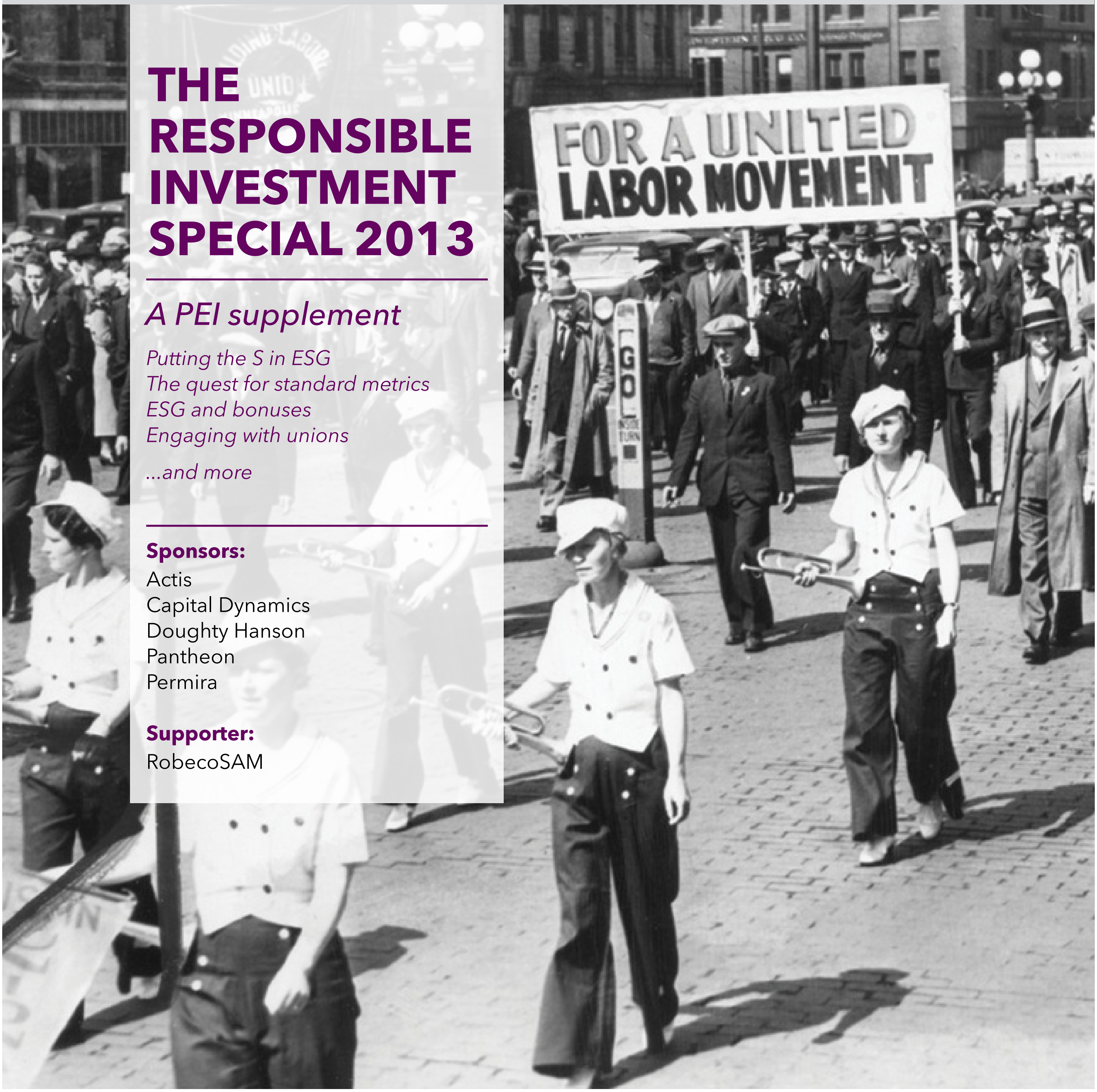
PEI Alternative Insight

February 2013 privateequityinternational.com

FOR THE WORLD'S PRIVATE EQUITY MARKETS

PRIVATE EQUITY INTERNATIONAL



THE RESPONSIBLE INVESTMENT SPECIAL 2013

A PEI supplement

Putting the S in ESG
The quest for standard metrics
ESG and bonuses
Engaging with unions

...and more

Sponsors:
Actis
Capital Dynamics
Doughty Hanson
Pantheon
Permira

Supporter:
RobecoSAM

REPORTING

A clearer focus

GPs have long taken an interest in ESG issues – but they need to start talking to investors more about how the work they do in this area adds value, says Capital Dynamics' John Gripton

The last couple of years have seen GPs make great strides in the way that they think about and report on environmental, social and governance (ESG) issues. Much of this has been down to pressure from some experienced and progressive LPs – including global alternative asset manager Capital Dynamics.

"It's not that managers were ignoring ESG in the past," says John Gripton, a managing director and head of global investment management at Capital Dynamics. "Most have clearly been conscious of this area in the investments they make – they commission environmental reports, they consider social implications, they look at governance issues. It's just that they haven't reported on these issues fully, or it's only been part of their general due diligence and monitoring work. So there's been no real focus on reporting on this area specifically to investors."

This greater focus on ESG issues first became apparent in the public markets, he says – leading to the creation of socially responsible investment portfolios, amongst other things – and has gradually made its way into the private equity market too.

As far as Gripton is concerned, this is a very positive development. "We truly believe that observing ESG and incorporating it into due diligence and the ongoing building of a company really does add value and make a company more attractive to a potential acquirer."

It also represents a natural step in the industry's evolution, he suggests. "The first stage was about financial engineering, where debt partly supported returns. That's now evolved into managers building the operating experience required to develop and grow companies. ESG is the next stage on from that. What we're going to be looking at is how working on ESG issues has really created value within the portfolio."

Gripton: *transparency is key*

IDENTIFY AND RESOLVE

Perhaps the key aspect here is reporting. If GPs really are more focused on this area, how do they convey this to the investors in their funds in the best possible way? To Gripton, this is becoming an increasingly significant area.

"It's important to remember that reporting won't create value in itself; it's just a means of communication. What's really changed is that investors are much more focused on understanding the contribution that comes from ESG improvements. Therefore, reporting is becoming increasingly important for managers because we – along with many other investors – will be looking at how GPs have handled ESG, and how this has contributed to the value created in a company during their stewardship. In addition, this is becoming an increasingly important element during our due diligence process in understanding how a manager creates value," he explains.

Not every LP will think about ESG in terms of value creation, he says. Some will largely be interested in it from a risk management point of view (another important consideration, as Gripton admits). However, for those that do, what exactly are they looking for from their GPs?

"The first point is that when a manager is making an investment, we're looking to understand that the manager has identified the ESG risks during their due diligence process – and more importantly, identified how to create value by working on these issues. That should be part of the overall value creation package they put in place, just like financing arrangements, or expansion plans, or cost savings; ESG is just another factor within this. That's what we need to see as an investor in a fund, and what we try to show the clients on »

» whose behalf we work: that the manager has a plan for working on ESG issues to create value, just as they would with any other aspect of the company."

The next step is to track a GP's success in achieving these ESG improvements during the period it owns a particular company – and to try to quantify exactly what contribution that has made to any increase in value as and when the company is sold. "At the moment, we're focusing on sales, profits and the use of debt to analyse how a manager has created value," says Gripton. "So we'll be focusing on ESG issues within that, as part of our own ongoing due diligence work. This will help us assess the quality of the manager, and decide whether we want to support them in the future."

NOT TOO ONEROUS

Of course, the aim is not to avoid ESG risks altogether. In fact, if anything the reverse is true. "If these issues are identified properly and handled correctly, so the GP works to improve them, the company can be sold at a higher value," Gripton points out. "So it's not a question of shying away from a company with significant issues – it's about concisely evaluating existing risks, knowing how you're going to deal with them in a way that adds value and how to minimise their potentially negative impact."

As ESG issues become more important in the corporate world, LPs will attach increasing weight to this aspect of due diligence, he suggests. After all, they're investing for the long haul. "We have to select managers who will perform well during the next decade, not the last decade."

In fact, says Gripton: "If the answers to these questions are not apparent from the manager's reports – i.e. if a GP cannot show that it is adding value by working on ESG issues – it would pose serious questions about whether Capital Dynamics would want to back them in the future."

So what exactly does good reporting look like, in practice? The industry is working hard to develop a more specific answer to this question (Capital Dynamics is currently part of a working group set up by the British Private Equity and Venture Capital Association for that very purpose).

According to Gripton, it's very important to develop some kind of standard 'best practice' similar to existing Valuation and Reporting Guidelines. "Reporting needs to evolve. It's vital that investors agree what they want, so managers can deliver on that rather than trying to deal with individual investor requests."

But while the specifics may still be under discussion, the broad imperatives for GPs are clear. The first step is identifying ESG issues in the due diligence process and developing a clear plan to deal with them; then there's the ongoing reporting during the life of an investment (particularly in the event that things go wrong); then there's trying to identify the value contribution from dealing with these issues on exit.

With all of this, the key is to deliver the information to LPs in a digestible way. "It's about giving investors what they need in a concise way, without it getting too onerous – and without it wasting anyone's time."

For many GPs, says Gripton, it will just be a question of greater transparency. "In the main, managers have identified these issues; when you look at their due diligence reports, the information is often there. The key is to get it to the forefront in the details they send us when they make a new investment – these are the risks, here's what we plan to do about it, and this is how it will enhance value." ■

It's about giving investors what they need in a concise way, without it getting too onerous – and without it wasting anyone's time

Performance: the result of long-term dedication

We understand the dynamics of performance and know that long-term dedication to uncompromising quality is the best route to success. Capital Dynamics is an award-winning private asset manager highly skilled in funds of funds, separate accounts and structured products.

To discover how our extensive experience in private equity and clean energy infrastructure – together with our long-standing industry relationships – can link you to the full potential of private assets, please contact us at clientrelations@capdyn.com.

www.capdyn.com

Capital Dynamics

London | New York | Zug | Tokyo | Hong Kong | Silicon Valley | Sao Paulo | Munich | Birmingham | Brisbane

COMPANY PROFILE: CAPITAL DYNAMICS

Capital Dynamics* is an independent, global asset manager, investing in private equity and clean energy infrastructure. We are client-focused, tailoring solutions to meet investor requirements. We manage investments through a broad range of products and opportunities including separate account solutions, investment funds and structured private equity products.

Our investment history dates back to 1988[1]. Our senior investment professionals average over 20 years of investing experience across the private equity spectrum. We believe our experience and culture of innovation give us superior insight and help us deliver returns for our clients. We invest locally while operating globally from our London, New York, Zug, Tokyo, Hong Kong, Silicon Valley, Sao Paulo, Munich, Birmingham (UK) and Brisbane offices.

RESPONSIBLE INVESTING AT CAPITAL DYNAMICS

In recent years the private equity investment community has become increasingly aware of the importance in observing the principles of Responsible Investing when acquiring investee companies and in the development of these companies whilst in their stewardship.

Capital Dynamics has been at the forefront of this development. In 2008, it became one of the early signatories to the United Nations Principles of Responsible Investment. Since then, Capital Dynamics has continued to strive for these principles to be integrated throughout the private equity industry.

John Gripton, Head of Investment Management, Private Equity at Capital Dynamics, sits on the BVCA Responsible Investment Advisory Board and has been closely associated with the International Initiative on Environmental, Social and Governance (ESG) in Private Equity.

These Principles, involving ESG issues, are now firmly embedded in the investment processes at Capital Dynamics.

SUPERIOR INSIGHT LEADS TO RESULTS

We believe informed decisions lead to enhanced performance. We gain insight through rigorous due diligence, ongoing market monitoring and industry-leading portfolio and risk management. Then, we select what we believe are the best investments. Our extensive experience, long-standing relationships and targeted research give us the additional insight required to generate attractive, risk-adjusted, long-term returns for clients.

FOCUS ON INNOVATION AND QUALITY

Our approach is simple – understand clients' needs, then design products and services accordingly. The result – original solutions that work. We are an industry leader in quantitative risk management, an essential component of successful investing. Our risk management services help strengthen portfolios by reducing risk and volatility and our risk management methodology has been adopted by ratings agencies such as Moody's and Standard and Poor's.

BROAD RANGE OF INVESTMENT PRODUCTS

Direct investments – Our longstanding relationships with the globe's top-tier fund managers provide immediate access to powerful direct dealflow and high-quality investment opportunities. Our co-investment strategy is focused on mid-market buyouts, but also includes select development capital and special situations.

Primary fund investments – We have invested in private equity funds since the late 1980s[1], across various cycles, diverse geographies and multiple strategies. We have invested with many of the industry's pre-eminent managers since those managers launched their first funds. Currently, we monitor more than 800 active funds managed by over 400 General Partners in which we or our clients are invested.

Secondary fund investments – Active in the secondary market since the early 1990s[1], we raised one of the first dedicated secondary funds. Today, we have consistent access to secondary deal flow through our global network of over 1,500 managers. Our extensive, active fund investments and deep pool of performance and fund data give us a unique advantage when evaluating secondary transactions.

Clean Energy and Infrastructure – Our specialised team of senior industry investors employs a direct investment strategy focused on proven clean energy technologies that can offer attractive risk-adjusted returns and compelling diversification benefits from this new class of real assets.

STRUCTURES

Funds of funds – We invest in private equity primary and secondary funds of funds, allowing investors to implement a global allocation and portfolio diversification strategy through access to premier private equity managers.

Separate accounts – Individual investment programs tailored to meet clients' unique risk profiles and liquidity parameters. We offer legal structuring services to meet the regulatory, tax and compliance obligations for each separate account client.

Structured products – We customise solutions one client at a time. Every structured solution is designed to deliver compelling benefits such as early liquidity, enhanced return on investment, reduced risk, lower open commitments and/or decreased risk-weighted capital reserves.

Please contact us at **clientrelations@capdyn.com**, or visit our website **www.capdyn.com** for further information.

* Capital Dynamics comprises Capital Dynamics Holding AG and its affiliates.

[1] History includes 2005 acquisition of Westport Private Equity Ltd.