

CapitalDynamics

TRULY INVESTED.



EMBRACING ESG AS A VALUE DRIVER

RESPONSIBLE INVESTMENT/ESG SURVEY
OF PRIVATE EQUITY GENERAL PARTNERS

APRIL 2020

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ABOUT THE SURVEY

SUMMARY

Integrating Environmental, Social and Governance (ESG) factors into private equity's investment process can lead to better returns for investors. As an early signatory of the Principles for Responsible Investment (PRI), Capital Dynamics truly believes in the value proposition of integrating ESG principles both into day-to-day activity as well as into investment processes. We are the first global private equity fund platform to launch a Clean Energy strategy. In the traditional private equity investing world, Capital Dynamics (as a Limited Partner) integrated ESG principles into its fund selection process and monitored ESG implementation among its General Partners (GPs).

A key focus of our underwriting and monitoring process is to understand how the General Partners of private equity funds use ESG factors in value creation. With this in mind, we embarked on our inaugural survey among our GPs in 2016 to determine the views of managers and observe the results of their ESG integration into the value creation process.¹ Three years later, we have taken another snapshot of ESG progress in this area and reflect on the findings based on responses from 157 GPs who collectively manage over USD 1 trillion globally in private equity assets.²

As conveyed by our survey results, GPs increasingly recognize the importance of Responsible Investment (RI)/ESG in generating sustainable returns for investors. GPs who took tangible action on RI/ESG implementation were able to measurably improve operational performance and reduce business risks for their investments. However, we also observed that some GPs merely declared following RI/ESG for marketing purposes. It is important to distinguish this greenwashing from real RI/ESG impact on portfolio company performance. Therefore, analyzing the implementation of RI/ESG principles and measuring their impact on value creation is pivotal when conducting due diligence.

157

**PRIVATE EQUITY
GPs SURVEYED
WORLDWIDE**

1.1

**USD TRILLION
IN PRIVATE EQUITY
ASSETS UNDER
MANAGEMENT**



ANGELA WILLETTS, MANAGING DIRECTOR,
CO-CHAIR OF RESPONSIBLE INVESTMENT
COMMITTEE



BRYN GOSTIN, MANAGING DIRECTOR,
CO-CHAIR OF RESPONSIBLE INVESTMENT
COMMITTEE

¹ Capital Dynamics "Responsible Investment in Private Equity – a Key Component of Value Creation" March 2017.
² Based on Preqin data on the private equity funds raised during past 10 years by GPs – respondents to our survey.

KEY INSIGHTS

1 **ESG engagement is growing rapidly outside of Europe.**
We observed higher response rates and much greater participation from North American and Asian GPs.

+40%
Growth in survey participation

2 **ESG is increasingly viewed as a value creation tool.**
Experienced managers, particularly in Europe, are leading the pack in integrating ESG into the strategic value creation process.

74%
of GPs plan to use ESG for value creation

3 **GPs advanced their efforts to measure ESG impact on performance.**
A growing number of GPs introduced quantitative metrics to measure the influence of ESG actions on revenue, cost savings and operational risk of portfolio companies.

14%
of GPs measure ESG impact on revenue

4 **Increased evidence of the positive link between ESG and performance.**
The overwhelming majority of GPs who measure ESG actions saw a positive influence on portfolio company performance.

+50%
increase in number of GPs reporting cost savings

5 **ESG implementation becomes more important for a successful exit.**
Buyers, particularly other GPs, increasingly conduct ESG due diligence. As sponsor-to-sponsor exits become more frequent in a mature private equity market we expect companies with strong ESG records to be valued at higher multiples on exit.

79%
of GPs find that buyers conduct ESG due diligence

6 **Venture GPs are late adopters of ESG but we expect this to change.**
As VC-backed companies stay private longer, these businesses are now much larger and under more scrutiny. Consequently, VC managers will most likely be under increasing pressure to take ESG seriously.

41%
of Venture GPs have an RI/ESG policy

7 **ESG progress in reporting to LPs has been slow.**
We expect significantly more private equity GPs to step up their efforts in providing comprehensive ESG reporting to LPs.

73%
of GPs plan to improve ESG reporting to LPs

8 **GPs are planning to boost resources for ESG efforts.**
GPs are trending away from sharing ESG responsibility across investor relations and compliance functions and are engaging their investment teams more directly in these efforts.

35%
of GPs plan to increase ESG resources

ESG JOURNEY: FROM RISK MANAGEMENT TO VALUE CREATION

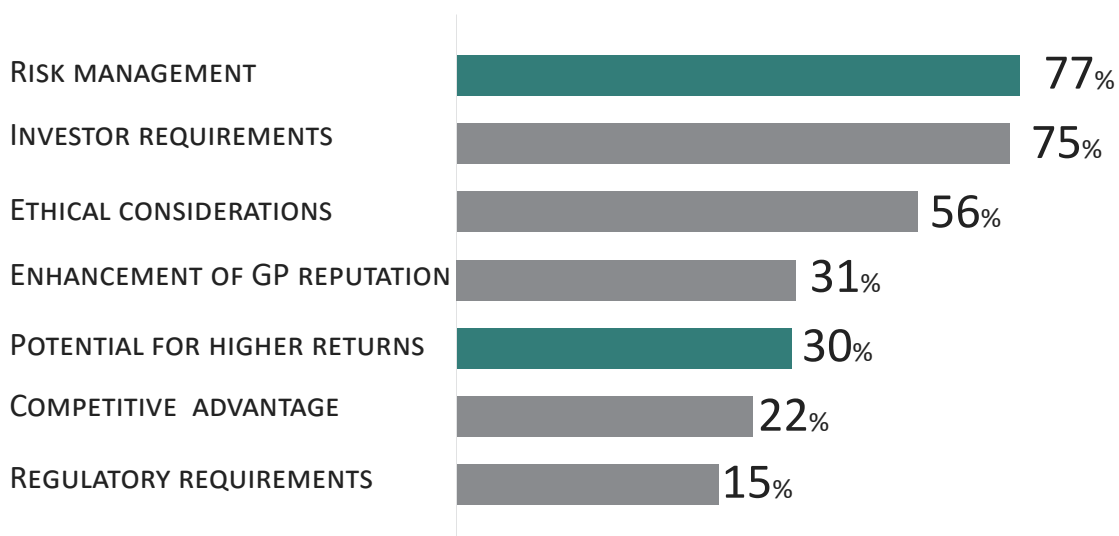
According to our survey, private equity managers' initial motivation to integrate Principles of Responsible Investment and ESG factors into their investment process were primarily driven by risk management considerations and investors' requirements, as shown in **figure 1**.

Managers typically consider ESG to be part of a robust risk framework at both the investment and corporate level. Therefore, incorporating ESG principles can enhance the existing risk practices of private equity managers. Encouragingly, these two main drivers were also most frequently cited in our 2016 survey, illustrating GPs' consistent perspective over time.

Interestingly, the late adopters of ESG, those who established policies over the last three years, cited enhancement of GP's reputation significantly more often (52%) than the early adopters (24%).

"THE VAST MAJORITY OF PRIVATE EQUITY GPs STARTED CONSIDERING RI/ESG DUE TO INVESTOR REQUIREMENTS OR BECAUSE OF ITS BENEFIT FOR EFFECTIVE RISK MANAGEMENT."

FIGURE 1: PRIMARY DRIVERS FOR RI/ESG IMPLEMENTATION



Return potential may not have been on the radar of many GPs in the early days of ESG integration. However, the notion of additional value-add of ESG beyond risk management appears to be gaining momentum. Three out of four survey participants disagreed that ESG only reduces risks and does not add value. Moreover, the same proportion of managers believe ESG can increase returns.

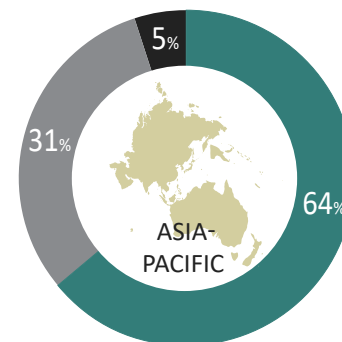
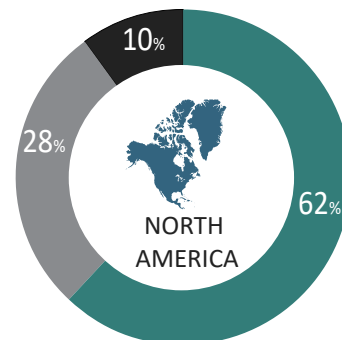
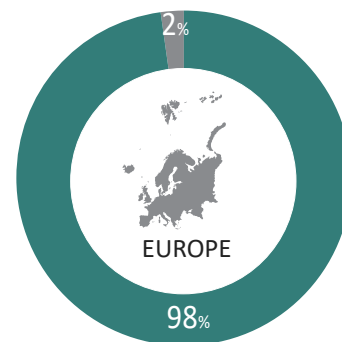
“THE NOTION OF ADDITIONAL VALUE-ADD OF ESG BEYOND RISK MANAGEMENT IS MANIFESTING.”

However, North American and Asia-Pacific managers were less convinced of the value creation benefits of ESG integration when compared to European managers. While almost every GP in Europe agreed that ESG can increase returns, less than two-thirds of North American and Asia-Pacific managers said so (see **figure 2**).

“Our approach is not simply to assess the potential to mitigate risk, but also to find opportunities to support value creation through enhanced management, such as resource efficiency or sustainable product development.”

A EUROPEAN GP

FIGURE 2: PROPORTION OF GPs WHO BELIEVE ESG CAN INCREASE RETURNS



■ AGREE ■ NO OPINION ■ DISAGREE

COMMITMENT TO RI/ESG IS STRONG BUT VARIES BY REGION

Establishing a formal policy is the first step on a long ESG journey. Globally, 80% of our survey respondents established RI/ESG policies. Experience with RI/ESG implementation is increasing, with half of the surveyed managers having policies in place for five or more years. The RI/ESG adoption rate increased in recent years as 18% of respondents established policies over the last two years.

The level of commitment to RI/ESG varies by region. Almost every European GP who participated in our survey has formalized their RI/ESG program – 94% of European managers have an RI/ESG policy versus less than three quarters of North American and Asia-Pacific managers (see figure 3).

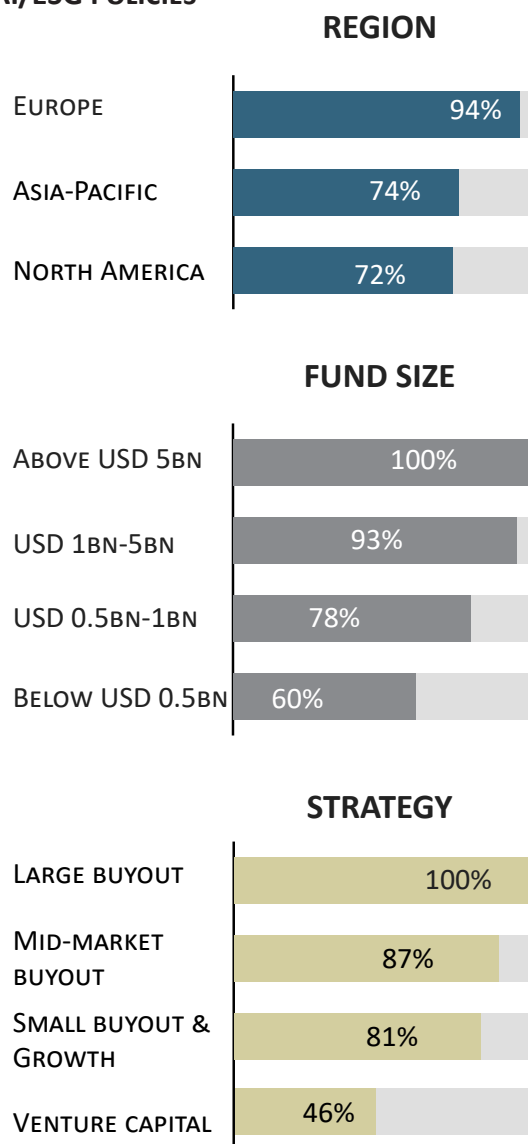
The RI/ESG policy adoption rate diminishes with smaller fund sizes and varies across strategies. Venture managers are the least likely to have a policy while buyout strategies, particularly large buyout managers, are the most likely. We believe venture funds, particularly access-constrained funds, have historically been under less pressure from investors when it comes to RI/ESG.

“ESG COMMITMENT IS LACKING AMONG VENTURE MANAGERS - WE EXPECT THIS TO CHANGE IN THE FUTURE.”

Further, venture managers may not recognize that RI/ESG is important from a performance perspective. Only 46% of venture GPs agreed that RI/ESG can increase returns compared to 79% for buyout strategies and 74% for growth capital strategies. However, this notion may change in the future as a recent example of weak governance and social issues at WeWork resulted in a significant decrease in the company’s valuation. Start-up

companies stay private under venture ownership much longer these days and grow to multi-billion dollar businesses with thousands of employees. Venture GPs may recognize that they need to better support founders in managing HR issues, such as sexual harassment or bullying claims, as these firms evolve into larger organizations.

FIGURE 3: PROPORTION OF MANAGERS WITH RI/ESG POLICIES



While four out of five GPs have an RI/ESG policy, the proportion of those who integrate RI/ESG considerations into fund formation documents is much less, as shown in **figure 4**. Almost two thirds of GPs incorporate RI/ESG language into side letters with their LPs, while one-third of GPs do so in private placement memoranda (PPMs).

In our experience, some GPs supplement PPMs with RI/ESG due diligence questionnaires to address the most common questions from prospective investors. Just 16% of GPs incorporate RI/ESG clauses into limited partnership agreements (LPAs). At the other end of the spectrum, over one quarter of firms do not formalize their RI/ESG commitments beyond establishing a policy.

There exists significant regional variation in the proportion of GPs with membership to PRI or similar organizations – 72% of European managers belong to RI/ESG associations versus just 16% of North American and 22% of Asia-Pacific GPs, as illustrated in **figure 5**.

FIGURE 4: PROPORTION OF MANAGERS INTEGRATING ESG CONSIDERATIONS INTO FUND FORMATION DOCUMENTS

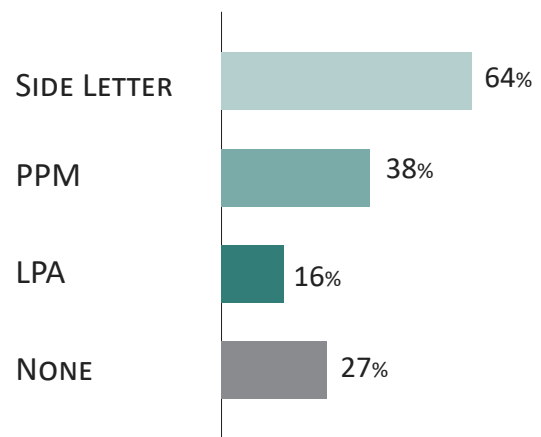
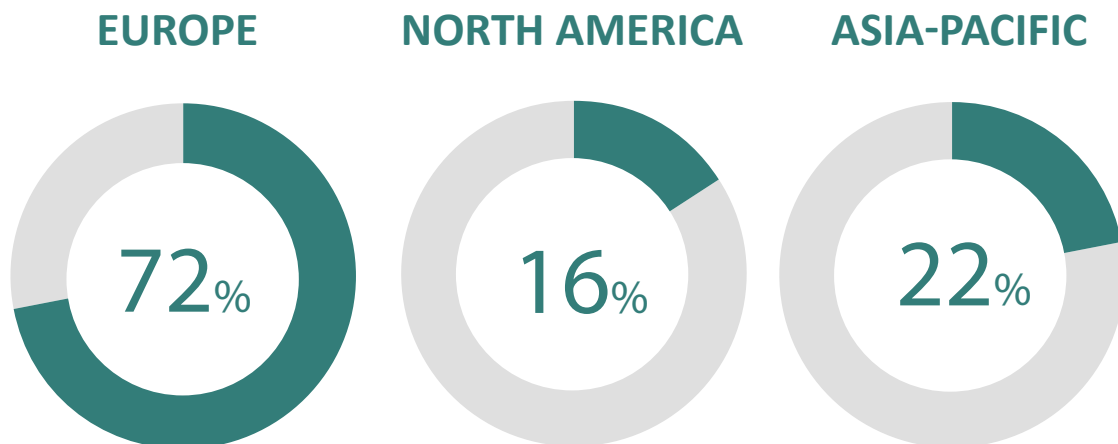


FIGURE 5: PROPORTION OF MANAGERS WITH MEMBERSHIP TO PRI OR SIMILAR ORGANIZATIONS



INVESTMENT TEAMS EMBRACE RI/ESG WITH DEDICATED RESOURCES

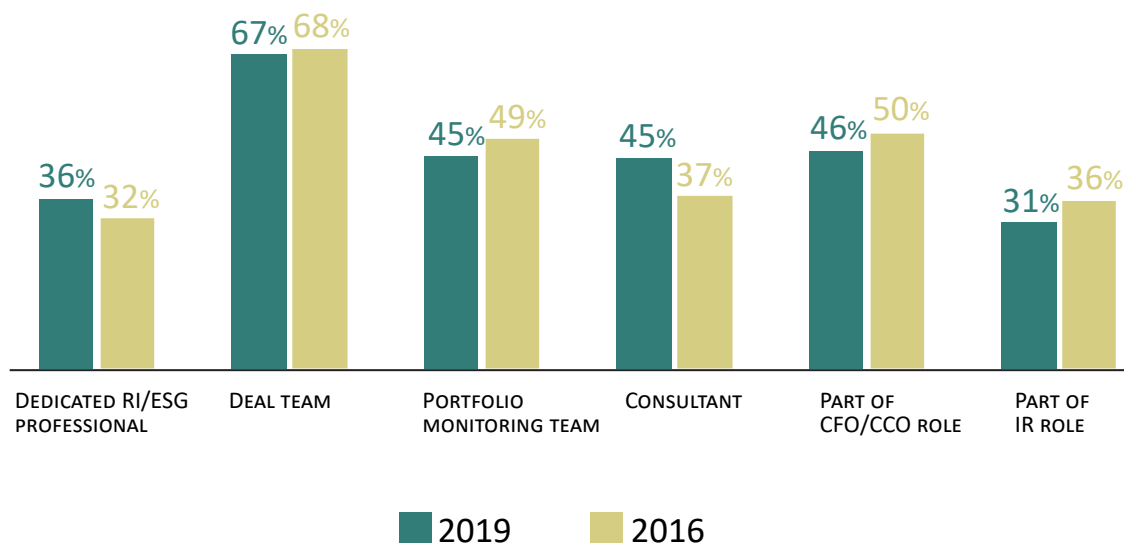
In many cases, the ways in which GPs allocate resources, whether in terms of staff or time to ESG implementation, can often be a differentiating factor. It is important for GPs to select suitable resources to carry out RI/ESG efforts and establish accountability. We observed an increasing number of GPs that have dedicated professionals spearheading RI/ESG efforts across their organization. The percentage of respondents with dedicated full-time internal resources increased by four percentage points to 36% over the last three years, as shown in **figure 6**. Further, the majority of firms appointed various teams and functions with additional RI/ESG responsibility.

Sharing ESG functions with other teams, particularly with deal teams, can also be beneficial to the cultivation of an investment culture that embodies RI/ESG principles throughout daily work. Two thirds of survey respondents have deal teams accountable for RI/ESG – results have been stable since our last survey. In addition, firms increasingly engage external resources such as

consultants to assist with RI/ESG while conducting due diligence in order to assess specific legal, social or environmental risks in certain sectors. The percentage of such firms increased from 37% in our prior survey to 45% in the current survey.

At the same time, our survey revealed that part-time RI/ESG responsibility among Investor Relations and Compliance functions notably declined compared to our prior survey. This greater dedication to RI/ESG is a positive trend as it shows the topic is gaining importance in GPs' day-to-day investment processes.

FIGURE 6: PROPORTION OF GPs WITH RI/ESG RESOURCES



ESG GAINS IMPORTANCE IN INVESTMENT DECISION-MAKING

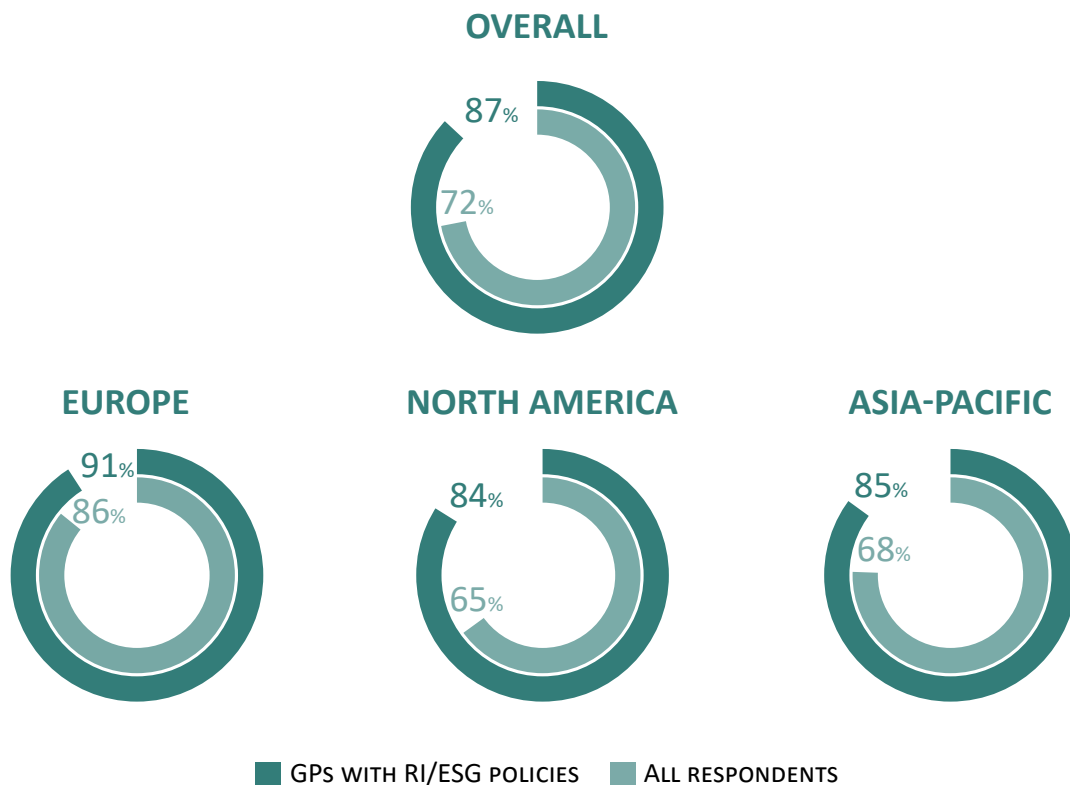
RI/ESG implementation in the investment process starts with the sourcing of deal opportunities. At this stage, the prevailing approach across many GPs is to filter out opportunities that comply with the established RI/ESG policy. 71% of respondents avoid sourcing from specific sectors that are prohibited by international conventions or are typically not in favor with investors (e.g. narcotics, pornography, weapons). Some firms do not maintain a predetermined list of excluded industry sectors but determine the suitability on a case-by-case basis.

Our survey shows that once an investment has been selected for due diligence, almost three quarters of managers globally conduct specific

RI/ESG due diligence with respect to each opportunity, as shown in **figure 7**. As expected, this proportion increases to 87% for managers with an existing ESG policy. While this percentage looks impressive at first glance, it also indicates that 13% of GPs with RI/ESG policies fail to put words into action.

For European GPs RI/ESG due diligence is becoming the norm. Almost nine out of ten of them conduct RI/ESG due diligence compared with about two thirds of North American and Asia-Pacific managers.

FIGURE 7: PROPORTION OF GPs CONDUCTING ESG/RI DUE DILIGENCE FOR EACH PORTFOLIO COMPANY INVESTMENT

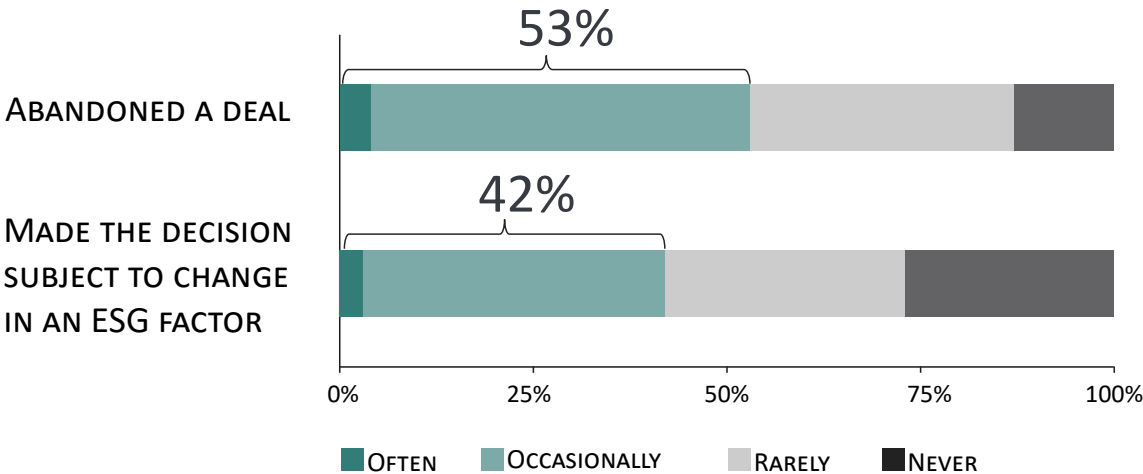


RI/ESG issues identified at target companies are often discussed at Investment Committees. As our survey results indicate, such RI/ESG analysis is increasingly included in the investment memoranda of GPs. 87% of them address RI/ESG due diligence results in their investment recommendations – five percentage points more than our 2016 survey. RI/ESG due diligence is not done for the purpose of “ticking the box”. As shown in **figure 8**, the analysis has a meaningful influence on ultimate investment decisions. Half of GPs abandoned deals due to the outcome of an RI/ESG analysis.

“The identification of potentially material sustainability opportunities and/or risks may impact the investment selection and deal structuring processes in many ways, including in terms of price paid and the terms in the shareholder/purchase agreements. Sustainability aspects may also lead to the abandonment of a potential investment.”

A EUROPEAN GP

FIGURE 8: THE OUTCOME OF ESG ANALYSIS



MORE METRICS, MORE EVIDENCE OF ESG'S POSITIVE IMPACT ON RETURNS

The value-add stemming from RI/ESG implementation starts even before the acquisition of a company, as it can enable GPs to identify risks, deficient standards and value -creation opportunities. Enhanced awareness of risks and opportunities helps GPs negotiate better prices, as well as deal and financing terms, thereby contributing toward a positive financial return. According to our survey, one third of respondents reduced the bid price for their acquisition target based on the results of an ESG analysis, as illustrated in **figure 9**.

RI/ESG efforts are most rewarding when embedded into a strategic value-creation plan. Three quarters of GPs do so – a similar proportion to our last survey.

Since our last survey, the proportion of GPs measuring RI/ESG impact on portfolio risk has increased to almost one third versus less than one quarter in 2016, as shown in **figure 10**. GPs are also more conscious about measuring RI/ESG impact on performance, and therefore, demanding greater KPI reporting from their portfolio companies.

FIGURE 9: ESG IMPACT ON INVESTMENT TERMS

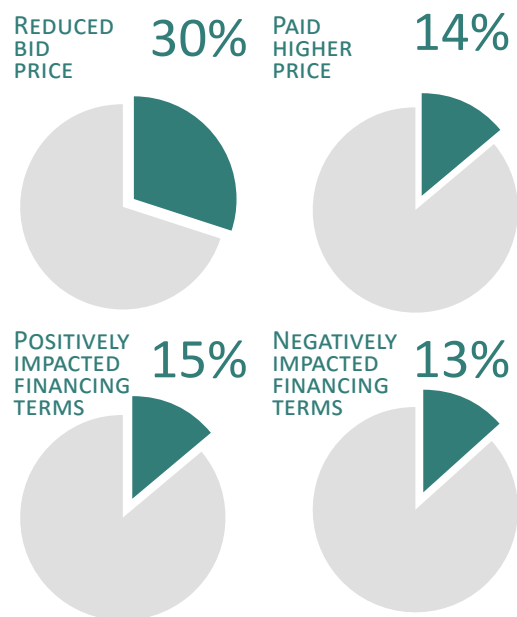
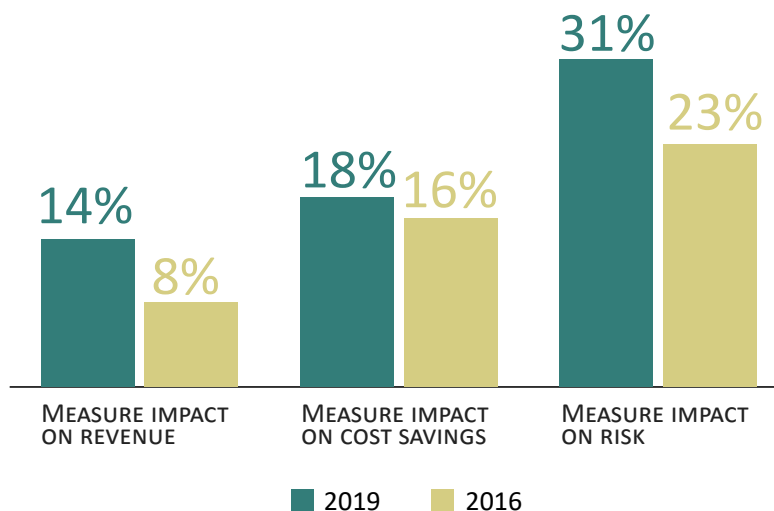


FIGURE 10: PROPORTION OF GPs MEASURING ESG IMPACT ON PERFORMANCE AND RISK



The results of such measurements provide evidence of positive impact. Further, a higher share of respondents, respectively more GPs, experienced positive tangible results from their RI/ESG implementation compared to our initial survey. As shown in **figure 11**, 21% of respondents achieved growth in revenue according to our current survey compared to 15% in 2016.

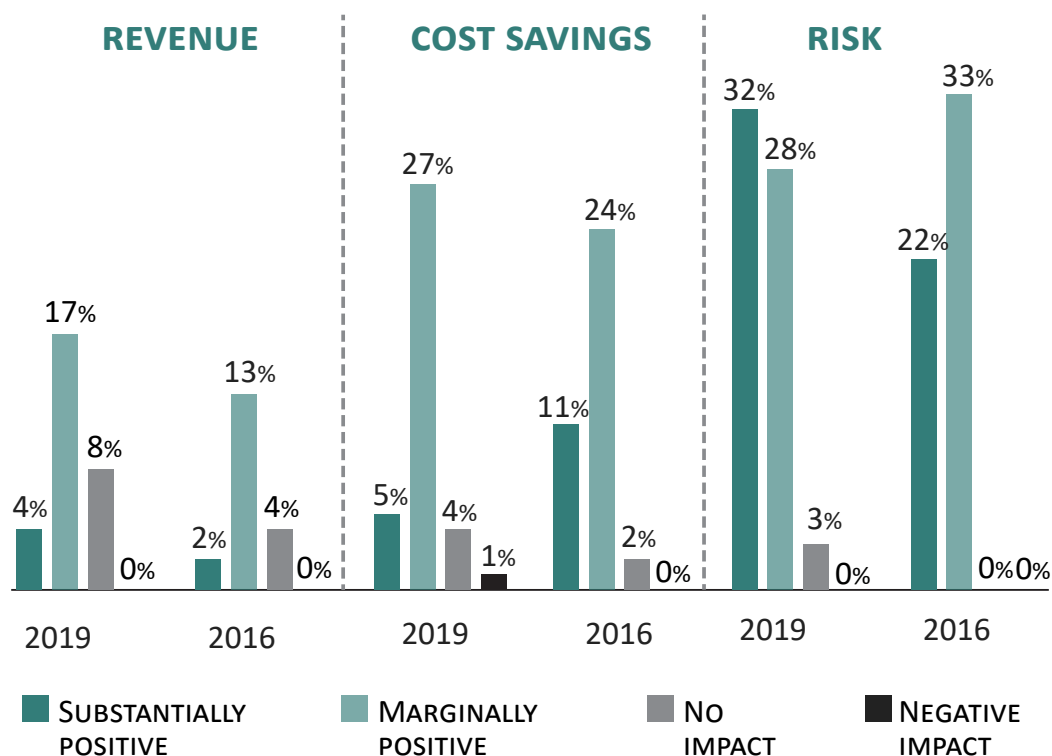
Although the share of GPs reporting a positive impact on cost savings declined slightly compared to the last survey, the absolute number of such respondents increased by 50%.

The measurement of RI/ESG impact on operational risk is the most developed area, with 60% of respondents observing positive impact on risk, up from 55% in 2016. Of those GPs that

do measure the impact of RI/ESG on operational performance, over 70% experienced incremental growth in revenue, and 86% noted cost savings. Meanwhile, almost all GPs noted RI/ESG's positive impact on risk.

Implementation of RI/ESG can also enhance a company's valuation upon exit. Improvements in the RI/ESG rating of the company during ownership can make the target more attractive for potential bidders and increase the number of buyers willing to commit to a deal. Our survey results show that buyers, and increasingly financial buyers, conduct ESG due diligence more often compared to our last survey. Four out of five GPs find that potential bidders of portfolio companies conduct RI/ESG due diligence versus two thirds that did so in 2016.

FIGURE 11: IMPACT OF RI/ESG ON REVENUE, COST SAVINGS, RISK



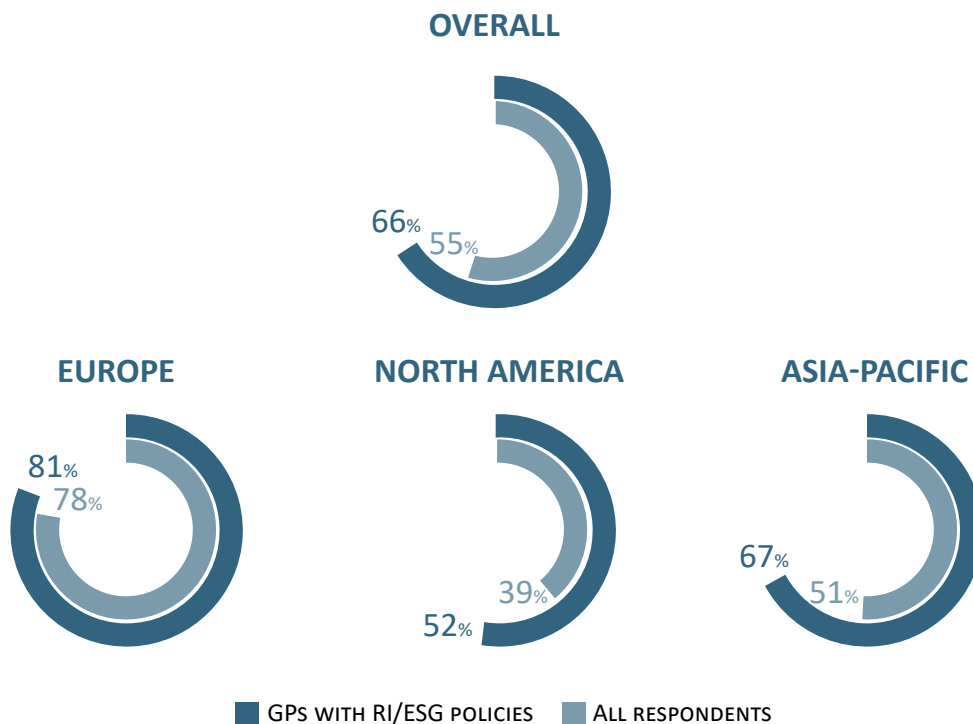
SLOW PROGRESS IN RI/ESG REPORTING

GPs in North America and Asia-Pacific fall short of their European counterparts when it comes to RI/ESG reporting to investors. Even for GPs with RI/ESG policies, just half of North Americans and two thirds of Asia-Pacific managers provide RI/ESG reporting to their investors versus four out of five Europeans (see **figure 12**). Relatively low reporting is largely driven by a lack of data.

We also believe that these low levels of reporting are due to varying investor demands regarding RI/ESG information. However, our survey does indicate that since our last survey four years ago, more GPs have started to provide dedicated RI/ESG reporting to investors.

GPs can only produce meaningful reporting once it has been implemented throughout the investment process, and where applicable data is gathered from portfolio companies.

FIGURE 12: PROPORTION OF GPs PROVIDING RI/ESG REPORTING TO THEIR INVESTORS



OUTLOOK

There are a number of trends that leave us optimistic about GPs' RI/ESG progress. Almost all GPs agree that RI/ESG will increase in importance in the near future given its positive influence on returns, while eight out of ten GPs believe that RI/ESG factors will be used more frequently as a value-creation tool for investors (see **figure 13**).

We expect significantly more private equity GPs to step up their efforts in providing comprehensive ESG reporting to LPs. According to our survey, almost three quarters of GPs plan to integrate RI/ESG monitoring of results into their investor reporting. This compares to 39% of GPs in our last survey in 2016, as illustrated in **figure 14**.

The main priorities in RI/ESG engagement remain consistent between surveys (see **figure 15**). Data gathering and reporting from portfolio companies is the most pressing concern, followed by RI/ESG integration into the value creation process and reporting to investors. In order to advance their RI/ESG practices, GPs plan to enhance their human resources – 35% of them said so in our current survey versus 21% in 2016.

FIGURE 13: GPs' VIEWS ON OUTLOOK FOR RI/ESG

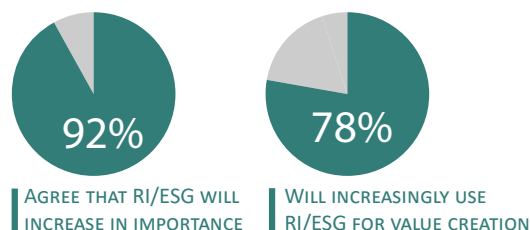


FIGURE 14: PROPORTION OF GPs WITH PLANS TO ENHANCE ESG INVESTOR REPORTING

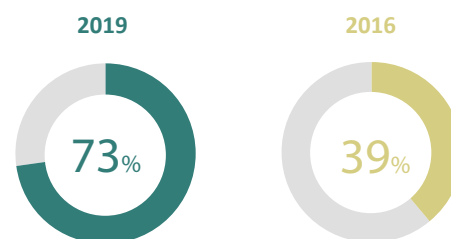
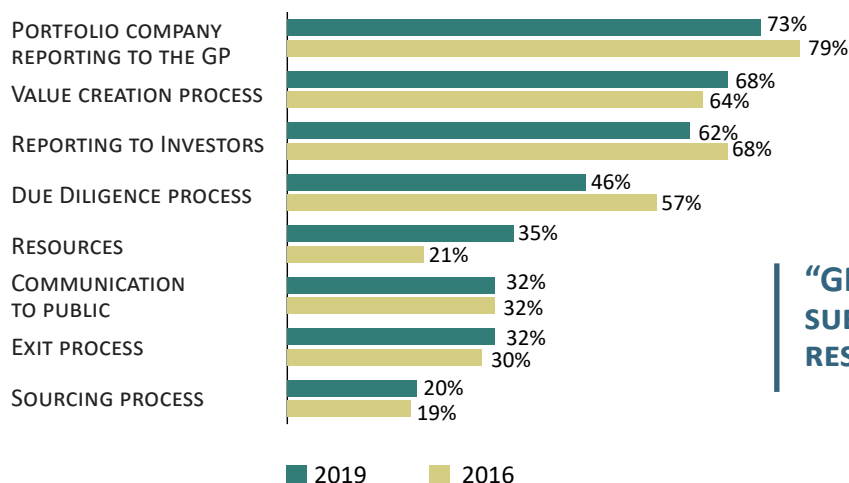


FIGURE 15: AREAS WHERE GPs PLAN TO ENHANCE RI/ESG ENGAGEMENT OR IMPLEMENTATION



“GPs WILL DEDICATE SUBSTANTIALLY MORE RESOURCES TO ESG.”

RI/ESG AT CAPITAL DYNAMICS

The current survey underpins our responsible investment approach toward private equity. We envisage that RI/ESG will increasingly be used as a necessary ingredient to enhance operational value. This trend has intensified since our last survey in 2016.

Capital Dynamics has a dual role as a Limited Partner (LP) in private equity funds, and General Partner (GP) managing mid-market private equity and private credit funds, and Clean Energy infrastructure funds. As such, we recognize our unique position as both an influencer and partner to GPs, and the responsibility towards our clients to integrate RI/ESG into our investment processes.

Capital Dynamics established its RI/ESG policy over a decade ago in conjunction with the firm being an early signatory of the PRI. This policy is now updated on an annual basis and serves as the guiding document for our RI/ESG practices throughout our investment decisions and business practices. Capital Dynamics has been, and continues to be, actively involved in initiatives to improve RI/ESG standards. For example, the firm is engaged in several LP initiatives to establish broadly accepted RI/ESG standards, such as the ESG Disclosure Framework for Private Equity and the active involvement in creating the British Private Equity and Venture Capital Association's (BVCA) RI guidelines.

Capital Dynamics' investment teams conduct RI/ESG analysis and discuss the findings at Investment Committees and document them in their investment recommendations. All investment decisions are also reviewed by a representative of the firm's RI Committee. Further, beginning in 2019, all investments made are also monitored and reviewed from an RI/ESG perspective throughout the holding period of that investment.

Our GPs are also requested to sign RI/ESG-related Side Letters, while investment teams monitor GPs' handling of emerging RI/ESG issues. In order to measure the ESG actions across our investments, Capital Dynamics has developed its proprietary ESG evaluation tool – **R-Eye™** – which has been described in detail in our recent article on private markets having reached an inflection point in ESG.³

We distribute the detailed results of our survey to GPs to help advance their RI/ESG efforts. As a global private asset manager, we believe it is our responsibility to assess and measure the quality of RI/ESG integration and to encourage the adoption and advancement of RI/ESG best practice across the private equity GP and LP community.

³ Capital Dynamics Investment Perspectives "The Private Markets have reached an Inflection Point in ESG" November 2019.

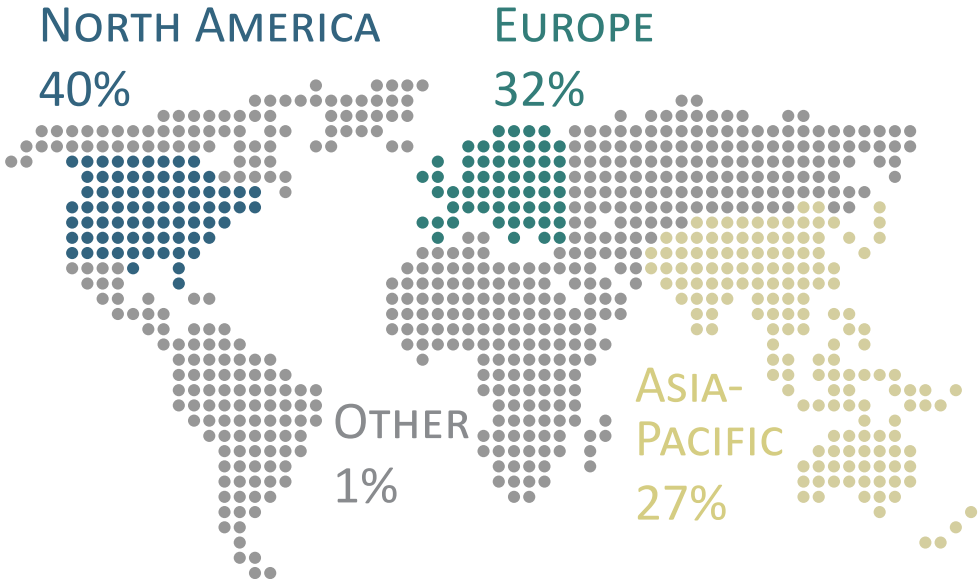
ABOUT THE SURVEY

Capital Dynamics conducted its second Responsible Investment and ESG survey among General Partners (GPs) of private equity funds in the fourth quarter of 2019. We received responses from 157 GPs – a 40% increase since our first survey in 2016.

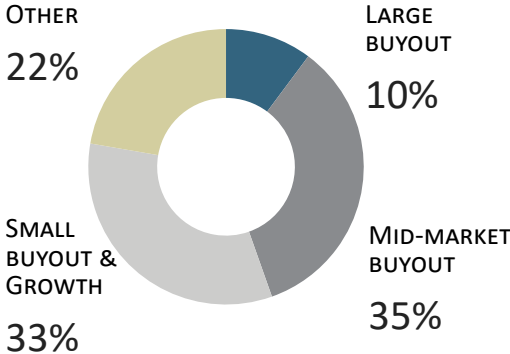
Participation has markedly increased among North American and Asia-Pacific GPs indicating the growing importance of RI/ESG in those regions. North American GPs replaced European GPs as the largest cohort of respondents in our current survey – 40% versus 32% respectively. Our survey is truly global in nature.

By strategy, mid-market buyouts, and small buyout and growth capital GPs each comprised around one third of respondents. This is also reflected in over half of GP respondents having fund sizes of less than USD 1 billion.

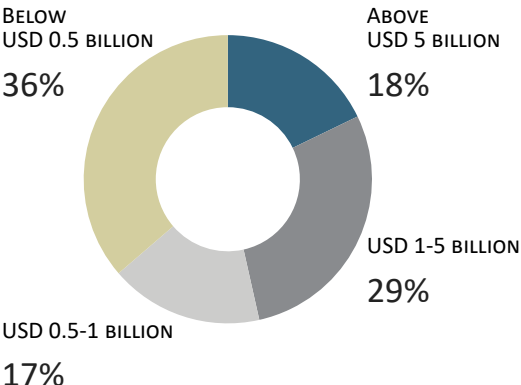
LOCATION OF SURVEY RESPONDENTS' HEADQUARTERS



BREAKDOWN BY STRATEGY



BREAKDOWN BY FUND SIZE



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ABOUT CAPITAL DYNAMICS

Capital Dynamics is an independent global asset management firm focusing on private assets including private equity, private credit, and clean energy infrastructure. 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 advisement¹. 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.

Capital Dynamics' roots go back to 1988, the year our predecessor (Westport Private Equity) was founded in the UK. Our headquarters were established in Zug, Switzerland in 1999. The firm employs approximately 160 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. For more information, please visit: www.capdyn.com

¹As of December 31, 2019.

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When considering alternative investments, such as private equity funds, the Recipient should consider various risks including the fact that some funds may use leverage and engage in a substantial degree of speculation that may increase the risk of investment loss, can be illiquid, are not required by law to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager. Any such investment involves significant risks, including the risk that an investor will lose its entire investment.

By accepting delivery of this document, each Recipient agrees to the foregoing and agrees to return the document to Capital Dynamics promptly upon request.

For more information, please visit

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