapped to the original research questions, to facilitate further analysis and determine possible outcomes of the research.

4.5 Research limitations

Due to the scope of this study and the approach selected, including constraints of available information, the following limitations have been identified:

- A limited number of participants have been included;

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- ESG requirements may vary depending on the participants chosen;
- The data collection approach for primary data may be open to response bias and unconscious misrepresentation;
- A lack of data related to the overall impact or realisation of development mandates by private equity funds:
    - This is due to the lack of publicly available data.
    - Toolkits for measurement and indicators may vary amongst limited partners and general partners.
- Models chosen or utilised by participants to implement and manage ESG requirements may vary amongst participants.

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5 Chapter 5: Results

5.1 Introduction

A total of ten interviews were conducted with participants within the private equity sector, participants were based in South Africa, Europe and the United Kingdom. However in all the cases, participants had experience with private equity investment in Africa. The interviews were conducted during August and September 2012. Due to the large number of private equity firms, investors and advisory services, the sample does not reflect a significant percentage of the population. As an example in South Africa there are 68 full members of the South African Venture Capital and Private Equity Association (SAVCA) and from this list only five full members agreed to participate. In total 22 potential participants were contacted; of this twelve private equity funds were based in South Africa, four were based in Europe and the United Kingdom, the remaining six were DFIs and investors with a presence in South Africa.

In reviewing and presenting the data, a research philosophy of realism was adopted more specifically direct realism. Saunders and Lewis (2012, p.105) define this philosophy as one where “what you see is what you get”, and that our experiences are “an accurate representation of the world”. This approach was chosen in an attempt to remove any interviewer bias.

5.2 Results of qualitative interviews

For the purposes of this study it was deemed necessary to treat details of participants and their companies as confidential. This approach was conveyed to all participants, to ensure that the responses provided would not prejudice them in any possible way. In most cases, consent was provided to include the names of participants and their companies in the following list; the order of participants is alphabetical and does not reflect the actual participant numbers used during the analysis.

Table 3. List of Participants

Participant Name	Company Name
Farhaad Khan	Old Mutual

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Participant Name	Company Name
Gloria Mamba	Global Environment Fund
Sandeep Khanna	**
Sandra Abiola	International Finance Corporation
Sarah Shackleton	Development Partners International
Sarita Bartlett	Norfund
Sean McPhee	Deloitte – Corporate Finance
Shaun Collyer	Batian Fund
*	Actis
*	**

(* No consent to include name, ** No consent to include company name)

The interviews were conducted either in person, or via Skype, and recorded for the purposes of transcription. Average time of the interviews was forty-five minutes. All interviews were transcribed prior to analysis.

Emerging themes from the interview responses were mapped to the research questions, as displayed in the following table.

Table 4. Mapping of key themes to research questions

Research Question	Theme
1. What impact do ESG objectives have on expected returns for private equity funds?	Cost considerations of ESG
	Effect of ESG on returns
2. What role does ESG play in the investment	Use of standards for measurement and

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Research Question	Theme
management process?	management of ESG factors
	Tools and approaches
	The effect of reporting requirements on fund managers
3. What impact does ESG have on the valuation and selection process?	Effects of ESG on the valuation approach
	Role of ESG during screening and selection
	Consideration of materiality during valuation and selection phases
4. What factors contribute to the achievement of ESG objectives?	PE as a suitable asset class to achieve ESG
	The effects of regulation and laws
	The need for skills and education
	The role of culture within fund managers
	The effect of media and reputation
	External advisory services

5.3 Analysis of qualitative interviews

5.3.1 Question 1

What impact do ESG objectives have on expected returns for private equity funds?

During the discussion with the various participants, a number of points were raised that would have an impact on the returns which could be earned by private equity funds, while

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considering ESG and development mandates. The two emergent themes related to costs considerations of ESG, and the effect that ESG can have on returns.

5.3.1.1 Cost considerations of ESG

The views related to the costs of ESG, were somewhat divergent but consistent around the fact that it is a necessary consideration when investing in a responsible manner. The costs referred to below were at two levels, at the portfolio company level and at the fund manager level.

The response from Participant 1 was that ESG was not an added cost, and that "it's part of the business model because it's not a nice to do or nice to have" and that "it's part of the due diligence and it's an integral part of the business model [of the fund manager]".

Whereas Participant 5 indicated that in emerging markets, consideration of ESG issues could actually save costs, stating that "there are a couple of deals that we have approached and worked on from an ESG perspective, we actually find that it saves costs, you avoid it by applying [a] governance matrix, you avoid fraud, you avoid loss of assets, you avoid insurance mishaps". An area that was specifically mentioned by two of the participants related to energy usage and efficiency. Participant 8 indicated that the commercial imperative was a driver, stating that "energy efficiency has become massive over the last three years" and that "it has fundamentally changed certain businesses, that they are figuring every single way in which they can to actually change the energy usage in their business because of the cost implications". This was similar to the view of Participant 9, who indicated that a focus on waste and energy usage had cost advantages, by converting waste to an energy source "you're taking ten tons a year and converting to energy, and reducing your costs that way, the fact is it maybe when you are doing a thousand tons a year that you really see huge impact and value".

In terms of costs that are incurred by the fund managers to manage ESG, Participant 5 highlighted the expenses related to this, stating, "it's expensive and costly and timely, I have to hire an ESG person dedicated that sits on my P&L".

However, there was one participant with a contrary view, it was discussed that the cost of avoiding ESG issues remained too cheap and reduced the focus on it. This was highlighted by Participant 3, who said "the cost of the status quo is so cheap" and that as

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"as the punitive cost increases it's going to change the focus just generally of business, whether it's in a private equity portfolio or not".

5.3.1.2 Effects of ESG on returns

There was a general consensus around the benefits of ESG, and the ultimate impact that it has on returns and outcomes. However, it was highlighted that the lack of data made it quite difficult to compare and quantify the exact impact.

Of the participants, three felt that although quantitative data or a suitable study wasn't available, that by considering ESG factors private equity fund returns are improved. Participant 7 said that you could "anecdotally see that funds that are doing well from an ESG perspective are also doing well financially whereas you see the converse, companies or fund managers that tend to have problems those tend to extend also over to the ENS[7]". This is a similar view that is held by Participant 4, who included that "if you have companies that have poor ENS performance at the beginning of the private equity funds investment and the fund works with them to improve that then of course it affects their return". Although this was similar to the opinion of Participant 8, it was qualified by the following statement, "I think clearly we all want to believe that ENS also has an effect on the bottom-line, I don't know if that connection is clear".

Participant 6 indicated that although ESG was not a primary decision-making method, that "once you are in the company it is absolutely as much emphasis in our firm as EBITDA[8] growth". Pursuit of ESG objectives for Participant 5 was a clear method to achieve better returns, stating, "if the business is cleaned up it will command a better value" and "businesses that have high levels of ESG compliance do command a higher price, that's ergo what I try to do and that's how I make my money as well". Participant 6 had a similar view, that "a clean company in Africa will absolutely command a premium" and that if they "have owned a company for a five year period, more likely that the company is performing better and is much cleaner than we found it, so we do a lot of work on it, particularly governance".

[7] ENS refers to environmental and social, and in this context has been used interchangeably with ESG.
[8] EBITDA refers to Earnings Before Interest, Taxes, Depreciation and Amortization. It is used as an indicator of a companies financial performance, and it used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions. Source: Investopedia (http://www.investopedia.com/terms/e/ebitda.asp#ixzz2BGy8XRsc)

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Participant 1 indicated that it was necessary to understand if it is possible to correct aspects of the business from an ESG perspective and recognise that it can't necessarily be corrected in a short time frame. This was expanded further to indicate that if they can "add value to this and the business is sustainable and on a sound platform [it] will have a better exit value". Participant 3 held a similar view, but indicated "there is a balance between where you invest and how you get your return" and that "they [fund managers] are there to build the responsible businesses in a sustainable and responsible manner, which in turn will increase their exit price". This was echoed in the response from Participant 5, stating "that's where the opportunity for us as private equity investors [is], go in clean it up and put in place the governance and policies, and guidelines from a governance, social and environmental perspective, such that it becomes attractive to the institutional buyer".

5.3.1.3 Conclusion of Question 1

From the themes that have emerged related to question 1, it appears that ESG has a positive impact on the ultimate returns that are generated by private equity. Although it was recognised that the ESG objectives may come at a cost, these are actually a part of doing business and important in the generation of positive returns. Similarly, addressing ESG issues and the underlying risks has a positive impact on the exit value of the portfolio companies and returns that can be generated. In general participants agreed that ESG is a necessary aspect of developing sustainable portfolio businesses.

5.3.2 Question 2

What role does ESG play in the investment management process?

In attempting to answer question 2, the emerging themes related to the standards or measurements that can be applied, the standards that are applied to reporting and monitoring, and the tools which are applied during the investment management process.

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5.3.2.1 *Use of standards for measurement and management of ESG factors*

Within the theme related to standards for measurement and management that are applied, there were divergent views expressed. However a recurring comment related to the use of the IFC standards as a basis, and in some cases the dominant standard that is applied when managing ESG within portfolio businesses. Participant 4 stated that the IFC standard was developed through a consultative process, which included clients, industry associations, governments and various DFIs. This has resulted in the development of a set of standards that are comprehensive, and inclusive of the views from a wide range of stakeholders.

In support of the use of the IFC standards, Participant 2 stated "they have the standards, which a lot of the people in the industry use as a sort of best practice standard for companies to work towards in terms of checking and considering ESG matters, so we require that of our companies". For Participant 7, it was slightly different, as their company had developed a proprietary standard and toolkit. However Participant 7 did state the following "specific requirements that are contained in the legal agreements, you know with a red thread going back to the exclusion list and the IFC performance standards, and the IFC occupational health and safety guidelines", which highlights that even with the development of internal standards the IFC standards still inform the process.

In applying standards to the management of ESG factors, there are also additional factors related to the context that need to be considered. According to Participant 7, it depends on the risk level of the company and in addition "it would also depend on the country or countries in which the fund manager was investing, the stage of the project life". The risk level of the company that is referred to relates to an assessment of each proposed portfolio company, and the risk levels attached has a bearing on the level of ESG and related reporting requirements. From Participant 4's perspective, portfolio companies are expected to comply with the IFC performance standards and to comply with the national laws of the country in which they operate.

In the case of DFIs it was found that specific requirements existed, over and above the compliance with agreed performance standards. Participant 5 highlighted that as a fund manager there are specific resource requirements as "DFIs require that there be a designated ESG individual on-board and that that person has some experience in ESG and related matters so that you can improve the expertise balance". From an investor perspective, and as a DFI, Participant 4 specified that the reporting required depended on the risk of the fund and underlying portfolio, with higher risk funds and portfolios having to

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provide reports more often. A typical reporting cycle would be based on quarterly or annual reports, which are agreed between the investor and fund manager.

5.3.2.2 Tools & Approaches

Various tools and approaches were discussed with the participants, with a general agreement around a suitable management system, which is required to effectively manage ESG. Although this is based on the metrics and standards highlighted in the previous section, there are some alternative views provided around the approach adopted.

The use of management systems has been highlighted in the literature as a requirement to effectively manage ESG. From a DFI's point of view, a suitable management system is essential for the placement of an investment in a fund. Participant 7 indicated that it is a requirement for "most fund managers to have a social and environmental management system", which will include reporting requirements for both fund managers and portfolio companies. As stated by Participant 4, DFIs will assist fund managers with setting up and appropriate management system, and assist with the identification of potential risks and issues. The view of Participants 4 and 7 were similar, in that the ESG reporting requirements can add to the administrative burden of the reporting process. Another challenge highlighted by Participant 4, was the potential for information overload in cases where multiple DFIs are invested in a fund and the fund spends a significant amount of time on reporting requirements. Participant 5 shared a similar view and mentioned that a response to this challenge, was the recent efforts by DFIs in Europe who "are trying to refine and standardise to reduce the burden on GP's".

One of the participants highlighted the fact that the key to their company's ability to effectively manage and integrate ESG into the investment process was appointing a senior member of the firm to be responsible for this. The points discussed centred on the fact that to ensure effective integration of ESG, it has to be built into the investment process instead of simply meeting reporting requirements. Participant 9 stated that the approach that was adopted was to have a managing director, whose sole focus was sustainability and ESG related matters. This was highlighted as a shortcoming in some companies as "they don't have the sort of senior level, full-time job to make sure that this thing is done as it needs to be", instead they probably have someone "whose job it is to make sure that we are ticking the boxes correctly".

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The view of Participant 2 was that the management of ESG issues was a process that required constant attention and development. It was stated, that “it’s kind of a live process because we are continually improving it if necessary, house-keeping that would improve our procedures in this area” and that it “will only improve over time as we get more experience or situations… and it will be reflected in our procedures over time”.

With regard to tools for the purpose of tracking ESG issues, there were responses both in support of their usage and views related to challenges in their use. The tools are monitoring or reporting templates that are used to track and evaluate ESG issues. Participant 2 stated that their company made use of a tool to quantitatively track the development impact of the companies within their portfolio; however, that this was “an art rather than a science, it is quite subjective and it’s difficult to really measure, but certainly we are doing so”. The goal of this approach is that over time, they will be able to clearly demonstrate the impact of their funding. The view of Participant 6 was however contrary to this, with regard to the use of a blanket platform, stating that it was necessary to “make it relevant”, and the approach that they adopt is based on a few key principles and then tailored to the relevant portfolio company. A key requirement for Participant 10, was to reduce complexity within their process, and intended to build it into quarterly valuations of each investment on “an asset-by-asset basis by each individual investment principal”.

5.3.2.3 The effect of reporting requirements on fund managers

Responses from certain participants did allude to the onerous nature of reporting requirements, and particularly in the case of ESG objectives and DFIs.

Participant 5 highlighted that over and above being onerous, DFI requirements placed additional resource requirements on their fund, and stated “you need just one person focussed on that, just dealing with reporting requirements, once a quarter a summary of every company - it’s quite onerous”. The onerous nature of the reports stems from the reporting template that is required, along with the agreed reporting frequency.

From Participant 9’s perspective, reporting requirements were onerous due the varying requirements from each investor (LP), which would make the task more difficult.

Participant 4 provided more insight into the requirements from DFIs, stating that the key driver of their reporting requirements was based on their policies and the development mandate. Adding to this, that these requirements were only a subset of the indicators that

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a company or fund would have to report. Participant 4 did however highlight that some reporting templates are too detailed, stating, “I personally find it to be overkill, I have seen the template that they had to go through that regularly is quite crazy. It takes a lot of time and in the end it’s not worth the effort [due to the] value that you churn out”.

Participant 9 felt that their firm was better able to deal with the reporting requirements from investors, due to an existing reporting standard. It was discussed that in the absence of a suitable reporting framework, LPs are likely to enforce their requirements on GPs, which makes the reporting requirements challenging.

5.3.2.4 Conclusion for Question 2

From the interview responses it appears that the IFC performance standards have become central to the management and achievement of ESG objectives. Although it was not necessarily the actual tool or approach that was adopted, it was used as a basis and has contributed to the efforts to effectively measure and manage ESG factors.

In order to effectively manage ESG objectives during the investment process it emerged that the need for dedicated resources is important. Furthermore it is important that the approach adopted to manage ESG is tailored to both the portfolio company and the context within it exists. In addition, the development of a standard reporting template and consensus amongst LPs, particularly DFIs would prove useful in reducing the administrative burden on fund managers.

5.3.3 Question 3

What impact does ESG have on the valuation and selection process?

To answer this question, participants were asked to consider the impact that ESG has made to the valuation approaches, and if ESG could be modelled into the process. With regards to the selection process, questions were based on the use of exclusion lists and impact that ESG had on the selection of deals.

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The themes that emerged related to the role of ESG, the effects of ESG on the valuation process and the issues related to materiality[9]. Although the previous section did touch on the effects on the investment process, the following is specifically related to the valuation process.

5.3.3.1 Effect of ESG on the valuation approach

With regard to the valuation of portfolio companies and the decision based on that, participants generally felt that ESG did have some effect on the investment decisions that are made. According to Participant 9, ESG is just one of the factors when presenting an investment proposal and it is related to the potential costs of the transaction. When asked if there were ESG factors that would make them walk away from the deal, Participant 9 stated, "if you are not doing those things you are creating significant risk in the transaction… financial [risk] that will impact everything else, so why would you want to do the transaction anyway". In response to a similar question, Participant 5 stated that this was particularly helpful in emerging markets, where governance and money laundering is an issue and that they have "passed on many investments because of dodgy people". Participant 3 provided a slightly different perspective, and indicated that positive ESG factors should lead to better valuations. According to Participant 3, when asked about the impact of ESG on valuations it was stated that companies with "good management, good governance, good processes, good systems, those companies are worth more than companies that don't follow good practices" and that "it's just about doing business the right way".

Participant 10 has had a different experience, where considerations of ESG factors would actually negatively impact the valuation, forcing the value to be written down due to social or governance issues. This indicates that in past valuations, without due consideration of ESG, their firm has either overpaid or could have improved the valuation approach.

During the interviews, the effect of ESG on valuations during the exit stage was highlighted. The consensus amongst participants was that positive ESG factors, would lead to better valuations and exits from the portfolio businesses. The view of Participant 8 is that management of ESG factors would help avoid any liability risks at exit and that would drive the choices that are made. A similar view was held by Participant 5, who

[9] A concept that refers to the significance of a cost or issue, usually defined according to a threshold value. In the context of an investment decision, any cost or issue below the threshold value is deemed to be insignificant and is not considered during the valuation.

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stated that it reduced the likelihood of mistakes and provides discipline when led to the generation of value, and made the business more attractive when selling. Participant 4 highlighted two cases, one in Egypt and another in Madagascar, where they believed that addressing the ESG issues would lead to a higher multiple and a higher price. The view of Participant 8 is that a fundamental consideration was the ultimate sale of the business, and therefore "natural alignment to have at least certain minimum levels of ESG type compliance and governance put into your process" and that "ultimately it's taking your business forward". This, according to Participant 3, would be highlighted in the due diligence process, and that if the "[due] diligence was done and found not to be compliant, in the model they would have to take into the account the cost of becoming compliant plus the cost of any penalties and outflows".

The response provided by Participant 2 indicated that addressing ESG issues would have a positive impact on the valuation, but that it was difficult to know how it would "play out in a valuation"; however, it would indicate "the ability of the company to operate and to improve its operating procedures". Participant 6 also highlighted challenges in the valuation process, specifically the discounted cash flow approach, which they believed, was "more of an art than a science" and that to build in ESG factors is difficult "unless you can see demonstrable costs".

5.3.3.2 Role of ESG during screening & selection

The following section details the responses from participants, to questions that related directly to role of ESG in the screening and selection process.

Participant 1 stated that the role of ESG was important during their investment selection process, and they "would look at investment and [if] they have serious ESG issues then [they] will probably not do it, like if [the business] is employing child labour". The view of Participant 4 was similar, however it was stated that the IFC performance standards and compliance with local laws should also be included in the screening process. Participant 8 also felt that ESG issues are sometimes an indicator; the example used was the dumping of waste that may indicate further governance issues that could reduce the attractiveness of an investment. Participant 8 also indicated that during the due diligence process a number of issues would be highlighted and therefore there isn't a "blanket approach", and that "you must do an assessment of how important those are, or how real they are or how they will impact on the financial model". According to Participant 10 their screening

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process contains specific sections dealing with ESG, and that they avoid gambling and microfinance, as they don't believe that either "are sustainable businesses from a social perspective".

In the case of Participant 5, certain industries such as mining are avoided completely due to the fact that it violates many of their ESG requirements. This differs from standard exclusion lists that are proposed by DFIs such as the IFC, and is specific to the fund manager. Participant 5 also stated that "sometimes the best work you do is the ones you don't do, in other words if you see a red flag you see an issue and you avoid that investment".

Two of the participants did highlight 'the know your customer (KYC) process' as part of their screening process. Participant 5 specifically highlights the risks around reputation and the use of the KYC process to evaluate the risk; it is used for "background checks on the various managers, promoters or whatever the case may be [and] if there is some suspicion of reputational issue or franchise value, brand value of the Company 5 is far better preserved that we just avoid that". According to Participant 6, every portfolio company goes through the KYC process and "if our KYC comes up negative then it is a big issue".

5.3.3.3 Consideration of materiality during valuation and selection phases

All participants were asked whether materiality of ESG issues would have an impact on the investment selection process, and in most cases they did not express a particular opinion. From the responses that were received, it was not a key factor but it was highlighted that the context of the ESG issues is a relevant concern.

In response to the question around materiality, Participant 8 stated that it was necessary to consider the importance and the materiality of the ESG in the context of the portfolio business. Participant 8 explained further that it was necessary to consider if "it [is] a value driver in the context of that particular investment or business… that's, I think is probably critical". Participant 6 provided a similar view, but that it was necessary to consider the various options that are specific for a company, and focusing on those issues that improve the company.

Participant 4 in particular felt that the use of materiality wasn't suitable as a basis for selecting ESG issues to be addressed, stating it was "misleading in my opinion… it's like picking and choosing what you will and won't do". This was explored further, and the

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reason for the viewpoint was due to the potential for small issues to escalate and have a major impact at a later stage. It was also highlighted that some issues may not cost anything to resolve, and potentially have a significant reputational risk. In the response of Participant 7, the prioritisation of the issues would be necessary based on the risk of the various ESG issues.

The view of Participant 5 was in slight contrast to this, indicating that materiality of ESG issues didn't play a role if it doesn't create a burden on the portfolio company. However Participant 5 also stated "if it's a compliance that has to be there and it's a cost on the business, then definitely there is no material limit on that", but only if it didn't result in an unnecessary burden on the company.

Participant 3 did express the need to consider the role of materiality, in the final investment choices that are made. In the response, Participant 3 highlighted the role of materiality in cases where it fundamentally alters the valuation or the sustainability of the business. This would ultimately have an impact on the structure of the transaction, either altering the price or in the case of a tax liability only purchase the assets of the company.

5.3.3.4 Conclusion for Question 3

In general participants indicated that ESG had a positive impact on the valuation process, assisting with the management of risk during the valuation process. Furthermore ESG had a positive effect on the exit valuation of portfolio businesses, and it was a desired feature amongst buyers.

Materiality did not appear to be a dominant factor in the consideration of ESG issues. However, an aspect that was discussed was the role of context when considering materiality, that ESG factors, which are value drivers and could contribute to company growth, were important.

5.3.4 Question 4

What factors contribute to the achievement of ESG objectives?

To determine the possible factors for question 4, a varied set of questions was used in order to elicit all the varied factors that participants considered as contributors to achieving

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ESG objectives. The aim of the questioning was to determine if any possible factors had come to light, which may not have been covered in the current literature.

The themes that emerged related to the suitability of private equity to achieve ESG objectives, the effect of regulation and laws, availability of skills and resources, culture of fund managers, and external advisory services.

5.3.4.1 Private Equity as a suitable asset class to achieve ESG objectives

An emergent theme was the suitability of private equity as an asset class to achieve ESG objectives. Of the participants, four generally agreed that private equity was effective in meeting ESG objectives.

According to Participant 9, it relates to the active ownership model, stating “I do think that the active involvement, the relationship that’s built over time to build value in this business, is a very effective way and in my experience it has been a better way to make sure those things happen”. From an investor standpoint, Participant 4 agreed, indicating that from an ESG perspective, private equity has provided the best results. Participant 4 also highlighted that the fact that private equity funds owned a stake in the business, which incentivises their behaviour. Furthermore, due to the smaller portfolio, when compared to a bank or other asset classes, the impact of ESG issues can have a far greater effect that encourages a focus on ESG issues.

The view of Participant 6 is that private equity is absolutely a suitable asset class to achieve ESG objectives. The example that was used, related to the transformation of governance within a company, and even if the earnings remained the same the company should be worth more. Participant 9 shared a similar view, adding that “you facilitate a management structure that makes sense, you are going to see a direct relationship between that and the value of the company”. Participant 3 indicated that private equity was able to provide structure to businesses and that “the private equity players provide that direction to the businesses to make sure that that is enhanced because it has been proven, companies that have proper good governance outperform companies that don’t”.

In terms of investment strategy going forward, the participants generally indicated that achieving ESG objectives are a part of doing business, particularly for private equity. Participant 10 clearly indicated that it was not about compliance; instead “[their] view is that it just makes good business sense, to be investing in businesses that are sustainable”.

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In the case of Participant 2, the role of ESG was important, and they felt that “having invested in Africa for a number of years, we have always done this and we actually think we are ahead of the field among the bigger private equity players”.

5.3.4.2 The effect of regulation and laws

A theme that did occur through certain responses was the effect of regulation and law on the achievement of ESG objectives. In most of the cases, it was the lack of regulation or law that mentioned, particularly in emerging markets. This was, however, not a common view amongst all the participants.

From the perspective of Participant 9, it was about the correlation between legislation and the ESG objectives being pursued. Participant 9 referred particularly to the achievement of social objectives, and when comparing South Africa to Angola it was stated, “that [legislation] may not exist in a country like that and so people in South Africa are probably seeing a tighter correlation because of legislation”. Participant 3 held a similar view, but indicated that it is perhaps the area of pollution where laws are really absent in most of Africa. From the perspective of Participant 5, environmental law was also a significant issue and it shaped the behaviour of companies in those countries, and made companies less willing to adopt ESG best practices. This implied that the lack of suitable regulations and laws results in portfolio companies only implementing measures to meet the minimum regulatory requirements, and in areas where regulation is weak it is less likely they would adopt ESG focused changes.

Participant 4 provided a similar response, but added that there was a lack of incentives as well, which was needed to encourage the adoption of ESG practices. Participant 4 stated the following with reference to emerging markets - “a company that the fund wants to invest into has no incentive whatsoever to do well on the ENS side so that’s one of the key constraints”. In the case of Participant 1, the lack or weakness of local legislation in many countries created a challenge for their firm to proactively manage ESG issues within their portfolio.

Another aspect that emerged within this theme, related to uncertainty with regard to regulations and laws. Participant 2 stated, “You know a lot of regulatory acts are always changing and you can’t always make sure you are on top of everything”. Participant 9 identified the growing certainty of the regulatory framework as an attraction for their fund,

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particularly in terms of investments in clean energy. However Participant 9 did highlight that regulatory certainty was required for all aspects of ESG.

Participant 5 in particular highlighted approaches necessary, which were not mentioned by other participants but were relevant to this theme. In an attempt to meet ESG objectives, Participant 5 indicated that in many countries in Africa it was better to ignore regulation, and focus on best practices as a benchmark, and then convince the management of the portfolio company that it would be beneficial to their company. Another point that was alluded to by Participant 5, was the impact of bribery in the avoidance of ESG issues, in particular an example related to tax avoidance was used and the use of bribery to reduce the level of a tax liability. This points to the cost of avoidance being too cheap, as discussed in section 5.3.1.1, and that ESG issues can be avoided without much consequence.

Common views expressed by Participants 4, 8 and 9, pointed to the stronger regulatory framework in South Africa. In particular, both the strength of the labour and environmental legislation was highlighted as factors that provided incentives for companies to comply with certain ESG objectives. Participant 4 also indicated that the incentives and penalties in regions such as Europe were a key contributor to the achievement of ESG objectives.

5.3.4.3 The need for skills and education

The lack of skills and education at both fund manager and the portfolio company level was raised, particularly with respect to achieving ESG objectives and managing related issues. This was highlighted in response to questions based on obstacles to the achievement of ESG objectives.

Participant 7 highlighted the limited resources that are available to smaller fund managers, which “can't have one person that is totally dedicated to following up on environmental and social issues, and also qualified to do so”. In exploring the topic further, Participant 7 included that it’s necessary for the fund manager to be trained or possibly have the ability to hire resources to assist, but concluded that this could be a challenge due to the location of the fund manager.

Participant 4 indicated that the capacity of the private equity fund was the starting point, being able to understand ESG related issues and risks. Furthermore Participant 4 stated that “a fund manager is a financial institution, everybody is trained to look at returns and

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identify good investment opportunities, not just on [ESG] issues". However Participant 4 did also state that "[when] compared to other financial institutions private equity funds are probably the ones with the highest capacity and the highest willingness and commitment to address ENS issues, so that's a positive". Finally Participant 4 indicated that commitment to ESG objectives was a key issue, and that if the commitment to achieve the objectives was present then the necessary skills could be developed over time.

Participant 8 highlighted an alternative obstacle to the achievement of ESG objectives, and it relates to the available resources and ability of the underlying management teams within portfolio businesses. According to Participant 8 "ultimately it's not the private equity practitioners that drive this through, the operational fulfilment is sitting with the underlying management team". Participant 2 expressed a similar view, stating that in many cases it is the support that the portfolio companies require, requiring help to define clear objectives and steps that need to be implemented. However, Participant 8 also believed that if the management team is strong enough it would have a clear understanding of its value drivers, and the role of private equity in that case would be strategic input and assistance with driving the implementation.

5.3.4.4 The role of culture within fund managers

The role of culture was explored during the interviews, and although the positive role that it plays did emerge as a theme, it wasn't consistent amongst participants. Culture refers to the attitudes, values and beliefs that present within the fund managers.

Participant 1 believed that the focus on ESG objectives, required buy-in at all levels, the shareholders, the board and the company management. It was also stated that it was "a cultural mind set challenge which you have to bring about [in] people". Participant 6 believed that the commitment from senior management was a key element to their firm's view of ESG, and the ability of senior management to drive the importance and focus on ESG. However Participant 6 also believed that the focus on ESG was in their DNA. Participant 4 highlighted that the inclusion of these concepts in their DNA, would be important for fund managers in future. However, even if it isn't part of their DNA, Participant 4 felt it was possible to convince fund managers of the importance of ESG, basing the argument on the impact it could have on reputational risk and the effect on returns.

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Participant 2's view related to challenges at the portfolio business level, indicating that their company had mixed responses from portfolio companies, with some of the companies more willing to broadly adopt ESG objectives and that some companies would address it at a higher level. However, Participant 2 did indicate that a focus on ESG factors was not optional, and that "the culture of a company has an impact on this".

Participant 9 provided a slightly different view, highlighting the integration of ESG into all aspects of the investment process, and stating that it was about the ethos of the fund manager and not a compliance issue to satisfy investors. This was similar to the response by Participant 7, where the compliance requirements from DFIs are forcing fund managers to address ESG objectives; however, that it was necessary to further the ESG agenda. Although Participant 7 did concede that the checklists and compliance requirements could actually act as a deterrent.

5.3.4.5 The effect of media and reputation

Although the theme related to reputation was closely linked to culture, it was determined that it would be necessary to highlight the responses. The number of responses and content was limited; however, it has to a certain extent a role to play in the achievement of ESG.

Participant 5 was clear in the role that reputation and media play, but did highlight the challenges present in Africa. In parts of Africa it was highlighted that public shame was a deterrent, therefore the "press is absolutely vital in making sure that there is compliance [where] reputation is very important, and avoidance of public shame". Participant 5 also highlighted the negative consequences of bribery; in trying to avoid compliance with ESG related legislation bribery is prevalent and that can lead to reputational risk on the part of fund managers.

From an investor standpoint, Participant 4 indicated that they faced reputational risk if they pursued investments that provided financial returns but also had a number of ESG issues. Participant 4 also indicated that the track record of fund managers was important, and that it would be part of the due diligence process.

Participant 2 responded that the role of reputation or media exposure was not necessarily their approach and that it was not the only reason for the increased focus on ESG, but did

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agree that media and reputational aspects could drive the increased focus and attention that ESG is getting.

5.3.4.6 External Advisory Services

Certain participants raised the role of advisory services and third party consultants. The following were identified as further considerations: the resources available to fund managers, the availability of in-house resources and the location of the fund manager.

The requirements of different countries and locations, featured in the decision to make use of third-party consultants or advisory services, was a point raised by Participants 1 and 9. Participant 1 indicated that they would use outsourced skills in cases, and it depended "on the nature, the geographies and the high risk" because they already have an understanding of the practices and the relevant experience. Participant 9 stated that their company typically would look for assistance with tax and legal issues, particularly when working in different regions and in cases where they did not understand certain sectors very well. However, Participant 9 did also state that for regular business activities and most of the financial modelling they would rely on in-house resources. Participant 7 shared a similar view, but added that the cost of using advisory services was often difficult to find as well as being expensive, in instances where the fund was located in less developed markets.

Participant 5 identified that advisory firms are particularly helpful in shifting any bias during the investment process; that they "rather give it to a third party and they provide an assessment and a report that avoids the conflict". Participant 5 also included that there is a need for advisory services to deal with complexity in certain regions.

5.3.4.7 Conclusion for Question 4

From the responses that were received, it was not clear if there was one specific factor that stood out, and often the factors varied in importance depending on the participant. It is clear that that there is a number of contributing factors that could either detract or improve the possibilities of achieving ESG objectives. However, participants did indicate that private equity, and the nature of its involvement with portfolio businesses, does provide a suitable and beneficial approach when pursuing an ESG agenda.

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The lack of regulation and suitable incentives, or penalties, is a challenge for the various participants. This appears to be a particular challenge in developing markets, where legislative forces and frameworks are less developed. Hence implementation within portfolio companies, in these markets, remains a challenge and requires that fund managers are a driving force in its implementation.

The impact of culture was considered a contributing factor. This was particularly the case when driven through the management structures of the various fund managers. The role of DFIs remains an important one, to guide and drive the implementation of ESG objectives and to create the necessary focus.

Skills and education, reputation and the media, do play a smaller role in achieving ESG. Although these areas were not specific areas of focus during the questioning, it does provide areas for future focus.

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6 Chapter 6: Analysis

6.1 Analysis of Sample

6.1.1 Quantity and Quality of Responses

Due to the large number of fund managers and investors in the industry, the responses provided a limited number of responses. Although the views and responses are useful to further the research objectives, it does lack a suitable range and quantity of participants to sufficiently explore the impact of ESG on private equity fund performance.

6.2 Discussion of Research Question 1 Results: What impact do ESG objectives have on expected returns for private equity funds?

6.2.1 Cost Considerations of ESG

The views expressed by the various participants highlight the fact that cost is a necessary consideration when pursuing ESG objectives. However, there wasn't general consensus around the role of cost considerations. The responses that were received, with regard to costs, focused on the effect of costs at both a portfolio company level as well as a fund manager level.

Dowse (2012, p.204) argues that objections to the focus on ESG have become reduced, because it leads to "risks being avoided, and opportunities are being taken". Responses were to some degree consistent with this argument, indicating that a focus on ESG could have a positive effect, in terms of managing costs. Specifically the contributions that a focus on ESG makes to risk management, which can help, reduce costly mistakes and potential liabilities. This was also highlighted by Dowse (2009, p.660) who stated that ESG issues might highlight issues, which can form part of the negotiation process.

Further cost reductions that were discussed related to energy efficiency; and that through a focus on ESG it has been possible for portfolio companies to reduce energy costs. This is consistent with the findings of Nissan, Case, Koopman and Paul (2012, p. 11) who indicate that some fund managers have begun tracking the benefits associated with ESG programmes, using aspects such as cost savings to attach a financial value to specific interventions. A negative aspect of the costs of ESG issues is the fact that in developing markets the punitive costs of noncompliance may remain relatively low. Therefore while

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there are clear opportunities for cost reductions or cost avoidance, the low punitive costs could reduce the focus on ESG issues.

In terms of the effect on the fund manager, the focus on ESG does require the employment of additional resources to effectively manage ESG issues and the related reporting. This would have a negative effect on the profitability of fund managers. This is particularly relevant considering the finding by Andrykowsky and Barbary (2011, p.41) that "GPs struggle to cover costs on standard 2% management fees, particularly for funds under $100 million".

6.2.2 Effect of ESG on Returns

Many of the participants agreed on the positive impact that ESG has on returns, with a lack of data affecting the ability to quantify the impact that it is having. Particular mention was made on the positive impact that was realised upon exit of the investment. According to Dowse (2012, p.204) companies that effectively manage social and environmental issues perform better than their peers, and funds that similarly address these issues achieve the same performance gains.

Nissan *et al.,* (2012, p.10) provide a similar view, their findings indicate that management of ESG issues doesn't harm the exit valuation; however, that it wasn't possible to quantify the improvement in value due to addressing ESG factors. This was a topic that was raised by a number of participants, and therefore represents a clear challenge for fund managers, especially when determining which ESG issues should be addressed.

Del Bosco and Misani (2011) have argued that responsible private equity investors can add value to companies through their expertise and resources, improving both the overall management of the portfolio companies. They include that it is the low costs and risks related to social and environmental issues, that may make these portfolio companies attractive. This view was shared amongst participants, however, it was noted that this provided added benefit in emerging markets such as Africa.

It was clear that from the responses that ESG does have a positive effect on private equity fund returns, and provides additional avenues through which fund managers are able to add value to portfolio companies. A prevailing challenge relates to the inability to quantify the exact effect that ESG has on returns. This, however, does not detract from the positive

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impact that ESG objectives can have, and in emerging markets it could prove a useful tool to improve the valuation upon exit.

6.3 Discussion of Research Question 2 Results: What role does ESG play in the investment management process?

6.3.1 Use of standards for measurement and management of ESG factors

From the responses that were received, the IFC performance standards were identified as a base that many participants referred to when defining ESG objectives. The comprehensive nature of the performance standards contributes to its use, and provides a suitable reference point for fund managers. This would imply that there is some standardisation that is occurring within the industry and differs from the findings of Amaeshi and Grayson (2009, p.14-15) whose research highlighted the lack of appropriate standards or measures, which could be applied to manage ESG. This is similar to the view that is presented by Cadman (2011, p.3) that there is a need for consolidation of the approaches that have been adopted, and that there is a general lack of consistent standards that can be applied. Due to the number of participants, this would require further analysis within the private equity industry to determine if the IFC performance standards are in fact widely used.

Although it would be beneficial to have a common set of standards applied in the private equity industry, there are a number of challenges that remain. More specifically the differing contexts of the portfolio companies would influence the chosen ESG objectives and standards. Context refers to the regions and countries in which the companies operate, and the effect of local legislation or regulatory frameworks. The impact of this was identified as a challenge by Amaeshi and Grayson (2009, p.15), who found that differences of ESG data according to industries, regions and countries contributed to inconsistency, which hampers the measurement of impact and comparability.

6.3.2 Tools and Approaches

From the responses it was determined that the use of a suitable management system is an important element during the investment management process. A suitable management system would comprise the policies, procedures and monitoring approach to be adopted

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for ESG factors. This is particularly the case for the management of the underlying portfolio. Amaeshi and Grayson (2009, p.17) found that inadequate management systems "constitute one of the main challenges in mainstreaming ESG issues". Cunha Callado and Fensterseifer (2011, p.52) attribute this in part to lack of consensus among academics and practitioners over the best approaches that can be used in the development and implementation of systems for measurement of sustainability indicators". From the responses it wasn't clear from all participants if they had a defined management system, or the manner in which it was used.

In cases where DFIs are investors within the fund, this element is of particular importance and was raised during the interviews. However, DFIs would assist fund managers in the development of the management system, as well the identification of risks and issues. Therefore it would be important to develop some consensus around the management systems that are implemented, to ensure some level of consistency and transferability of these systems to various portfolio companies.

Participant 9 indicated that the successful management of ESG objectives benefits from senior management involvement, which creates the necessary focus and drive within the firm. This is consistent with the findings of a survey conducted by Pricewaterhouse Coopers (PwC), which stated that most of the participants that were surveyed "were able to identify a senior or executive level sponsor with ultimate responsibility for overseeing the house's RI strategy" (Nissan *et al.*, 2012, p. 7).

Even though some firms use tools to track and quantify ESG indicators, as indicated by Participant 2, it was discussed that this process was subjective and would only improve over time. This is considered a significant challenge in the management of ESG issues. Bassen and Kovacs (2008, p.191) argue that the focus "on numbers might divert attention from the actual issues, especially if they have an obscure character".

The discussion and the literature do point to the requirement for a suitable management system; however, challenges still remain with regard to the quantification of all the ESG factors. As described in the literature review, there have been efforts to provide a suitable library of indicators; however, the assessment of certain indicators remains subjective, particularly for qualitative indicators. As highlighted by one of the participants, the ability to effectively monitor and assess development impact is likely to improve as fund managers gain further experience.

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6.3.3 The Effect of Reporting Requirements on Fund Managers

Bassen and Kovacs (2008, p.190) argue that the current approaches for gathering and analysing ESG information is “laborious and costly”. From the interview responses, this was due to the cost of hiring additional resources, and the requirement to meet different reporting requirements. The focus on cost and the negative impact of reporting requirements was generally the focus, without any mention of the possible improvements or changes it has made to the portfolio management.

It is therefore important that fund managers develop their own reporting standards, to be presented to investors. With the intention of adjusting these reporting standards to cater for minor differences, however, the important point is to develop a reporting standard that can be effectively managed while providing suitable ESG related information. This may require some collaboration between fund managers and investors, to develop reporting standards that can serve the needs of multiple investors and reduce the administrative burden on fund managers.

It is likely that the additional reporting requirements would add an additional cost, however in cases where DFIs are investors it is a key requirement to raising funds. For smaller fund managers, the impact is likely to be greater due to the lean structure of the firm and lack of available resources to effectively monitor an manage ESG reporting requirements. It is also likely that investors would have a greater influence over the reporting standards for smaller fund managers.

6.4 Discussion of Research Question 3 Results: What impact does ESG have on the valuation and selection process?

6.4.1 Effects of ESG on the Valuation Approach

A number of participants indicated that the consideration of ESG factors played a role during the evaluation of an investment proposal, as it provided an additional aspect for risk management and improved the due diligence process. In addition the achievement of ESG objectives through management of portfolio businesses could lead to better valuations upon exit, reducing any liability exposure and was viewed favourably by potential buyers. In the work conducted by UNEP FI (2006, p.12), it found that “company valuation is not complete unless it includes a consideration of ESG issues”.

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It is clear that the consideration of ESG factors was only one aspect of the evaluation process, but through its inclusion it can help reduce any liabilities in a transaction. A specific point related to the management of risks within emerging markets where governance and money laundering is a concern, which is a concern that was not raised in the reviewed literature. Furthermore the inclusion of ESG factors can have a dramatic impact of valuations, reducing the valuation based on any existing liabilities. This requires a comprehensive due diligence process, to highlight any ESG concerns over and above any existing legal or financial issues. In the case of ESG issues, this may manifest in costs associated with compliance or related penalties, which may alter the structure of the investment in a portfolio company. Participants also indicated that the management and focus on ESG factors has a positive impact on the portfolio business valuation at exit. Benefits to the companies relates to reduction in mistakes, improved discipline and can lead to value creation therefore the portfolio business would be more attractive at exit.

Dowse (2012, p.206) argues that a possible approach is the use of a "valuation tool that can calculate the value at risk from ESG issues" and the possible financial returns from the resultant actions to address the issues. However, Participant 2 and 6 were of the view that it is difficult to include the impact of all the ESG factors in the valuation model; part of the reason is the inability to associate cost with all of the relevant ESG factors. According to UNEP FI and WBCSD (2010, p.15) the inclusion ESG factors in the valuation models requires a judgement call, but "there is sizeable opportunity for asset managers to expand their valuation models to build a bridge between qualitative ESG factors and measurements of financial performance".

6.4.2 Role of ESG during Screening and Selection

Renneboog *et al.* (2008, p.1734) present two possible arguments in favour of using screening processes, as an indicator of managerial quality, and the reduction of possible costs due to environmental or social issues. Certain participants did indicate that ESG factors are considered as part of the screening and selection stages of potential investments. Mention was made of the fact that ESG issues are in some cases an indicator that point to further governance or management issues. Protti-Alvarez (2010, p.13) states that ESG factors are becoming more important during the deal origination stages, and therefore the use of these to assess the quality of management teams should be just as relevant.

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From the responses, it was evident that some participants would exclude certain deals based on existing ESG issues, and in some cases, entire industries if they felt it violated their ESG requirements. This differs slightly from the argument by Dowse (2009, p.660) who states that apart "from clear environmental liabilities or inoperable reputational damage, it would be rare for ESG issues to stop an acquisition cold". For the majority of fund managers the argument by Dowse (2009) probably holds true, as the ESG issues would have to be considered for each investment and the effect that it may have.

The interview responses did not provide any clear link of ESG factors to the screening approach that is typically adopted. Based on the questions that were asked it was anticipated that fund managers would have defined screening strategies. However it did highlight the consideration of ESG factors when evaluating investments, which is aligned with the integrated screening approach according to Renneboog *et al.* (2008). Some participants did indicate the use of exclusion lists, which avoids an investment in certain sectors but does not relate to ESG factors alone.

6.4.3 Consideration of Materiality during Valuation and Selection Phases

Materiality of ESG issues did not appear to be an overwhelming factor that is considered during the valuation and selection process. Questions related to materiality were posed to participants, to understand the approach taken in evaluating ESG objectives. However in response, it appears that materiality is not a fundamental part of the valuation process but context of the ESG issues was raised as a concern, which would have to be addressed. This differs from the findings of Amaeshi and Grayson (2009, p.19) that identify materiality as a key element to ensure the mainstreaming of ESG issues; however, it was also noted that this role of materiality requires further exploration. This is similar to the findings of UNEP FI (2006, p.11) that have found that "ESG issues are material" and that "there is robust evidence that ESG issues affect shareholder value in both the short and long term". However it is evident from the work by Amaeshi and Grayson, (2009) that there is a lack of consensus around the role of materiality in the investment process, which is consistent with the findings of the various interviews.

The concept of materiality does have a role to play, particularly for ESG issues that could dramatically alter the structure of a deal and the valuation; an example would be an existing environmental liability. However, the risk does remain that ESG issues that fall below the materiality threshold would be ignored even though the associated costs may be

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relatively low. This would have two possible effects: firstly, that specific opportunities to add value may be overlooked and, secondly, the ESG issues would only be measured in financial terms, which would ignore the possible liability or reputational risks associated with the issues.

It was clear from the responses received, that there isn't agreement on the role of materiality during the valuation stages. However, important points have been raised about purely focusing on materiality as a measure, which would lead to the exclusion of certain ESG issues which would have little or no financial impact on the portfolio business. The consideration of ESG issues would be best served through a risk management or value driver approach, as this would ensure that all the relevant ESG factors would receive due consideration.

6.5 Discussion of Research Question 4 Results: What factors contribute to the achievement of ESG objectives?

6.5.1 Private Equity as a Suitable Asset Class to Achieve ESG Objectives

In consideration of private equity as a viable asset class for responsible investment, Joly (2010, p.23) describes a private equity investor as one that "has the authority and capacity to act as an active owner on all matters, has a seat on the board, and the power to unseat management if needed". The general consensus was that private equity was a suitable asset class, due to the level of engagement in portfolio companies and influence that fund managers have over the management of the companies.

Private equity is a suitable asset class due to the active ownership model, which is due to active involvement and the relationships that are built, which can have a direct influence over the achievement of ESG objectives. Participant 4's view was that the ownership model incentivised the behaviour of the fund managers, as well as the smaller portfolio of private equity funds, which make ESG issues more important. This is an important point, as it creates an alignment of interests between the fund managers, company management and stakeholders.

There was generally a greater focus on the ability of fund managers to transform the governance or management structure within portfolio businesses that would add more value. The view that through the strategic input of fund managers, combined with better governance structures, the portfolio companies would naturally perform better. This is

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consistent with the findings of Bloom *et al.,* (2009, p.13), who conclude that private equity-owned companies tend to be the best managed ownership group, when compared to government-owned, family-owned and privately-owned companies. Part of this is due to the fact that private equity ownership is "associated with broad-based improvements across a wide range of management practices rather than simply just stronger performance incentives".

Achieving ESG objectives could be seen as part of the private equity business model, and that it made good business sense. However, it is perhaps those ESG factors that add most to value creation that would receive the greatest focus, and from the interviews it appears that governance remains the most important factor. This follows from the findings of Bloom *et al.,* (2009), as fund managers would pursue opportunities to create additional value and improve operational aspects of the portfolio companies.

6.5.2 The Effects of Regulation and Laws

The effects of regulation and laws were seen as possible factors in the achievement of ESG objectives. This did not appear to be a view shared by many participants, although participants highlighted some prevailing shortcomings. Lydenberg and Sinclair (2009, p.64) conclude that in order to make responsible investment part of the "mainstream" it would be necessary for collaboration amongst government, private business and non-governmental organisations (NGOs). This, they argue, is essential in order to drive change and ensure that responsible investment practices can achieve their stated objectives.

The lack or uncertainty around regulation, with regard to ESG factors, may have a negative impact on the achievement of ESG objectives. This is primarily due to the lack of any punitive costs or incentives for portfolio companies to comply with regulation. In the absence of suitable regulation, the role of fund managers is more important to drive the focus on ESG issues as portfolio companies may only seek to meet the minimum levels of compliance.

In developing markets the lack of regulation can be seen as a barrier to the achievement of ESG objectives, and there is a general lack of incentives or punitive measures to meet certain minimum levels of compliance. The effect of bribery and corruption to avoid compliance cannot be underestimated, as highlighted in the interview responses. In order to improve this, it would require a contribution from both the private sector and NGOs, to

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effectively improve the achievement of ESG objectives in regions with weak regulatory frameworks.

6.5.3 The Need for Skills and Education

The need for skills and education was only highlighted by a few participants, and therefore does not seem to be a key factor. However, it was mentioned that the ability of smaller fund managers to retain the necessary skills was both costly and challenging. The responses provided highlighted a lack of available skills and resources at the fund manager level, as well as within portfolio companies. Lydenberg and Sinclair (2009, p.61) argue that professional credentials would ensure that responsible investment is integrated into investments, and that in general the financial and academic institutions have not been proactive in the development on standards, training and certification for responsible investment.

In terms of skills and available resources, the smaller funds will tend to face the greatest challenges due to the associated costs and the structure of the fund. Larger funds that are able to retain dedicated resources and teams, focused on ESG issues, are more likely to succeed in achieving ESG objectives as they are able to provide the relevant support and guidance for portfolio companies. The challenge extends further to portfolio companies, as they are responsible for the implementation and operational aspects of ESG issues. Amaeshi and Grayson (2009, p.24) found that re-education and capacity building were necessary, however, they identified this as the approach to change mindsets and attitudes towards ESG issues.

The lack of available skills and resources is a challenge for private equity funds, and has an effect on achieving ESG objectives. To a degree DFIs are assisting fund managers and improving the available skills, but only for those funds in which they invest. However, as highlighted previously based on Lydenberg and Sinclair (2009), it is also necessary for the development of formal training and certification programmes to ensure that participants in the industry obtain a basic level of understanding with regard to ESG and responsible investment practices. Another possible solution is the use of advisory services; however, that too presents certain challenges, which are discussed in section 6.5.6.

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6.5.4 The Role of Culture within Fund Managers

Culture was another factor that did not appear to play a significant role, although it was discussed during some of the interviews. In cases where this was discussed, the role of culture was seen as a positive influence on the focus on ESG objectives. An argument presented by Joly (2010, p.24) states that investment professionals, regardless of their personal values, are "loyal to the businesses they work for… they identify with the financial interests and the culture of their businesses".

Lydenberg and Sinclair (2009, p.58) argue that one of the indicators that the investment industry has changed, with regard to responsible investment, is the "change culture of capital stewardship". This, they argue, would result in fund managers considering that the "societal implications of their investment decisions" are important to clients and beneficiaries.

The culture of the fund manager and the support from senior management play a critical role in the pursuit of ESG objectives. As stated by Dowse (2012, p.205) if employees observe that management supports initiatives, then employees at every level "have been among the strongest advocates of social and environmental engagement". It would be important that the mindset of various stakeholders also changed, from a compliance-driven mindset to satisfy investors to one where ESG is integrated into the fund and portfolio company management.

Gorte (2008, p.34) argues that "investors are an important catalyst for change", and those religious and social investors have often been at the forefront to improve corporate policies with regards to ESG. Therefore from a fundraising perspective, as the focus of institutional investors increases with regard to ESG, it is likely that this will have a further impact on fund managers and the underlying portfolio companies.

6.5.5 The Effect of Media and Reputation

To a limited extent, the role of media and the reputation of the fund managers was a factor to achieve ESG objectives. Participant 5's view was that media could be used to play a role when reputation is very important, and would encourage compliance to avoid public shame. This can be at either the fund manager or portfolio business level.

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Balboa and Marti (2007, p.454) argue that in immature private equity markets, fund managers don't have track records and there is a lack of data. They expand on this further, stating that in these situations fund managers need to send "credible signals to the market", to distinguish themselves and attract investment. Although this does not specifically relate to ESG, it is expected that the same argument would be valid as the focus on ESG factors increases. From the perspective of investors, the track record and reputation of a fund manager is important, and would form part of the due diligence process.

6.5.6 External Advisory Services

The role of external advisory services was highlighted in a few of the interviews; however, it was seen as a measure to address specific ESG issues. The use of these services also depended on the availability of in-house resources, and the location of the fund manager and portfolio business. In the survey conducted by PwC (Nissan *et al.*, 2012, p.4) fund managers highlighted the "lack of internal capacity and expertise as a barrier to implementing their RI goals". They expand on this further, stating that the ability of fund managers to hire the required skill is limited, due to the "lean' structure of many PE houses and the current economic climate".

There is a need for advisory services in cases where fund managers are not familiar with local legislation or depending on the level of risk associated with the ESG issues. Areas such as legal and tax issues are of particular importance, as well as cases where the sector of the portfolio business isn't well understood. The view is that these services were typically quite costly and difficult to source in less developed markets. This is consistent with the findings of Andrykowsky and Barbary (2011, p.13) who state that "outside [of] South Africa, due diligence firms are not generally considered to be of particularly high quality, and thus global accounting, strategy or risk-consulting firms were often engaged to satisfy both GP and LP requirements, at a higher cost than the local equivalent".

From these responses it is evident that there is a role for advisory services, in the pursuit of ESG objectives. However, it appears that the role is to provide niche services, and to cater for the shortage of available skill and expertise within fund managers. The barrier they face is the cost of their services combined with their ability to serve clients in less developed markets.

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6.6 Conclusion

The view of participants was generally in line with some of the current research, however certain factors received greater attention that anticipated. As highlighted previously, majority of the participants did believe in the value of ESG within the private equity sector, and in majority of the cases their firms did have suitable policies in place. This appeared to introduce some bias into the responses, as there were very few competing views.

One aspect that did receive a significant amount of attention was the role of cost. The dominant view was based on the cost savings or the opportunities to avoid costs, which ESG provided. This follows from the literature review that the benefits that ESG can provide to the overall risk management approach, can be translated into cost savings or at least cost advantages within portfolio companies. It was anticipated that there would be reference to the onerous nature of ESG reporting requirements, and the associated costs. This does highlight the need for standardised management systems and reporting standards, to remove the unnecessary administrative burden and allow private equity funds to focus on the management of the ESG issues.

It was also evident from the analysis and responses that there are a number of factors that can influence the achievement of ESG objectives. The implication is that simply having a policy and treating this as a compliance requirement, will not yield any true benefits for fund managers and portfolio companies. This also negatively impacts the mainstreaming of ESG issues, and reduces the likelihood that ESG will be fully integrated into the investment management and portfolio management processes.

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7 Chapter 7: Conclusion

7.1 Key Findings

The approach that has been followed for this research project was based on the use of semi-structure interviews, with the objective of eliciting detailed responses. This was, however, limited due to the number of participants, which were not sufficient to represent the views and opinions of the private equity industry. Many participants shared similar views of ESG, and therefore this has introduced some response bias into the findings.

In addition to this, the nature of the private equity industry's disclosure policies does reduce access to data. Valuable data that could have provided greater insight would have included details around the management systems implemented and current data related to development impact achieved through portfolio companies.

7.1.1 Positive Effect of ESG on Private Equity Fund Performance

Although there is a general lack of quantitative data to evaluate the effect that ESG has on private equity fund performance, there is general consensus amongst the participants of its positive effect. This is consistent with the view that is provided by Bassen and Kovacs (2008), that there isn't any evidence that ESG affects a company's performance, and that it does highlight risks and opportunities. However, through focusing on ESG objectives, it is possible to enhance the investment management process and positively influence the returns that can be achieved, through both risk management and value creation.

The risk management helps reduce any legacy or liability costs that may remain once the fund exits the investment, and thereby positively influence the exit multiple. According to Kumar (2008, p.130) the incorporation of ESG into the investment process improves the due diligence that is performed, leading to the identification of potential problems and options to reduce risk and improve performance. Kumar (2008) expands on this to include the screening effect, which removes potential investments where political interference is prevalent and where there is a lack of governance; this is consistent with responses received, which related specifically to the KYC process. From this it can be seen that ESG can have a positive influence over the valuation and selection process, and thereby directly influencing the fund performance.

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The consideration of ESG during the investment management process identifies opportunities for the portfolio companies, and is one of the mechanisms through which fund managers can generate additional value. From the interview responses it is at exit where this has the greatest impact, and in emerging markets it is has a greater potential to attract buyers and lead to a premium being paid. This view is consistent with that of MacLean (2012, p.105) who argues that the link between ESG and value creation is less evident in the short term, but in the long term it proves to be essential to company survival. This is aligned with the investment cycle of private equity funds, with a typical five to seven year investment horizon, which combined with the active ownership model provides an opportunity to create significant value. Although ESG is one of many areas in which fund managers can shape portfolio companies, management of the issues can have a direct influence over the expected returns that can be achieved.

7.1.2 Lack of focus on all aspects of ESG

Although questions were posed to participants around ESG, the majority of the responses and benefits of ESG were attributed to the governance aspect. It didn't appear that the environmental and social aspects received as much attention or focus from the participants. This implies that the pursuit of ESG objectives may be hampered, as the environmental and social factors seem to receive less focus.

The views that were expressed did indicate that there was a general belief that environmental and social issues were important; however, very few examples were used or described. The changes to governance structure within portfolio companies can have a dramatic effect, and were noted that these changes alone would add significant value at exit. It is possible that limited experience with the environmental and social factors, results in greater emphasis on the governance factors. This could be directly linked to the lack of skills or expertise, and the mindset within the private equity industry. The implication is that although private equity funds may demonstrate commitment to ESG, the focus on governance, which has traditionally been part of the approach still receives the greatest focus. This does raise questions as to the actual commitment to the environmental or social factors, which remain more challenging and complex to manage.

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7.1.3 Varying Factors Influence ESG Objectives

In the pursuit of ESG objectives, there are a number of factors that can influence the achievement. Private equity is a suitable asset class that can aid in the achievement of ESG objectives; however, there are some prevailing challenges that hamper the process. The most notable are the lack of available skills, and the lack of suitable penalties or incentives in developing markets.

The lack of skills and expertise with the management of ESG issues remains a challenge for fund managers and portfolio businesses. The complexity of the issues and variation amongst portfolio companies compounds the problem. This extends to the portfolio companies that are responsible for the operational execution of ESG related activities, with the support of fund managers. The implication for private equity fund managers is that they will need to invest in their people and their skills, to enable them to fully benefit from integrating ESG into their investment processes.

In developing markets, particularly those in Africa, the lack of regulation or laws related to ESG objectives does present a challenge for fund managers. This reduces the incentives or penalties for portfolio companies to address ESG issues. Examples relate to labour laws or environmental law, which may either be weak or absent in developing markets. The effect of political interference with regard to developing markets cannot be underestimated. This means that as NGOs and governments, in emerging markets, aim to fully develop their economies it is necessary to focus some effort on the development of suitable regulatory frameworks, which have a broader focus to include environmental and social factors.

Until these two areas are improved, it is anticipated that there will be lower levels of success with regards to ESG objectives. Although there are a number of fund managers with a clear focus on ESG, it will still take some time before the smaller funds are able to build up the necessary expertise. In countries with weak or changing regulatory frameworks, it makes the pursuit of ESG objectives more challenging and reduces the commitment from portfolio companies to adopt ESG related changes.

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7.2 Recommendations

7.2.1 Standards and management systems to manage ESG objectives

A clear shortcoming that has been identified in both the literature and the interview responses, is the development of suitable management systems to cater for ESG objectives. With regard to responsible investment, Cadman (2011b) highlights the challenge posed by the proliferation of standards and systems to manage these investments.

Although the private equity industry faces a similar challenge, the interview responses highlighted the role of the IFC Performance Standards. The performance standards are comprehensive and form a reference for a number of the fund managers that were interviewed. It may prove useful to adopt this as the standard across the industry, which would improve the comparability of data and help reduce the burden of differing performance standards. This would require collaboration amongst the various industry associations, private equity fund managers and investors. Although this does not improve the development of reporting standards, it does provide a comprehensive base from which fund managers can approach portfolio businesses.

7.2.2 Elevation of ESG into Risk and Business Management Practices

The role of ESG within the investment management process has demonstrated that there is a positive link with performance improvement. However, the management of ESG issues still appears to be the compliance-related approach, instead of integrating the management of these issues into an overall risk management approach.

Using materiality to evaluate the relevance of ESG issues is not a suitable approach in all cases. As noted in the responses, certain ESG related issues could have very low costs associated, and this approach would exclude these from future consideration.

As fund managers are intimately involved in the management of portfolio companies, by including ESG considerations into business management practices it may lead to operational improvements or uncover possible opportunities. An example would be the pursuit of energy efficiency, which could dramatically reduce operational costs.

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7.2.3 Tracking and Quantification of ESG Impact

To effectively evaluate the impact that ESG objectives are having on portfolio companies, it would be important for fund managers to track and quantify the development impact that has been made. As has been mentioned in this paper, both reputation and skills development are factors that require consideration.

From a reputation point of view, as the focus on ESG and sustainability increases it will be necessary for fund managers to demonstrate their ability to identify, manage and implement ESG objectives. It has also been mentioned that in emerging markets where track records for fund managers are limited, being able to demonstrate a commitment and expertise with regards to ESG will become increasingly important. This will have an impact in terms of fundraising, as well as attracting buyers for portfolio companies.

It will be necessary for fund managers to continually develop in-house skill and expertise with regard to the management of ESG issues. Through the development of in-house tools for monitoring ESG issues, it would both create the necessary focus and improve the skills of resources. A further benefit would be the focus that this would create, to ensure that staff at all levels are aware of the role of ESG in the investment process, as well as the portfolio company management.

7.3 Opportunities for Future Research

7.3.1 Development impact of private equity funds in emerging markets

There are a number of open questions with regard to the pursuit of ESG objectives and the impact this has on both private equity funds and the portfolio companies. It has been stated that there is a positive link between ESG and fund performance, albeit without any quantitative evidence.

As highlighted in the findings, it appears that there is still a greater focus on governance when compared to environmental or social objectives. It would be helpful to determine the development impact that private equity funds have had, through a comparison of key indicators pre-acquisition and at exit. It is likely that the availability of information would prove a challenge, but in deals where companies have been taken private (delisted), and either listed again upon exit or purchased by a listed company, this data should be available.

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7.3.2 Effect of Regulations and Law on ESG objectives

Regulation and laws could prove to be essential in the achievement in ESG objectives. An opportunity exists to research the actions by private equity firms in countries with either weak or non-existent regulatory frameworks, with regard to ESG. To determine if the development impact of private equity funds is influenced by the strength or weakness of regulation.

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Appendix A: Development Indicator Library

	Development Indicator	Format	Definition
1	**Core DI**		
1.1	IRR - internal rate of return	Numerical + basic calculation hypotheses	The rate of discount for which the present value of the net revenue stream becomes zero, or at which the present value of the revenue stream is equal to the present value of the cost stream. It can be compared with the opportunity cost of capital
1.2	Employment (indirect) at investee companies	Numerical + Qualitative (if necessary)	(i) Number of jobs existing and sustained in investee companies, (ii) net employment creation in the year of reporting (if possible by gender & type)
1.3	Compliance with IFI Environmental and Social Standards	Yes/No	A clear statement that the project complies with international environmental and social standards and the specific requirements of the involved IFIs (which should be part of the normal contractual requirements).
1.4	Compliance with Core Labour Standards	Yes/No	A clear statement that the project complies with International Labor Organisation (ILO) Core Labor Standards and relevant national commitments
2	**Optional DI**		
	Economic Indicators		
2.1	Linkages Employment Impact	Numerical + Qualitative	Estimation of number of jobs sustained in indirect employment impact at the value chain / linkages of the investee companies to local suppliers or customer companies
2.2	Technology Transfer	Numerical or Qualitative	Expenses in technology or a qualitative judgement in terms of the sharing of knowledge impact and facilities as a result of the realised project.
2.3	Training	Numerical + Qualitative (if necessary)	The training budget associated (directly or indirectly) with this investment and the numbers of people receiving training, and type of training provided. (Or - average hours of training per year by employee & category of employee)
2.4	Net Currency Effects	Numerical or Qualitative	Percentage of exports/imports in sales/purchases or other numerical indicators which could assess the level of contribution to the national balance of payment contributed by the investee companies.
2.5	Diversification of the Local Economy	Qualitative	A qualitative assessment of the diversification impact (if any) of the project to the local economy, e.g. fund investments in underserved sectors or regions of the country (e.g. unemployment rate or poverty rate as indicators of low development).

	Development Indicator	Format	Definition
2	**Optional DI (continued)**		
	Environmental Indicators		
2.6	Compliance with National Environmental Standards	Yes/No	A clear statement that the project complies with all relevant national environmental standards and legislation.
2.7	Environmental Management Certificates	Names	Reporting of any environmental management certificate (e.g. ISO, EMAS, generation of carbon credits, etc).
2.8	Technical Assistance	Qualitative	Reporting of any environmental related technical assistance (either national or international) received in the context of this project.
	Social Indicators		
2.9	Impact on local poverty alleviation	Qualitative	Athough this is very difficult to measure, the fund manager should have the freedom to express his understanding on how his projects impact on local poverty alleviation (e.g. contribution to Millennium Development Goal # 1 "reduction of poverty" by creating jobs for unskilled employees).
2.10	Outreach Transparency & Accountability	Qualitative	Interaction with shareholders & stakeholders about risks & opportunities
2.11	Impact on Gender, Minorities or	Qualitative	The fund manager should report on any potential controversial issues or proactive positive approch taken with respect to these issues.
2.12	Labour Practices & Decent Work	Qualitative	Policies & Procedures for informing, consulting & negotiating with employees, ensuring occupational health & safety in line with e.g. the Basic Terms and Conditions of Employment of ILO, tackling major communicable
	Governance/Institutional Indicators		
2.13	Dealing with Human	Qualitative	Policies & procedures for dealing with human rights issues
2.14	Development of Global Reporting System	Yes/No	Is the promoter developing appropriate development accounting systems to account for increasing transparency and accountability (e.g. UNEP FI reporting requirements, EMAS, ISO, etc).

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	Development Indicator	Format	Definition
2	**Optional DI (continued)**		
	Capital Market Development and Financial Sector Indicators at PEF level		
2.15	Mobilisation of local capital	Yes/No; qualitative comments	The PEF should report how other financial resources are mobilized e.g. (i) investments by local investors or (ii) additonal funding from local banks.
2.16	Diversification of the financial sector	Yes/No; qualitative comments	The PEF should report how the fund contributes to the diversification of the financial sector in the country/region or contributed to an improvement of the regulatory framework ("deepening" by new type/instrument in local market, e.g. one of the first SME-funds, energy efficiency fund, mezzanine fund, or fund with majority sharholding strategy in the local market).
2.17	Diversification of equity allocation	Yes/No; qualitative comments	The PEF provides finance to business segments or regions ("fronteer regions") which have so far not or only insufficiently been serviced by the existing finance institutes (e.g. because the segment has so far been categorised as "unbankable", IT, telecommunication, renewable energy, SME/Micro, empowerment of disadvantaged groups like BEE, or the region has been categorized as "underdeveloped", etc.) ("broadening of
2.18	Institution building by PEF	Yes/No; qualitative comments	The PEF should report how a contribution of the fund to local company development and structure-building effects were generated (e.g. "added value funtion" by consultancy and technical support for investee company upgrading; e.g. Environmental and Social Management System (ESMS) at fund-management-level).
2.19	Employment Creation (direct) at PEF management company	Numerical + Qualitative (if necessary)	PEF managing companies create high skilled professional jobs in a locally small financial community. The larger number of trained experts contribute to a development of the PEF industry. The PEF should report on the (i) Number of jobs existing and sustained in fund management company, including qualitative aspects like job type & gender
	Private Enterprise Sector Indicators at investee company level		
2.20	Improvement of accounting and reporting	Yes/No; qualitative comments	The PEF should report how improvement of accounting and reporting standards and practice of local company (e.g. IAS or US-GAAP).
2.21	Improvement of Corporate Governance	Yes/No; qualitative comments	The PEF should report how improvement of corporate governance and/or strategic guidance was achieved.

Source: http://www.bidnetwork.org/sites/default/files/development_indicators_private_equity_funds.pdf

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Appendix B: IFC Performance Standards (Overview)

IFC International Finance Corporation World Bank Group

Performance Standards on Environmental and Social Sustainability

January 1, 2012

Overview of Performance Standards on Environmental and Social Sustainability

1. IFC's Sustainability Framework articulates the Corporation's strategic commitment to sustainable development, and is an integral part of IFC's approach to risk management. The Sustainability Framework comprises IFC's Policy and Performance Standards on Environmental and Social Sustainability, and IFC's Access to Information Policy. The Policy on Environmental and Social Sustainability describes IFC's commitments, roles, and responsibilities related to environmental and social sustainability. IFC's Access to Information Policy reflects IFC's commitment to transparency and good governance on its operations, and outlines the Corporation's institutional disclosure obligations regarding its investment and advisory services. The Performance Standards are directed towards clients, providing guidance on how to identify risks and impacts, and are designed to help avoid, mitigate, and manage risks and impacts as a way of doing business in a sustainable way, including stakeholder engagement and disclosure obligations of the client in relation to project-level activities. In the case of its direct investments (including project and corporate finance provided through financial intermediaries), IFC requires its clients to apply the Performance Standards to manage environmental and social risks and impacts so that development opportunities are enhanced. IFC uses the Sustainability Framework along with other strategies, policies, and initiatives to direct the business activities of the Corporation in order to achieve its overall development objectives. The Performance Standards may also be applied by other financial institutions.

2. Together, the eight Performance Standards establish standards that the client[1] is to meet throughout the life of an investment by IFC:

Performance Standard 1:	Assessment and Management of Environmental and Social Risks and Impacts
Performance Standard 2:	Labor and Working Conditions
Performance Standard 3:	Resource Efficiency and Pollution Prevention
Performance Standard 4:	Community Health, Safety, and Security
Performance Standard 5:	Land Acquisition and Involuntary Resettlement
Performance Standard 6:	Biodiversity Conservation and Sustainable Management of Living Natural Resources
Performance Standard 7:	Indigenous Peoples
Performance Standard 8:	Cultural Heritage

3. Performance Standard 1 establishes the importance of (i) integrated assessment to identify the environmental and social impacts, risks, and opportunities of projects; (ii) effective community engagement through disclosure of project-related information and consultation with local communities on matters that directly affect them; and (iii) the client's management of environmental and social performance throughout the life of the project. Performance Standards 2 through 8 establish objectives and requirements to avoid, minimize, and where residual impacts remain, to compensate/offset for risks and impacts to workers, Affected Communities, and the environment. While all relevant environmental and social risks and potential impacts should be considered as part of the assessment, Performance Standards 2 through 8 describe potential environmental and social risks and impacts that require particular attention. Where environmental or social risks and impacts

[1] The term "client" is used throughout the Performance Standards broadly to refer to the party responsible for implementing and operating the project that is being financed, or the recipient of the financing, depending on the project structure and type of financing. The term "project" is defined in Performance Standard 1.

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are identified, the client is required to manage them through its Environmental and Social Management System (ESMS) consistent with Performance Standard 1.

4. Performance Standard 1 applies to all projects that have environmental and social risks and impacts. Depending on project circumstances, other Performance Standards may apply as well. The Performance Standards should be read together and cross-referenced as needed. The requirements section of each Performance Standard applies to all activities financed under the project, unless otherwise noted in the specific limitations described in each paragraph. Clients are encouraged to apply the ESMS developed under Performance Standard 1 to all their project activities, regardless of financing source. A number of cross-cutting topics such as climate change, gender, human rights, and water, are addressed across multiple Performance Standards.

5. In addition to meeting the requirements under the Performance Standards, clients must comply with applicable national law, including those laws implementing host country obligations under international law.

6. The World Bank Group Environmental, Health and Safety Guidelines (EHS Guidelines) are technical reference documents with general and industry-specific examples of good international industry practice. IFC uses the EHS Guidelines as a technical source of information during project appraisal. The EHS Guidelines contain the performance levels and measures that are normally acceptable to IFC, and that are generally considered to be achievable in new facilities at reasonable costs by existing technology. For IFC-financed projects, application of the EHS Guidelines to existing facilities may involve the establishment of site-specific targets with an appropriate timetable for achieving them. The environmental assessment process may recommend alternative (higher or lower) levels or measures, which, if acceptable to IFC, become project- or site-specific requirements. The General EHS Guideline contains information on cross-cutting environmental, health, and safety issues potentially applicable to all industry sectors. It should be used together with the relevant industry sector guideline(s). The EHS Guidelines may be occasionally updated.

7. When host country regulations differ from the levels and measures presented in the EHS Guidelines, projects are expected to achieve whichever is more stringent. If less stringent levels or measures are appropriate in view of specific project circumstances, a full and detailed justification for any proposed alternatives is needed as part of the site-specific environmental assessment. This justification should demonstrate that the choice for any alternative performance level is protective of human health and the environment.

8. A set of eight Guidance Notes, corresponding to each Performance Standard, and an additional Interpretation Note on Financial Intermediaries offer guidance on the requirements contained in the Performance Standards, including reference materials, and on good sustainability practices to help clients improve project performance. These Guidance/Interpretation Notes may be occasionally updated.

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Appendix C: Interview Schedule

Topic	Number	Question
Introductory questions	i.	What is your current role within your firm?
	ii.	As a GP or LP - what is your core focus in terms of investment strategy?
	iii.	What role do you believe sustainability plays within the private equity industry/
	iv.	Does your firm have specific guidelines/policies that relate to Responsible Investing or ESG?
1. Returns of PE with ESG objectives/requirements	1.1	Do you believe that the alignment to specific ESG objectives or requirements affects the returns that can be achieved?
	1.2	In your opinion, are you able to effectively realise ESG objectives through PE?
	1.3	Would you forgo financial return in favour of development impact? What would the cost have to be before focus on development impact is reduced?
	1.4	Are there industries or sectors that lend themselves to reponsible investment? Other than the known exclusions (gambling, tabacco etc)
	1.5	Is the inclusion of ESG requirements on portfolio businesses affecting their competitiveness? And hence returns?
2. Obstacles to implement/realise ESG objectives/requirements	2.1	What would you consider to be the biggest obstacles to achieving ESG objectives?
	2.2	In your role as the GP or LP, do you believe that

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Topic	Number	Question
		other investors are key to driving the ESG agenda?
	2.3	How to do you proritise investment choices? Financial return vs development impact
	2.4	Does the increased focus on ESG in media or society have an effect on the implementation of ESG requirements?
	2.5	How does your company identify/assess the materiality of ESG issues/requirements?
	2.6	And does the long-term nature of most ESG issues make it less material?
	2.7	Does the complexity of ESG issues make it more difficult to integrate into the investment process?
3. Available fund data at selection	3.1	From an ESG perspective, what data do you provide/request during the initial investment stages?
	3.2	Does past performance of a GP influence the selection process?
	3.3	Does the level/degree of ESG focus affect the inclusion of an LP?
4. Affect of ESG on investment choices		Questions to LP
	4.1	To what extent does your firm consider environmental, social and governance risks and opportunities in your investment portfolio management?

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Topic	Number	Question
	4.2	How important do you think it is, if at all, for a GP or fund manager to aim to be sustainable and act responsibly with regards to the environment and society?
	4.3	Are ESG requirements highlighted during the initial investment phases?
		Questions to GP
	4.1	To what extent does your firm consider environmental, social and governance risks and opportunities in your portfolio company management? What priority does this take?
	4.2	How important do you think it is, if at all, for a portfolio company to aim to be sustainable and act responsibly with regards to the environment and society?
	4.3	Can this be effectively modelled into portfolio company valuations?
	4.4	How narrowly focused is ESG management within your portfolio? Are these factors strictly managed per business or across the portfolio?
	4.5	Would you say the GP culture has a role to play?
	4.6	Does the opinion/view of the fund manager influence the implementation/achievement of ESG requirements?
	4.7	Do you give certain ESG factors a greater focus?
	4.8	Does the reputational aspect or brand association with RI influence your companies approach?
	4.9	Does ESG form a part of risk management approach or is it merely a requirement to satisfy LP

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Topic	Number	Question
		requirements?
	4.10	Are there noticeable differences between the requirements of instiitutional investors vs DFI's? Or is this converging?
5. Monitoring of ESG performance	5.1	How frequently do you or your company assess ESG performance?
	5.2	Do these form part of the daily management of business operations?
	5.3	Is the data reviewed regularly and communicated to investors?
	5.4	What influence does the LP have over this process?
	5.5	Have your reporting standards changed to accommodate LP requirements
6. Key indicators to evaluate ESG	6.1	What are the key indicators that you use to evaluate ESG performance or portolio decisions?
	6.2	Are these determined based on the portfolio company or GP selected?
	6.3	Of the indicators used, which do you believe provide an indication of overall business performance?
7. Method/Approach to ESG evaluation	7.1	What is the preferred method to evaluate ESG impact?

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Topic	Number	Question
	7.2	Some measures may be qualitative, do these add value? How?
	7.3	Are these measures conducted independently? Would this have any effect?
8. Valuation	8.1	Is the increased focus on ESG driving up valuations for certain sectors or types of businesses?
	8.2	Does fund manager skill play a greater role in this process?
	8.3	Are companies that typically have better ESG standards proving to be a better investment?
	8.4	At the valuation stage, are there factors which would immediately exclude a target company?
Final viewpoint		Are PE funds able to deliver on development mandates/ESG requirements, while providing higher risk adjusted returns? (versus other investments or asset classes)

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