INVESTMENT PERSPECTIVES

CapitalDynamics
TRULY INVESTED.

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THE PRIVATE MARKETS HAVE REACHED AN INFLECTION POINT IN ESG

KEY COMMENTARY

SINCE 2006, WHEN THE PRI WAS INTRODUCED, PRIVATE MARKET INVESTORS HAVE NOT ALWAYS BEEN CONSISTENT IN THE ADOPTION AND APPLICATION OF ESG FUNDAMENTALS: BUT WE ARE REACHING AN INFLECTION POINT. ESG ENGAGEMENT IS UNDERGOING A SHIFT FROM A "NICE TO HAVE" TO A NECESSARY CONDITION OF MANAGER SELECTION AND ASSET UNDERWRITING IN THE PRIVATE MARKETS.

As an original signatory of the UN-supported Principles of Responsible Investment (PRI), Capital Dynamics was an early adopter of ESG principles. In part, this early adoption was driven by a desire to both help alleviate the increased ESG-related regulatory pressure that our institutional investor base is facing and to play our role as a corporate citizen and advocate for best practices in the private market investment community. Equally important, it is our hypothesis that an enhanced approach to responsible investment will result in more attractive, risk-adjusted returns for our clients. In this article, we explore this paradigm shift in several aspects, including:

(i) Disentangling "ESG" terminology;
(ii) Examining the recent surge in ESG engagement;
(iii) Proposing a quantifiable approach to ESG;
(iv) Considering the differences in ESG engagement by geography; and
(v) Exploring emerging trends in Europe, the U.S. and Asia.

I. DISENTANGLING "ESG" TERMINOLOGY

In the title of this section, we purposefully use the term "ESG" in quotations because the concept is often mistakenly used as a catch-all to describe any investment strategy which considers environmental, social or governance factors. In reality, important distinctions exist in investment objectives amongst Responsible Investment (RI) versus Socially Responsible Investment (SRI) and Impact Investment, as detailed in the terminology box. As an investment approach, RI is primarily focused on achieving an attractive risk-return profile for investments made by measuring and assessing the ESG factors of these investments. SRI is a values-based approach to investing where a manager incorporates investors' beliefs about particular ESG factors into their investment decision-making. Impact Investment is an approach to investing that actively seeks to make a beneficial change to the environment or society alongside a financial return.

Historically, Impact Investing has underperformed conventional private market investments. According to a Global Impact Investing Network (GIIN) and Cambridge Associates study[1] in 2015, impact funds returned 6.9% pooled net IRR for vintage years 1998 to 2010 – trailing the comparative universe of conventional private investment funds by 120 basis points. If Information and Technology sector investments had been included, the underperformance would have been even higher. To some extent, this outcome is unsurprising because, as described above, the mandate of Impact Investing goes beyond performance and seeks to achieve other beneficial social or environmental outcomes.

As the industry evolves, impact funds will likely perform better on a relative basis. There is an upward return trajectory for impact funds tracked by Cambridge Associates, with younger vintages achieving higher pooled and sometimes top-quartile returns versus more mature funds.[2] In the near-term, however, the underperformance of a limited pool of impact funds has been misapplied to all "ESG" investments because of the confusion in terminology. As a result, many traditional investors (particularly those in North America) have avoided funds that highlight ESG capabilities. This ignores the potential of ESG underwriting to enhance the returns of conventional private market investment strategies.[3] At a fundamental level, RI is designed to reduce the effects of environmental, social or governance risks on the financial performance of a company. A tangible example of this risk reduction is Capital Dynamics' investment in a

ESG TERMINOLOGY EXPLAINED

RI: Environmental, Social and Governance (ESG) factors of an investment can be measured or assessed at any point in time to identify potential risks or value-creation opportunities in relation to that investment. RI's approach aims to incorporate ESG factors into investment decisions to better manage risk and generate sustainable, long-term returns.

SRI: A values-based approach to investing where a manager incorporates investors' beliefs about particular ESG factors into their investment decision-making.

Impact Investment: An approach to investing that actively seeks to make a beneficial change to the environment or society alongside a financial return.

1 GIIN, CAMBRIDGE ASSOCIATES "INTRODUCING THE IMPACT INVESTING BENCHMARK", 2015.
2 CAMBRIDGE ASSOCIATES PE/VC IMPACT INVESTING INDEX AND BENCHMARKING Q1 2019.
3 IN 2017, CAPITAL DYNAMICS UNDERTOOK A SURVEY OF ITS MANAGERS. THE RESULTS OF THAT SURVEY DEMONSTRATED THAT RESPONSIBLE INVESTMENT HAS THE POTENTIAL TO HAVE A POSITIVE IMPACT ON A COMPANY'S BOTTOM LINE – OVER A THIRD OF PRIVATE EQUITY MANAGERS REPORTED INCREMENTAL GROWTH IN EBITDA ACROSS THEIR PORTFOLIOS AS A RESULT OF RESPONSIBLE INVESTMENT IMPLEMENTATION.

German healthcare and social care company that provides favorable employment conditions, and in turn, attracts better quality staff, lowers staff turnover and reduces the use of temporary staff. The company's decision to provide an attractive working environment also enhances its market reputation, lowers risk and increases returns. By clearly distinguishing between impact and ESG, return-seeking investors will rationally place more emphasis on a disciplined approach to RI in selecting private market managers.

II. EXAMINING THE RECENT SURGE IN ESG ENGAGEMENT

In a short window of time, the perception and relevance of ESG has shifted along with changing demographics. Millennials are typically more conscious of certain issues, such as climate change, use of plastics, resource depletion and social inequality, than previous generations. As this cohort enters positions of greater influence, these issues are taking center stage. A recent survey from Bloomberg found that 77% of Millennials were interested in ESG investing compared to 59% of Generation X respondents, and 34% of Baby Boomers.[4]

The alternative investment community is no exception to this rule. ESG is gaining traction in the industry as Millennials are entering more senior positions at investment firms and at the organizations making the bulk of the commitments to these managers. The Bloomberg survey also found that good private market managers pay close attention to shifting trends. Over the next 30 years, an estimated USD 30 trillion of wealth is expected to change hands from Baby Boomers to Millennials.

According to a survey from Morgan Stanley, "Millennials are nearly twice as likely as other generations to have made a purchase because of a brand's environmental or social impact".[5] With this demographic group increasingly looking to purchase sustainable and ESG-friendly products, it is no surprise that economically rationale investment managers making long-term investment decisions are in lock-step with this important buyer base.

> **"SHIFTING DEMOGRAPHICS AND THE DEVELOPMENT OF THE UN's SUSTAINABLE DEVELOPMENT GOALS HAVE RESULTED IN A SURGE IN ESG ENGAGEMENT."**

In addition to shifting demographics, the United Nations has also been a catalyst for change. In 2015, the United Nations announced 17 Sustainable Development Goals ("SDGs") for 2030. These goals are broad-based, interdependent, and represent a call to action for all governments, companies and non-governmental organizations.[6] Local governments, agencies, endowments and foundations, and individuals have responded in an unprecedented way. Not only have many countries, states and cities taken steps to implement binding resolutions but also the visibility of these actions has driven worldwide awareness of the SDGs – a fact not lost on the alternative investment community.

As a result, more private market firms are looking at ways to adopt the SDGs in their operations.

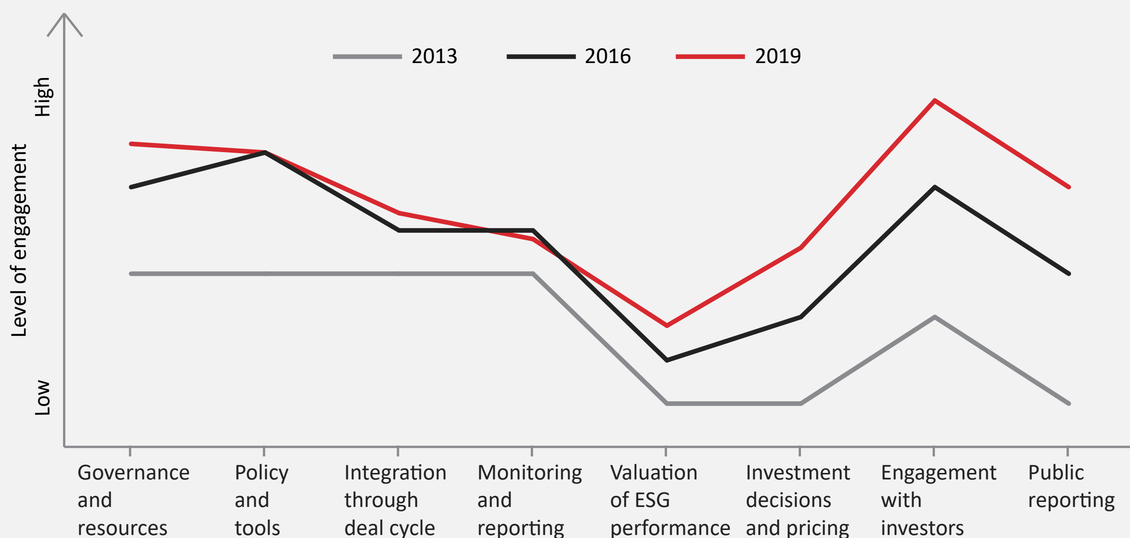
4 BLOOMBERG ESG PRESENTATION, OCTOBER 2019.
5 MORGAN STANLEY "SUSTAINABLE SIGNALS", 2017.
6 THE 17 SUSTAINABLE DEVELOPMENT GOALS ARE: (1) NO POVERTY; (2) ZERO HUNGER; (3) GOOD HEALTH AND WELL-BEING; (4) QUALITY EDUCATION; (5) GENDER EQUALITY; (6) CLEAN WATER AND SANITATION; (7) AFFORDABLE AND CLEAN ENERGY; (8) DECENT WORK AND ECONOMIC GROWTH; (9) INDUSTRY, INNOVATION, AND INFRASTRUCTURE; (10) REDUCING INEQUALITY; (11) SUSTAINABLE CITIES AND COMMUNITIES; (12) RESPONSIBLE CONSUMPTION AND PRODUCTION; (13) CLIMATE ACTION; (14) LIFE BELOW WATER; (15) LIFE ON LAND; (16) PEACE, JUSTICE, AND STRONG INSTITUTIONS; (17) PARTNERSHIPS FOR THE GOALS.

According to a recent report from the Emerging Markets Private Equity Association, a growing number of investors are asking firms how their investment strategy aligns with these global goals. In fact, some managers have responded to the SDG framework by launching dedicated impact strategies.

The increased visibility of ESG has resulted in a substantial increase in RI awareness in the alternative investment community. PwC, the global accounting firm with a substantial sustainability practice, recently conducted a responsible investment survey of private market managers. The results illustrated in **Figure 1** indicate that managers have stepped up their ESG engagement along key dimensions, including governance and resources, policy and tools, integration throughout the deal cycle, monitoring and reporting, valuation of ESG performance, investment decisions and pricing, engagement with investors, and public reporting.

Capital Dynamics is also currently undertaking its own survey to measure RI trends amongst private market managers, the results of which will be published early next year. Of the many areas of improvement, however, over one quarter of survey respondents still do not currently use Key Performance Indicators (KPIs) to measure their ESG performance. As we will explore later, KPIs are an essential tool to better track and understand the link between ESG risks and performance outcomes.[7] Understanding this link may be the key to more universal adoption of ESG criteria as part of conventional private market investment decision making.

FIGURE 1: APPROACH TO ESG IS MATURING AMONGST PRIVATE EQUITY MANAGERS



Source: PwC PE Responsible Investment Survey 2019.

7 CAPITAL DYNAMICS IS ALSO CURRENTLY UNDERTAKING ITS OWN SURVEY TO MEASURE RI TRENDS AMONGST PRIVATE EQUITY MANAGERS, THE RESULTS OF WHICH WILL BE PUBLISHED EARLY NEXT YEAR.

III. PROPOSING A QUANTIFIABLE APPROACH TO ESG

In the public markets, there is substantial research supporting the finding that a positive correlation exists between ESG and corporate financial performance. Lower ESG risk drives down the cost of capital, results in improved operating performance and stronger free cash flow. In fact, 88% of research studies found that solid ESG practices resulted in better operational performance.[8]

By contrast, only a handful of studies have explored whether this positive correlation extends to the private markets. It is Capital Dynamics' hypothesis that the relationship may be even stronger for several reasons:

1.
Private investing has a longer-term investment horizon. A long-term hold period means the risks associated with "poor" ESG management are more likely to negatively impact an investment.

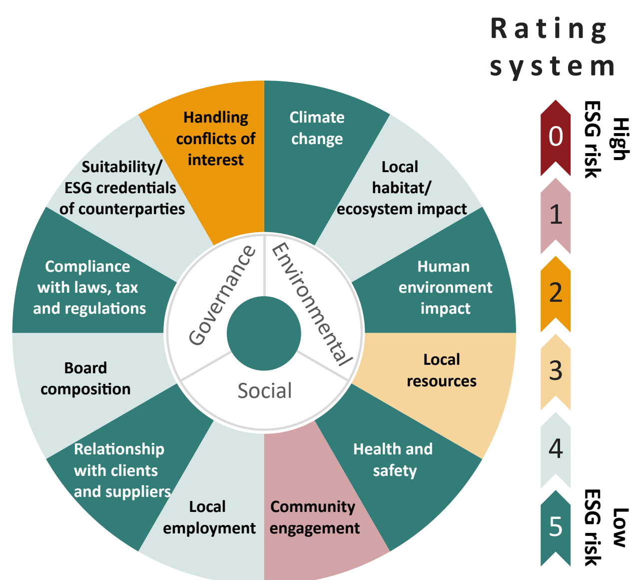
2.
The private markets are more conducive to a hands-on approach to operational improvements, making it easier to positively impact the ESG practices of a company during the hold period and take corrective action where necessary.

3.
Private managers can better align the financial incentives of senior management to encourage strong ESG practices.

4.
There is a larger pool of investments to choose from in the private markets. As a result, it should be easier to focus asset selection on companies with strong ESG without unnecessarily constraining the investment pipeline.

To prove that a strong positive relationship exists between ESG and performance in the private markets, a more quantifiable approach to RI underwriting is required. Working towards this goal, Capital Dynamics developed a proprietary framework for making RI assessments called the **R-Eye™** grading system. The grading rubric is based on the UN's 17 Sustainable Development Goals and scores each investment from 0-5 on a set of 10-12 criteria. Each investment team utilizes a strategy specific template, which is populated pre-investment and updated on at least an annual basis. On an individual investment case, this data should tell us where our assessments worked, where they did not, and give us the opportunity to take corrective action before and during the holding period. **Figure 2** shows an illustrative **R-Eye™** scorecard for Capital Dynamics' Clean Energy Infrastructure strategy.

FIGURE 2: CAPITAL DYNAMICS R-EYE™



8 OXFORD UNIVERSITY AND ARABESQUE PARTNERS "FROM THE STOCKHOLDER TO THE STAKEHOLDER – HOW SUSTAINABILITY CAN DRIVE FINANCIAL OUTPERFORMANCE", 2015.

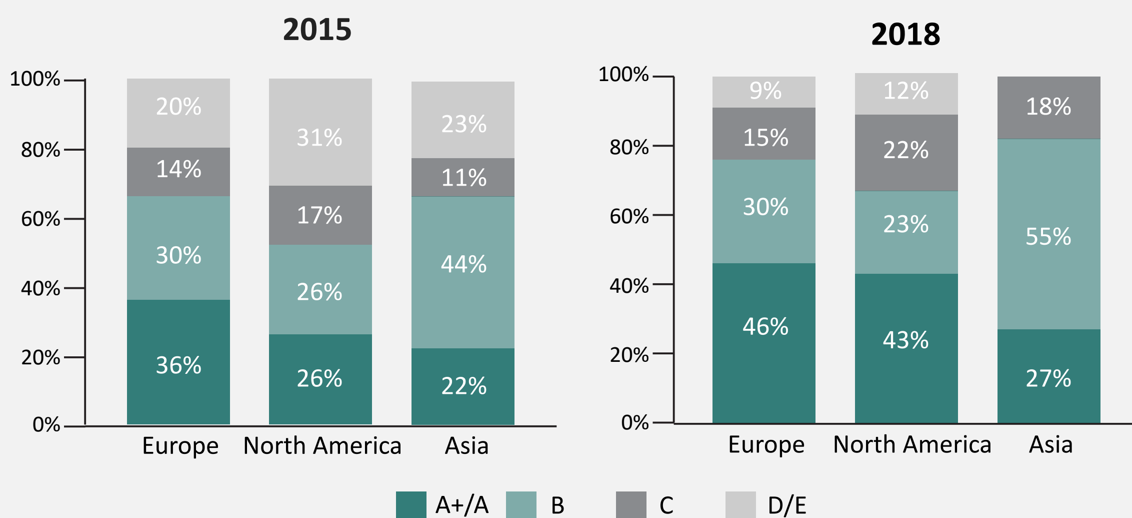
It is worth noting that Capital Dynamics has a diverse set of private market investment strategies. These strategies include: a global mid-market platform that makes private equity fund commitments, secondary investments and direct minority co-investments; a direct senior secured private credit strategy; and a direct energy infrastructure platform that invests in, and lends to, clean energy projects. There are necessary differences in how these varied strategies underwrite and manage ESG risk. For example, our control-oriented energy infrastructure strategies can often dictate ESG outcomes whereas our indirect, minority or debt-oriented strategies must rely more on influence and encouragement. Irrespective of these differences, the **R-Eye™** scorecard is applied consistently, enabling us to collect a wealth of data across the private markets that can be extracted and systematically analyzed. On a collective basis, this data will facilitate rigorous statistical analysis to determine connections between the different ESG factors themselves, risks, and returns.

IV. CONSIDERING THE DIFFERENCES IN ESG ENGAGEMENT BY GEOGRAPHY

As discussed earlier, private market managers have made significant strides in implementing RI practices in recent years. These improvements, however, have not been uniform with European managers further ahead of their peers in the U.S. and Asia. **Figure 3** below illustrates the UN-supported PRI scores of direct private investment managers.[9] While managers across regions have made substantial progress from 2015 to 2018, notable differences remain.

In particular, scores are more positively skewed in Europe compared to North America or Asia. Perhaps more indicative of ESG engagement is the number of PRI signatories. In Europe, 220 managers participated compared to only 51 in North America and 22 in Asia. As explored below, the contrasting level of ESG engagement in various geographies results from differences in regulation, the level of maturity of regional private markets, and differences in investor sentiment.

FIGURE 3: PRI ESG RATINGS OF DIRECT PRIVATE EQUITY INVESTMENT MANAGERS, BY PERCENTAGE OF TOTAL SIGNATORIES



Source: PRI.

9 CAPITAL DYNAMICS AS A FIRM RECEIVED A RATING OF A+ FOR STRATEGY AND GOVERNANCE FROM THE UN-SUPPORTED PRINCIPLES FOR RESPONSIBLE INVESTMENT.

REGULATION

In the United States, the Department of Labor (DOL) historically discouraged pension funds from considering ESG factors. Pension funds, and their financial advisors, were instructed to "always put the economic interests of the plan first." Since ESG underwriting was deemed ancillary to maximizing returns, pension funds were not supposed to consider these factors in allocating capital to managers. Given the amount of capital U.S. pension funds control, investment managers were not incentivized to adopt best-in-class RI practices.

In late 2015, the DOL under the Obama administration issued guidance clarifying that investment evaluation based on ESG criteria did not violate a financial advisor's fiduciary obligation to pensioners. This guidance was influenced, at least in part, by the growing evidence that strong ESG may enhance investment returns. Recently, however, President Trump issued an Executive Order promoting energy infrastructure and economic growth. This Order required the DOL to re-examine the use of ESG metrics when evaluating investments in this sector.[10] Not surprisingly, the new Executive Order combined with an inconsistent regulatory history has been a headwind in the development of market leading ESG in the U.S.

> **"When it comes to ESG integration, European private equity managers tend to be ahead of their North American and Asian counterparts, thanks largely to more supportive European regulation and greater investor sentiment."**

By contrast, regulation in Europe has been more supportive of enhanced ESG practices for investment managers. For example, the EU directive (2014/95/EU) requires institutions to disclose non-financial information related to social and environmental issues.[11] This type of regulation has led institutional investors in Europe to take a more active role in encouraging private investment managers to make RI decisions. As a result, European managers have done more to prioritize ESG to better attract capital flows from their investor base and to meet the increased investor sentiment for RI.

Further legislation is also forthcoming in Europe. The European Sustainable Finance Action Plan applies to financial market participants and financial advisers and was adopted by the European Commission in March 2018. Months later, the Commission established an expert group in an effort to establish an EU classification system (i.e. taxonomy) for sustainable activities. This expert group is especially focused on the need to address client change, placing particular emphasis on the 'E' in ESG. Some of the 10 high-level Action Points are particularly relevant to asset managers, especially Action Point 7: clarifying institutional investors' and asset managers' duties. The Action Plan is currently under consultation and the resultant Disclosure Regulation is due to come into force as early as Q4 2020. This regulation will introduce obligations on institutional investors and asset managers to disclose how they integrate ESG factors in their risk processes, as well as require integration of ESG factors in investment decision-making processes.

Further, in early October of this year The European Union took a major step towards internationalizing its work on sustainable finance via its EU Action Plan with the launch of a new International Platform on Sustainable Finance (IPSF) in Washington DC. The IPSF will be a new multilateral forum where organizations and networks from countries across the world can share, exchange and potentially align their initiatives on sustainable finance. Taken collectively, the regulatory environment in Europe has been far more of a tailwind in the development of ESG practices for European managers.

10 BARRONS "TRUMP IS PUSHING FOR A REVIEW OF HOW PENSIONS USE ESG METRICS", APRIL 2019.
11 HTTPS://WWW.GLOBALREPORTING.ORG/RESOURCELIBRARY/NFRPUBLICATION%20ONLINE_VERSION.PDF.

In the Asia-Pacific market, particularly China and South East Asia, regulation has focused on the growth and industrialization of local economies. As such, less attention has been paid to "softer" issues such as ESG. Where regulation has supported ESG best practices, it has focused on governance rather than environmental or social considerations. Not surprisingly, the "E" and "S" of ESG are the areas where Asian private market managers are furthest behind compared to Europe and the U.S. However, this is starting to change. Environmental and social factors are gaining traction aided by recent regulation and policy. As an example, the governments in Hong Kong and Singapore are positioning themselves as leaders in green finance and investment. Further, many stock exchanges in Asia are requiring enhanced ESG disclosures from issuers, which by extension, should have a carryover effect to private market investing. The inclusion of the China A-share market in major indices has already resulted in improved ESG data coverage and encouraged local companies to develop enhanced ESG practices – which we expect to spillover into the private markets.

MATURITY OF THE REGIONAL PRIVATE MARKET

ESG engagement also varies by geography depending on the relative maturity of the asset class in the region. In parts of Europe and the U.S., private market investing has been an established part of the investment community for over five decades. While new start-ups and spin-offs always emerge, established managers in these regions are often investing their sixth generation fund or later. [12] Over time, these managers have both the resources and pattern recognition to integrate strong RI discipline into asset selection and monitoring. In comparison, private market investing in Asia only began to penetrate the region in the mid to late 1990s.[13] As a result, most managers operating in Asia today are either global players with local presence in the market or smaller indigenous groups investing second or third generation funds. Alternative investment managers in this earlier part of their business development cycle are less likely to have the resources, infrastructure or experience to invest in enhanced ESG operations. As evidence, we estimate revenues from management fees for an average U.S. and European manager are about five times higher than their peers in Asia (based on the average buyout fund size closed over the last decade).[14]

> **"RESOURCES AND LONGEVITY ALONE, AS DISPLAYED BY CERTAIN LARGE GLOBAL, U.S. OR EUROPEAN MANAGERS, DO NOT DICTATE ESG OUTCOMES. THERE ARE SMALL AND MID-SIZED MANAGERS ACROSS THE GLOBE WHO EXHIBIT MARKET-LEADING RI."**

When considering that U.S. and European managers have benefited from carried interest revenues on larger funds and over longer periods of time, the resource disparity compared to Asia becomes even more evident. Having said this, resources and longevity alone, as displayed by certain large global, U.S. or European managers, do not dictate ESG outcomes. There are small and mid-sized managers across the globe that exhibit market-leading RI. Investing with these managers may offer broader portfolio benefits but identifying them requires local market presence and an experienced approach to integrating ESG within investment decision-making.

The evolution of private investing in a region also follows a natural path of development that is conducive to enhanced ESG. At the beginning, most private equity managers make minority investments in smaller companies (venture or growth investing). Over time, the industry evolves

12 PREQIN FUNDRAISING DATABASE.
13 ASIAN VENTURE CAPITAL JOURNAL (AVCJ) DATA.
14 CAPITAL DYNAMICS OWN CALCULATIONS BASED ON FUNDRAISING DATA FOR 2009-2018 FROM PREQIN AND THE AVCJ DATABASE.

to control-oriented investments in more established companies (buyout investing). Eventually, large buyout managers emerge that invest in companies with enterprise values in excess of USD 1 billion. For these larger investments, the public markets are often the preferred route to exit an asset. Taken together, it is easy to see why more mature regional private markets have enhanced RI practices: control oriented investments make it easier to implement strong ESG fundamentals at the portfolio company level; and the increased likelihood of an initial public offering (or exit to a publicly owned strategic buyer) makes it more important due to the added layer of required transparency. In the U.S. and Europe, between 66% and 80% of all private equity deals are buyout acquisitions. Compare this to Asia where only about 30% of private equity deals are buyout transactions. As the Asian private equity market continues to mature, we expect ESG engagement to continue to improve in the region.

INVESTOR SENTIMENT

Investor sentiment is another reason ESG engagement varies regionally. In Europe, institutional investors typically place a greater emphasis on ESG compared to both the U.S. and Asia. In part, this greater emphasis is driven by the strong public and regulatory pressure on European pension funds and insurers as well as pressure from beneficiaries who are often represented within the governance structure of European pension funds. In a recent study conducted by Schroders, 58% of pension fund investors in Europe already see ESG as an important consideration. This compares to only 21% in the U.S.[15] Perhaps more importantly, only 14% of pension fund investors in Europe believe that ESG will never be an important consideration for them. Whereas in the U.S. over 40% of investors take this view. These differing attitudes result in varying approaches to portfolio allocation decisions. In Europe, 40% of pensions consider ESG in allocating their investment portfolios compared to only 21% in the U.S. As a result, European investors are more likely to conduct due diligence on the RI practices of a manager prior to making a decision to commit capital to them. Private market managers seeking to attract capital from these investors have little choice but to invest the time and resources in strong ESG practices. This fact is best illustrated by a recent Aon survey that found clear reporting is the most popular factor global investors look for from ESG managers – approximately 56% of investors made this declaration.[16]

> **"INSTITUTIONAL INVESTORS TODAY ARE UNDER INCREASED PRESSURE TO ACTIVELY RATE THEIR PRIVATE MARKET INVESTMENT PORTFOLIOS AGAINST QUANTIFIABLE ESG METRICS."**

Further, the quality of ESG due diligence being conducted by investors in Europe is improving. As recently as a few years ago, RI-focused investors were mainly concerned with *whether* private market managers considered ESG. Demonstrating even modest, often qualitative, engagement on environmental, social and governance factors was sufficient. These same investors today are under increased pressure to actively rate their private market investment portfolios against quantifiable ESG metrics. To do this, institutional investors need to take their due diligence a step further. Rather than simply asking whether a manager considers ESG in making investment decisions, investors in Europe are asking *how* the manager is underwriting, monitoring and responding to ESG considerations at the portfolio and organizational level. Responding to this inquiry effectively requires hard-facts and data to support rigorous RI decision making. Consequently, managers in Europe have taken significant strides in implementing a more quantifiable and trackable approach to ESG.

15 HTTPS://WWW.SCHRODERS.COM/EN/MEDIA-RELATIONS/NEWSROOM/ALL_NEWS_RELEASES/EUROPEAN-INVESTORS-LEAD-US-COUNTERPARTS-FOR-ESG-ADOPTION/.
16 AON RESPONSIBLE INVESTMENT SURVEY 2019 OF 229 GLOBAL INVESTORS.

V. EMERGING TRENDS IN EUROPE, THE U.S., AND ASIA

As described in the previous section, Europe is generally further ahead in the adoption of market-leading RI practices versus the U.S. and Asia. We have observed several important developments from managers in this market over the past few years:

1. A shift in emphasis from pure risk management to value enhancement due to increasing awareness that strong RI underwriting not only offers downside protection but also has the potential to increase the value of an investment over time.[17] Both strategic and financial buyers are willing to pay more for assets with strong ESG underpinnings.

2. Historically, RI analysis was conducted as a part of the initial investment decision. Increasingly managers in Europe are placing equal importance on continuous monitoring and re-underwriting of ESG considerations throughout the ownership phase.

3. An increased realization that a rigorous approach to RI is not enough. Best-in-class managers must also effectively communicate ESG risks, considerations and trends to their investors. As such, we have observed more focus on the reporting of these issues in quarterly investment updates; annual reports; and real-time ESG alerts.

4. Efforts are also being undertaken to improve ESG data collection, an objective Capital Dynamics is seeking to help drive. This data collection represents an important step towards better establishing the link between RI practices and investment performance in the private markets.

While the U.S. is experiencing similar trends, implementation has been slower than in Europe. In recent years, more U.S. managers have implemented ESG policies. Having a policy in place, however, has only translated to active RI diligence and value creation processes on a limited basis. Where this translation has occurred, it is principally with larger U.S. private market managers with global investor bases. Globally operating U.S. managers have been under pressure from their European investor bases to implement strong, data driven approaches to ESG. It should also be noted that there are a number of strong mid-sized U.S. managers who exhibit market-leading RI – they are just harder to find. Identifying these managers requires an experienced partner who can differentiate fundamental RI underwriting from a more cursory approach.

Asia is a more heterogeneous market. Overall ESG initiatives in this region typically lag Europe and the U.S. Over time, however, this is changing as investors realize that environmentally and socially responsible investments have higher returns in the Asian market. According to data from the Asian Venture Capital Journal and Preqin, deals in environmentally and socially-friendly sectors in Asia have returned a median multiple of 3.4x compared to 2.5x for deals in other sectors.[18] The Japanese government and its pension fund (GPIF, the world's largest pension fund with USD 1.5 trillion in AUM) have also been strong advocates for the importance of the SDGs and strong RI practices. In 2017, GPIF implemented requirements for its fund managers to incorporate environmental, social, and governance factors into their investment practices and to become PRI signatories. Anecdotally, we have also observed a marked increase in ESG engagement at Asian alternative investor conferences and panels.

17 CAPITAL DYNAMICS STUDY BASED ON A SURVEY OF GENERAL PARTNERS "RESPONSIBLE INVESTMENT IN PRIVATE EQUITY – A KEY COMPONENT OF OPERATIONAL VALUE CREATION", 2017.
18 BASED ON EXITS BETWEEN 2014 TO 2018.

VI. CONCLUSION

A preponderance of evidence supports the conclusion that RI has reached an inflection point in private market investing. This shift is driven by a better understanding of "ESG" terminology, changing demographics in favor of Millennials, engagement from the UN and local governments (particularly in Europe), and ESG-conscious investors demanding more from their managers. The next step towards the universal adoption of best-in-class RI practices across regions is to develop better data to establish the link between RI underwriting and investment performance.

To further advance this cause, Capital Dynamics has implemented the **R-Eye™** grading system across its investment strategies to capture as much data as possible and to draw statistically significant conclusions. As this link is established, rational investors will be inclined to select managers with the strongest ESG practices. As capital flows towards these managers, other less ESG-sensitive managers will look to keep up. Over time, this should result in a stronger commitment to ESG from the private market industry and ultimately better performance from the asset class.

Until the rest of the globe catches up with Europe, how should investors build a portfolio of private investments? Investing exclusively in European managers is no solution. It would result in sub-optimal geographic diversification and potential underperformance in certain parts of the market cycle (particularly in periods of boom or bust). Instead, Capital Dynamics suggests building a portfolio with meaningful exposure to best-in-class European managers complemented by thoughtful allocations to managers in the U.S. and Asia. In making this allocation, investors may focus on managers in these regions that have global investor bases and are willing to adhere to ESG-specific side letters.

Further, ESG-minded investors should be on the lookout for emerging RI trends from U.S. and Asian private market firms. Managers in these regions have the benefit of learning from the ESG practices (and mistakes) of their European colleagues. It is often easier to improve on established practices as a new-comer rather than an early adopter. Further, there is another hidden problem with a European-centric approach to manager selection – the potential stagnation of RI practices from managers in the rest of the world.

> **"Capital Dynamics suggests building a portfolio with meaningful exposure to best-in-class European managers complemented by thoughtful allocations to managers in the U.S. and Asia. As the link is established between RI underwriting and investment performance, rational investors will be inclined to select managers with the strongest ESG practices."**

ESG-minded investors should not underestimate their ability to influence the behaviors of managers with their due diligence processes and capital allocation decisions. Such investors may also be well-served to partner with global allocators who understand the private markets, the role that market leading RI can play in investment decision-making, and have the relationships with managers to enable change.

AUTHORS

BRYN GOSTIN

SENIOR DIRECTOR,
CO-CHAIR OF RESPONSIBLE INVESTMENT COMMITTEE

NEW YORK
+1 212 798 3415
BGOSTIN@CAPDYN.COM

ANGELA WILLETTS

MANAGING DIRECTOR,
CO-CHAIR OF RESPONSIBLE INVESTMENT COMMITTEE

BIRMINGHAM
+44 121 200 8803
AWILLETTS@CAPDYN.COM

ABOUT CAPITAL DYNAMICS

Capital Dynamics is an independent global asset management firm focusing on private assets including private equity, private credit, clean energy infrastructure and clean energy infrastructure credit. Capital Dynamics offers a diversified range of tailored offerings and customized solutions for a broad, global client base, including corporations, family offices, foundations and endowments, high net worth individuals, pension funds and others. The firm oversees more than USD 16 billion in assets under management and advisement[1]. Capital Dynamics is distinguished by its deep and sustained partnerships with clients, a culture that attracts entrepreneurial thought leaders and a commitment to providing innovative ideas and solutions for its clients.

Founded in 1999 and headquartered in Zug, Switzerland, Capital Dynamics employs approximately 150 professionals globally and maintains offices in New York, London, Tokyo, Hong Kong, San Francisco, Munich, Milan, Birmingham, Dubai and Seoul.

In 2019, Capital Dynamics was awarded the highest corporate rating (A+) from the UN-supported Principles for Responsible Investment, while the firm's clean energy infrastructure platform received top rankings from GRESB (the ESG benchmark for real assets) for commitment to sustainability.

[1]As of September 30, 2019.

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