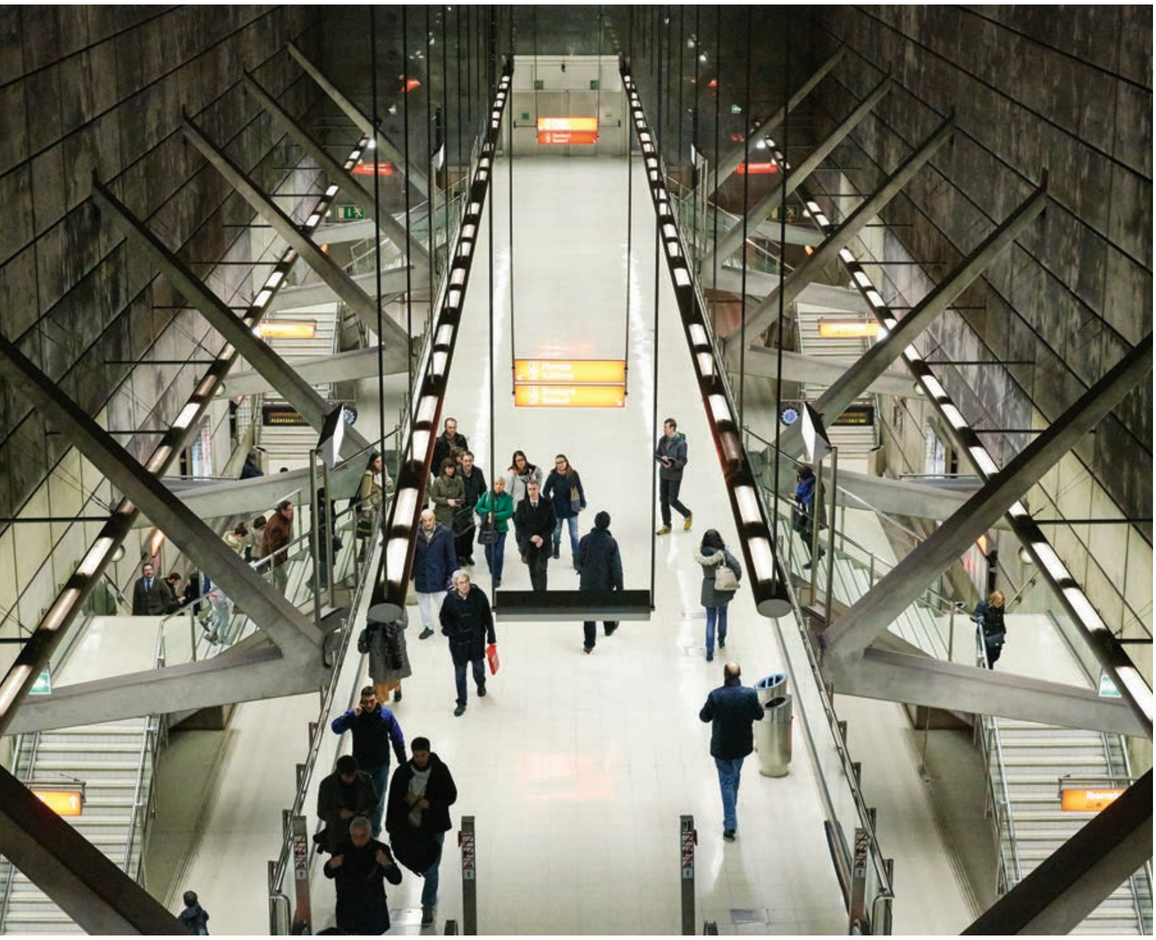
Driven by investors and now by the business case, the Private Equity industry believes in the value of responsible investment and is embedding the effective management of ESG issues in portfolio companies.

Are we nearly there yet? Private equity and the responsible investment journey



46%
say the majority of their investors are interested in responsible investment (compared to 21% in 2013)

83%
have a responsible investment policy

41%
would be prepared to pay a premium for a target company with strong ESG performance

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(PwC Global Sustainability Leader)

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Foreword

The private equity industry is on a journey. Its destination is one where it recognises its vital role in a sustainable financial system that rewards robust governance allied to environmental and social responsibility as a fundamental part of economic success.

There is a growing acknowledgement that business does not operate in isolation, but is interconnected with society and government, its actions having consequences for itself and its stakeholders. In recent years, society and media attention on issues such as fossil fuel production, poor working practices, environmental degradation, resource scarcity, food trust and tax affairs have had an impact on reputation, profitability and, ultimately, company valuation.

Business is starting to understand and quantify the benefits of adopting sustainable business practices. With an increasing focus on responsible investment, the private equity (PE) community is responding, not only by building in new checks and balances to reduce risk, but also by maximising the opportunities that spring from good governance and the mindful management of environmental and social issues.

As the results of our latest survey of the industry's attitudes to responsible investment show, a growing number recognise that good environmental, social and governance (ESG) management can add value, while poor ESG management can destroy it.

The PE community is taking ESG management increasingly seriously. Gone are the days when it was viewed as a 'nice to have', now it is seen as a business basic. We are now seeing ESG management embedded in the deals process itself with a mindful investment in the right skills, experience and training to support it.

This increasing focus on responsible investment and sustainability issues is timely. With the ratification of the Sustainable Development Goals (SDGs) in 2015, there will be increasing pressure on business as governments introduce new regulations and policies to help them achieve these 17 global goals that tackle major world issues. At heart, these goals tackle business risks that stem from sustainability issues – whether it's excessive resource consumption or a reliance on carbon intensive energy and processes or poor working practices.

Government will turn to business to help them deliver these goals, with those aligning to the SDGs and supporting government ambitions perhaps more likely to receive favourable treatment than those that don't. This engagement with SDGs and the on-going relationship with government are likely to become increasingly important for investors more broadly, including private equity firms. For the first time, we have sought to gauge their views on the SDGs in this survey (to discover that a surprising number are already actively engaged).

Given these trends, it is surprising to note that almost a quarter of PE houses have no internal ESG resource and a similar percentage offer no training on these issues. I cannot help wondering what is in store for those organisations which are now clearly lagging behind their peers.

My thanks to the increasing numbers of you who participated. Your collective views give great insight into how the market is developing and maturing. From my perspective, ESG management is an important aspect of the deal cycle and I appreciate your continued efforts in this area to drive good business practice and invest responsibly.

Malcolm Preston
PwC, Global Sustainability Leader

Executive Summary

1 ***The approach to ESG management has moved forward at pace since our last survey in 2013. European firms are more advanced in their approach to responsible investment, although Asian firms have made the biggest improvement.***

2 ***Private equity firms have embraced ESG management as a core part of the deal process, with 60% saying they always screen target companies for ESG risks.***

3 ***Slowly, but steadily, more PE houses, especially in France, are valuing the benefits of ESG initiatives. One in five now values the impact of their ESG initiatives, almost double over the last three years.***

4 ***PE houses recognise that emerging risks are on the horizon, but the challenge remains to mitigate them. For example, 85% are concerned about cyber security but only 27% have taken action.***

5 ***A surprising proportion of PE houses is engaged and taking action to align their ESG activities to the Sustainable Development Goals (SDGs) – 44% plan to assess their impact on the SDGs.***

Private equity houses, or General Partners (GPs), are responding to demand from their Limited Partner (LP) investors, to greater societal concern about ESG factors, and to evidence that proactive ESG management can deliver investment value. However, the business case for ESG management is changing. Our results this year show more emphasis on risk management as a driver, less on investor pressure. This is not due to investor interest waning (in fact it continues to grow, especially, in our view, in the US). It is more that it's accepted that there is value in managing ESG issues effectively and GP and LP thinking is more aligned. Investors may have been the initial driving force, but it is the business reasons for adopting ESG management principles that are maintaining the momentum.

There is more emphasis on ESG management in core parts of the business with the management of ESG issues becoming increasingly embedded within the PE industry. In the three years since we carried out our last survey, a much higher proportion of private equity fund managers have adopted responsible investment (RI) policies, practices and techniques; more are choosing to disclose to their investors; and there is a distinct change in the approach to resourcing. We now see a higher percentage of PE houses with staff dedicating time to ESG management, who have received formal training, and who sit in the deal team – in the forefront of discussion and decision making on company selection.

PE houses are horizon scanning for emerging risks. Risks are clearly identified, but action to mitigate them remains a challenge. PE houses are aware of the implications of the UN SDGs which many might view as an important potential measure of ESG management in itself. Response is split though between action and ambivalence (some PE houses are already implementing plans across their portfolio companies).

Moreover, although ESG management is becoming increasingly 'business as usual' for many PE houses, the journey is by no means over. There is more to be explored regarding disclosure to investors and the general public, and on how ESG management should be contractually agreed between GPs and LPs. And, while ESG factors are becoming increasingly integrated at the start of the investment cycle, few managers properly value the benefits of ESG initiatives at exit. It's not clear why formal valuation of ESG interventions isn't more widespread. In our experience, there appears to be real acceptance that ESG management adds tangible value, but that it doesn't always warrant an exercise to provide exact details of how much. Even so, 14% of respondents have paid a premium for good ESG management, bringing home the commercial importance of responsible investment.

About the survey

In our work with the private equity industry, we have seen responsible investment grow from a niche concern among a handful of specialist GPs to an approach that is increasingly adopted across the industry.

To track its evolution, we have carried out a series of surveys of PE houses and their investors since 2012. In 2015, we surveyed investors in private equity funds, to understand the evolving thinking of these Limited Partners about ESG issues.[1]

This survey was carried out in May and June 2016, based upon an online questionnaire. Responses were received from 111 GPs, based in 22 countries, making it one of the largest such surveys carried out to date.

It asks many of the same questions posed to GPs in our 2013 survey,[2] to allow for comparison over time, as well as exploring new topics including emerging areas of risk and opportunity.

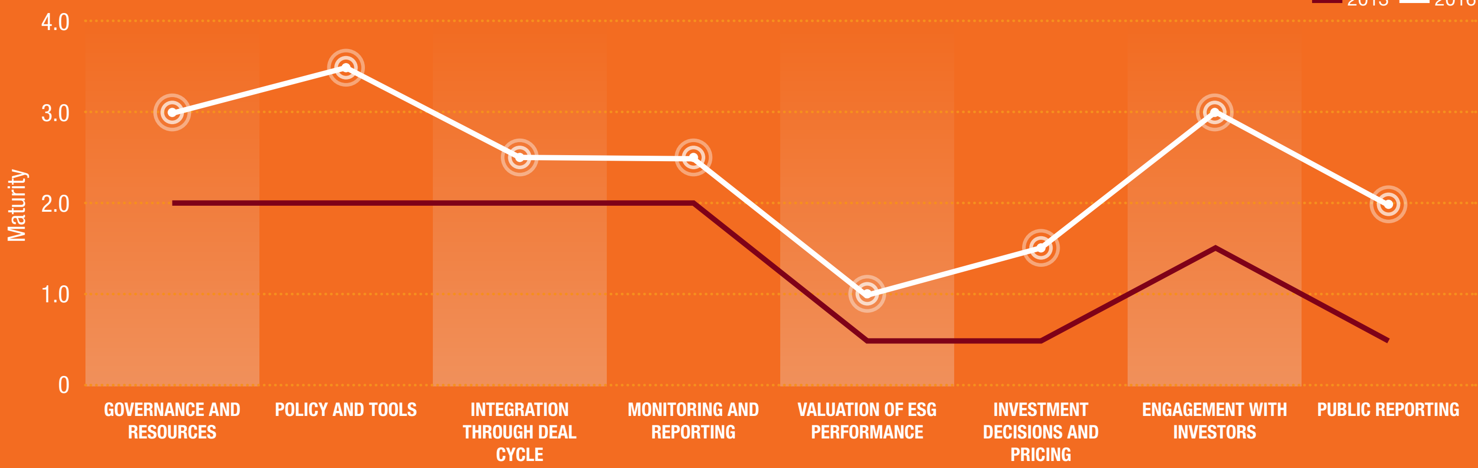
Responses were received from a wide spectrum of PE houses by size, by type of investment strategy and by size of investment, offering a comprehensive view of how the industry approaches ESG issues. While we endeavoured to poll as broad and representative a cross-section of the market as possible, responses were voluntary, and therefore are more likely to include PE firms with an existing interest in responsible investment. However, this is one of only a few studies that is truly global, not limited to only certain categories of assets. See Page 28 for a respondent profile.

1 Bridging the gap: Aligning the Responsible Investment interests of Limited Partners and General Partners, PwC (2015)

2 Putting a price on value, PwC (2013)

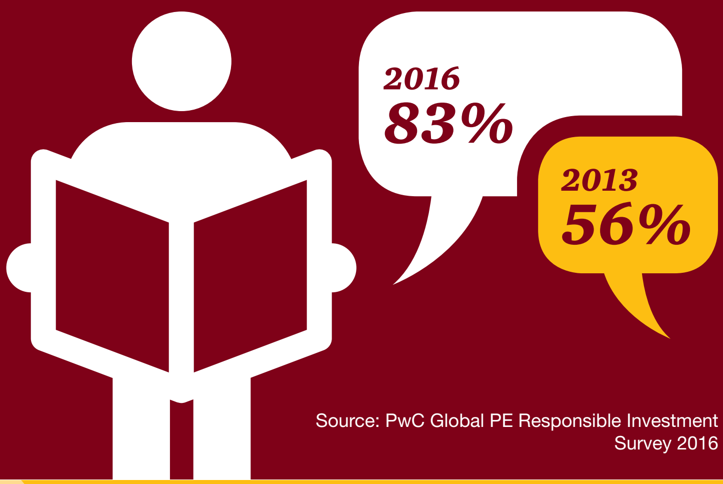
Results highlights

A maturing approach to responsible investment



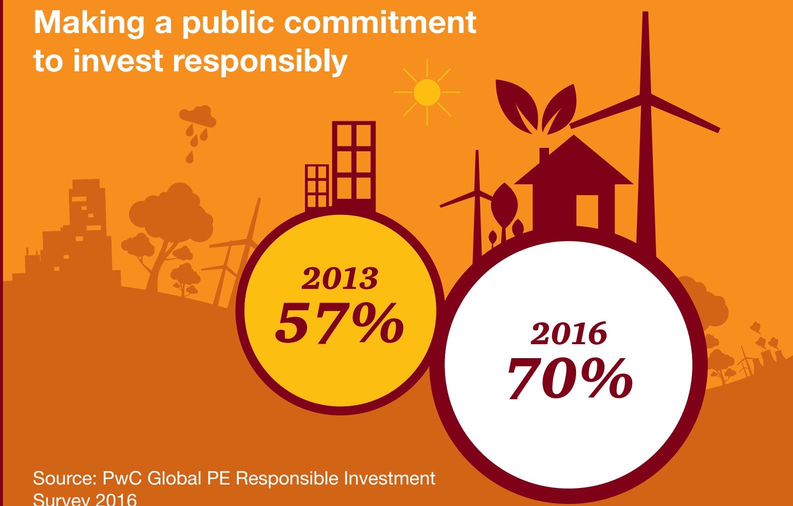
Source: PwC Global PE Responsible Investment Survey 2016

Reporting to investors on ESG activities



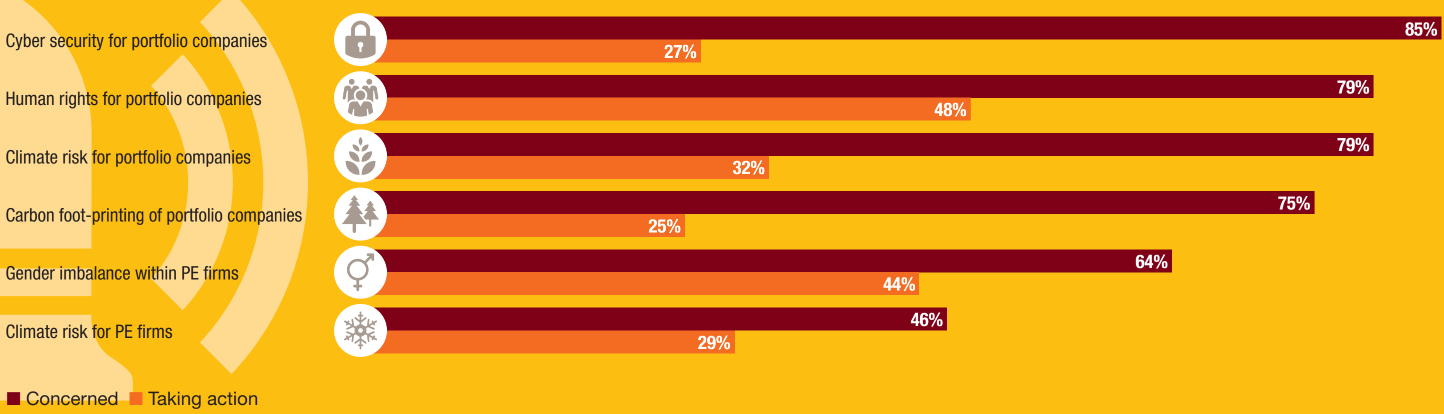
Source: PwC Global PE Responsible Investment Survey 2016

Making a public commitment to invest responsibly



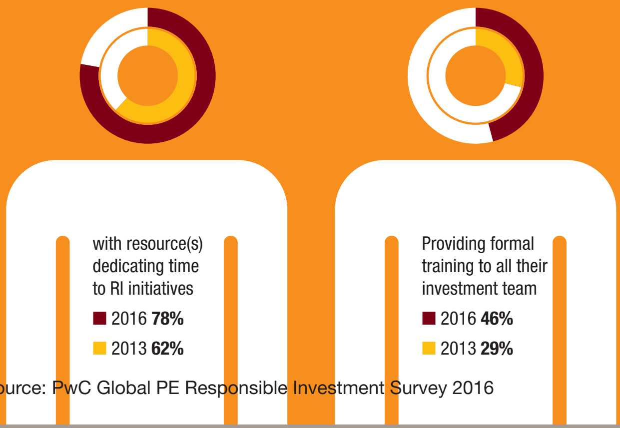
Source: PwC Global PE Responsible Investment Survey 2016

What's keeping you awake at night?



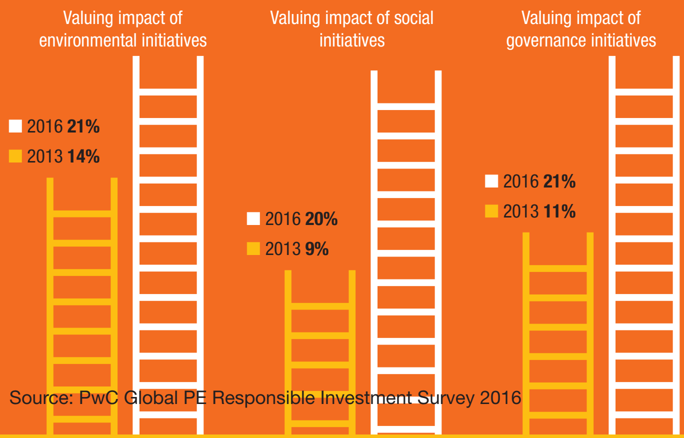
Source: PwC Global PE Responsible Investment Survey 2016

Investing in people



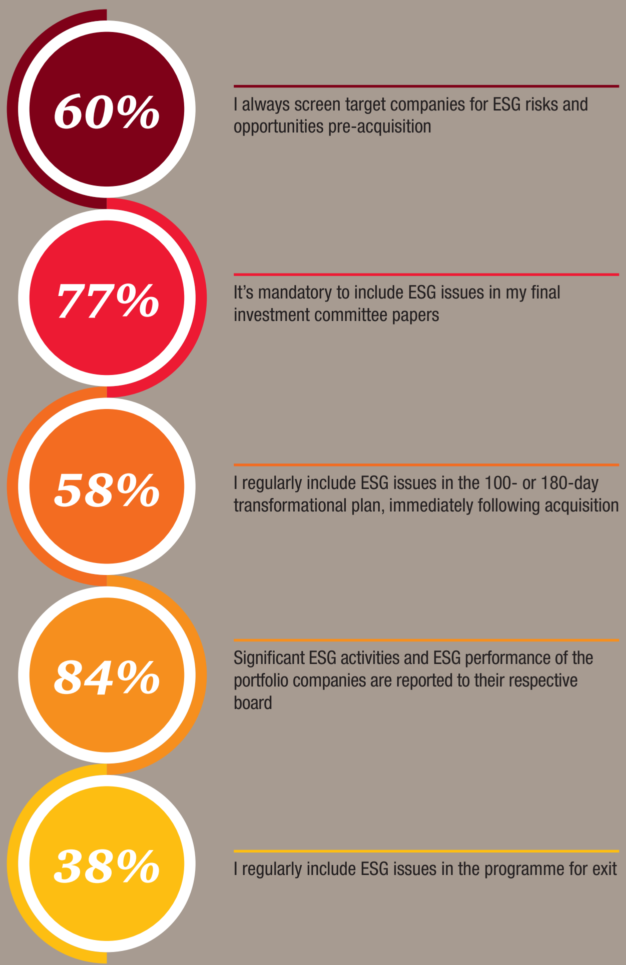
Source: PwC Global PE Responsible Investment Survey 2016

Putting a value on impact – step change



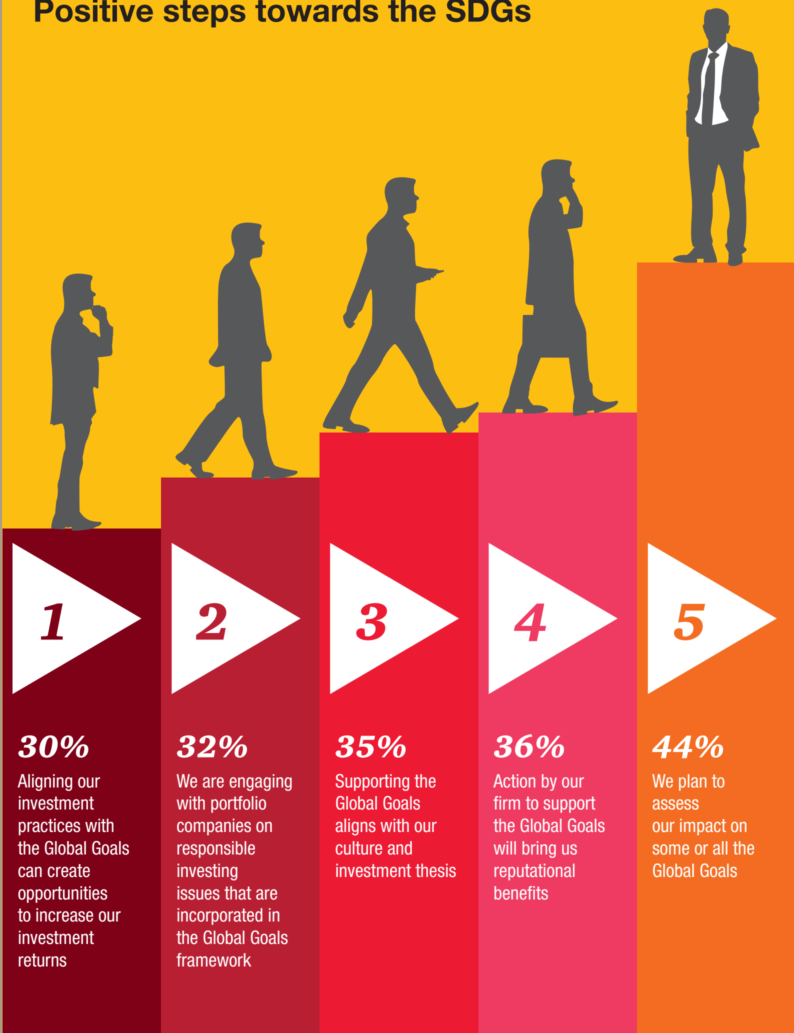
Source: PwC Global PE Responsible Investment Survey 2016

Managing ESG issues is now a core behaviour



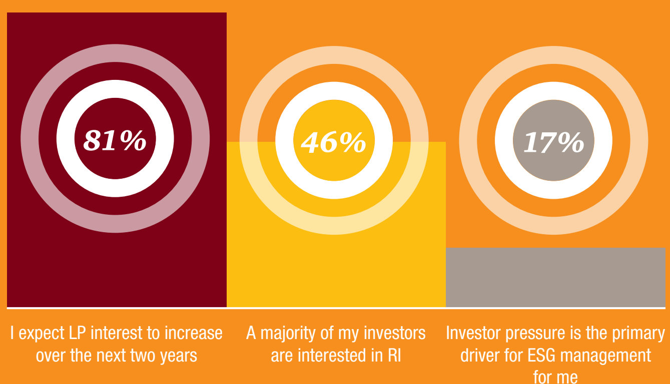
Source: PwC Global PE Responsible Investment Survey 2016

Positive steps towards the SDGs



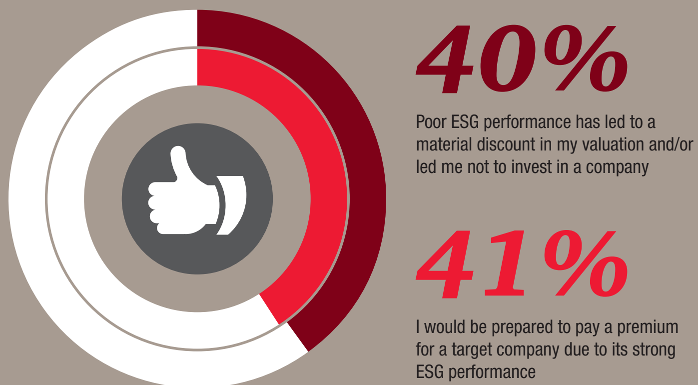
Source: PwC Global PE Responsible Investment Survey 2016

Perspectives of investors – interest is high, but pressure is low



Source: PwC Global PE Responsible Investment Survey 2016

Informing decision making



Source: PwC Global PE Responsible Investment Survey 2016

The PE sector's approach to responsible investment is maturing

Our latest survey clearly shows that a growing proportion of PE houses are embracing responsible investment through ESG issue management. A greater number of firms have explicit policies, firms are dedicating increasing resources to it and those management activities are increasingly located right at the heart of their investment processes.

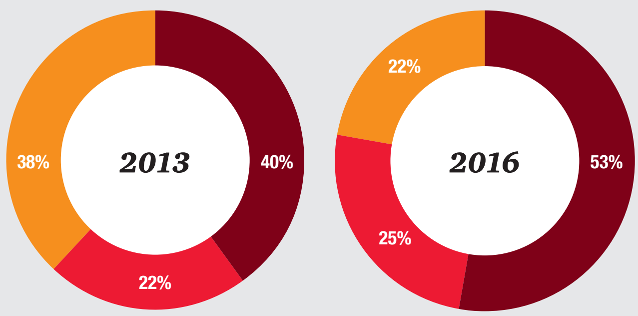
From our perspective, there is strong evidence that the market is maturing as ESG management is becoming embedded. Here, we point out the signposts that indicate how the PE sector has changed and set out our thoughts on what we believe a mature PE market would look like.

Being clear about investing responsibly

PE houses are becoming more vocal on responsible investment (RI) issues. More than two-thirds (70%) of respondents to this year's survey have made a public commitment to invest responsibly: this compares with just over half (57%) of respondents in 2013.

For many investors, the next step after making a public commitment is to develop RI policies to guide implementation. Since the 2013 survey, we have seen a marked uptick in the number of PE houses with such policies – from 55% to 83%. In addition, our results show that over half of those without policies in place (74%) are developing them. Combined, an impressive 96% of the PE community have, or will shortly have, an RI policy. These policies typically set out a firm's investment ethos, including any sectors that are excluded from investment on moral or ethical grounds, how they expect portfolio companies to address ESG issues, how ESG considerations are incorporated in their investment processes, and how they plan to report on ESG matters.

Figure 1: Dedicating time to ESG management



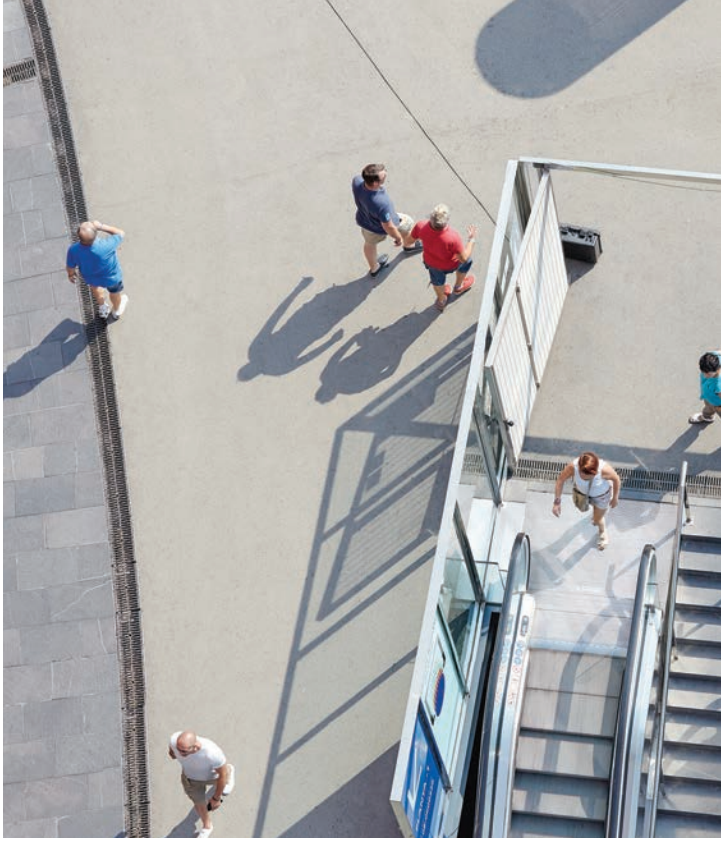
Source: PwC Global PE Responsible Investment Survey 2016

Investing in people to manage ESG issues

Our latest survey reveals increases in the resources dedicated time to RI – and changes to where those resources are located within private equity firms. In 2016, 78% of respondents said they had some resources dedicating time to ESG management – in 2013, that figure was 62% (see Figure 1: Dedicating time to ESG management).

Tellingly, these resources are more often drawn from functions at the centre of the investment process – from

96% of the PE community have, or will shortly have, an RI policy



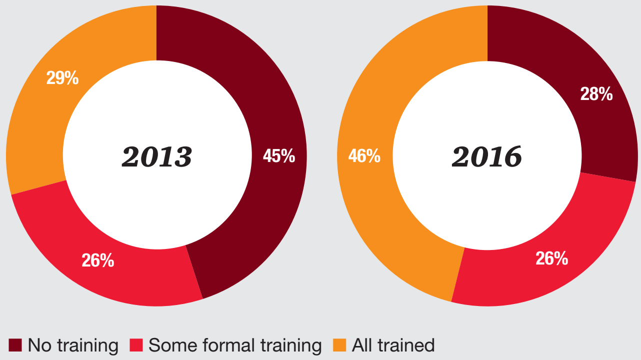
> “Taking into account ESG issues is an approach that is gaining momentum in Morocco, partly with the influence of the CGEM (General Confederation of Moroccan Companies). The Moroccan Venture Capital Association has implemented an ESG Commission and a first workshop to train AMIC’s members on such issues was organised.”
>
> Hassan Laaziri, AMIC Chairman – Moroccan Private Equity Association

the investment/deal team, rather than from ancillary functions such as marketing and communications, legal or investor relations. For example, in 2013, investor relations staff provided RI support at almost two thirds (64%) of responding firms – this year, that figure had fallen to 33%, while two thirds of respondents (66%) now report the involvement of the deal team.

Similarly, almost half (46%) of PE houses expect all of their investment team members to have formal RI training, rather than placing full responsibility for ESG management on a dedicated RI function. This figure has risen from 29% in 2013. (See Figure 2: Formal RI training for investment teams). However, 45% of PE houses offer either no training at all (28%) or on-the-job training only (17%), investing little into training their staff. The most preferable approach must be a combination of formal and on-the-job training and 25% of PE houses had packaged their training in this way (see Figure 3: Adopting diverse training methods).

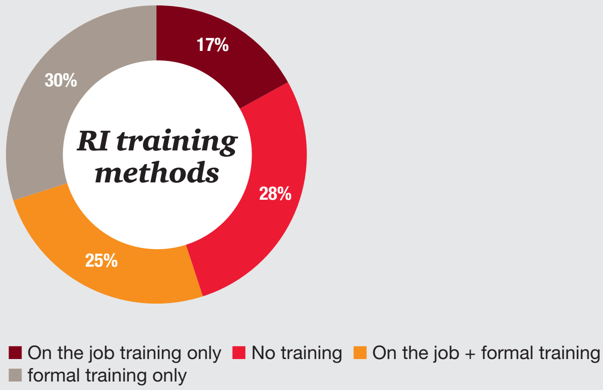
In our experience, ESG leaders within the private equity industry are increasingly recruiting responsible investment specialists to provide dedicated RI support, although the numbers remain small. More generally, we find the trend within responsible investment is an aim for ESG expertise to become embedded within investment processes, and for management of ESG issues to become the responsibility of all investment professionals.

Figure 2: Formal RI training for investment teams



Source: PwC Global PE Responsible Investment Survey 2016

Figure 3: Adopting diverse training methods[3]



Source: PwC Global PE Responsible Investment Survey 2016

3 Formal training covers e-learning, externally and internally facilitated face-to-face training.

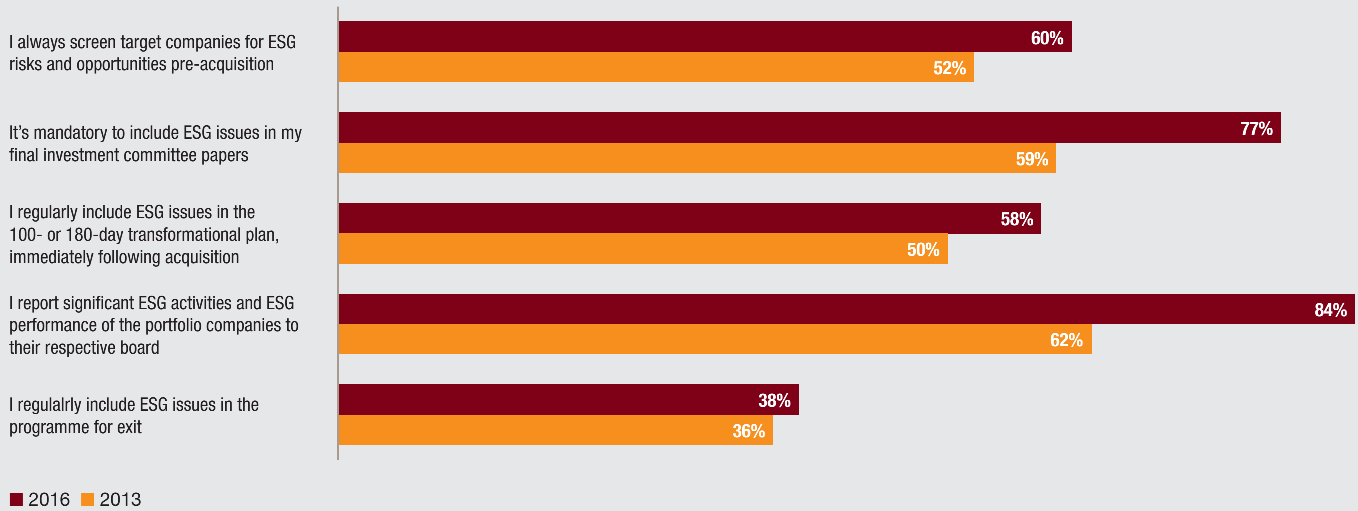
Embedding ESG management principles across the deal cycle

Growing and closer attention is paid to ESG matters across most stages of the investment lifecycle. However, it is noticeably lower at exit – arguably the most opportune time to value the difference that active ESG management has actually made.

We asked responding firms whether they screen target companies for ESG risks and opportunities, whether ESG issues are regularly included in the 100- or 180-day transformational plans drawn up following acquisition, and whether they are regularly included in the programme for exit. As is shown in Figure 4: Embedding ESG management principles across the cycle, there has been a marked increase in attention to ESG issues pre-acquisition and in the early stages of the hold period.

It's surprising that 60% of PE houses say they screen targets for ESG issues pre-acquisition, but only 38% include ESG issues in the programme at exit for others to do the same. There's a gap in expectation between potential buyer requirements for screening and what's currently provided that needs to be closed, especially when 41% are prepared to pay a premium when strong ESG management is evidenced.

Figure 4: Embedding ESG management principles across the cycle

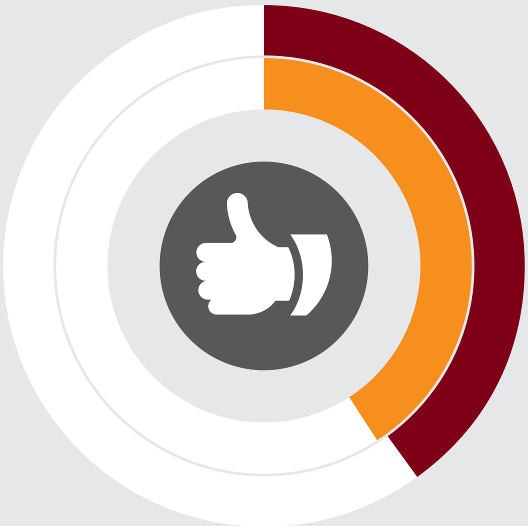


Source: PwC Global PE Responsible Investment Survey 2016

ESG management informs decision making

The reasons why PE firms are paying more attention to ESG issues is clear – there is strong evidence of commercial advantage. In our survey, two-fifths of PE houses say that the discovery of poor ESG performance at a target acquisition has either led them to materially mark-down the valuation, or abandon the acquisition entirely. The same proportion say that they are prepared to pay a premium for a target company that shows strong ESG performance (see Figure 5: Measuring ESG issues brings benefits).

Figure 5: Measuring ESG issues brings benefits



40%

Poor ESG performance has led to a material discount in my valuation and/or led me not to invest in a company

41%

I would be prepared to pay a premium for a target company due to its strong ESG performance

Source: PwC Global PE Responsible Investment Survey 2016

?

Has your approach to resourcing ESG management changed in line with your competitors?

Is ESG management becoming a mainstream activity that's embedded in your firm beyond your RI team?

How are ESG management principles and results informing decision making in your business?

PE firms are driven by the business case as much as investor demand

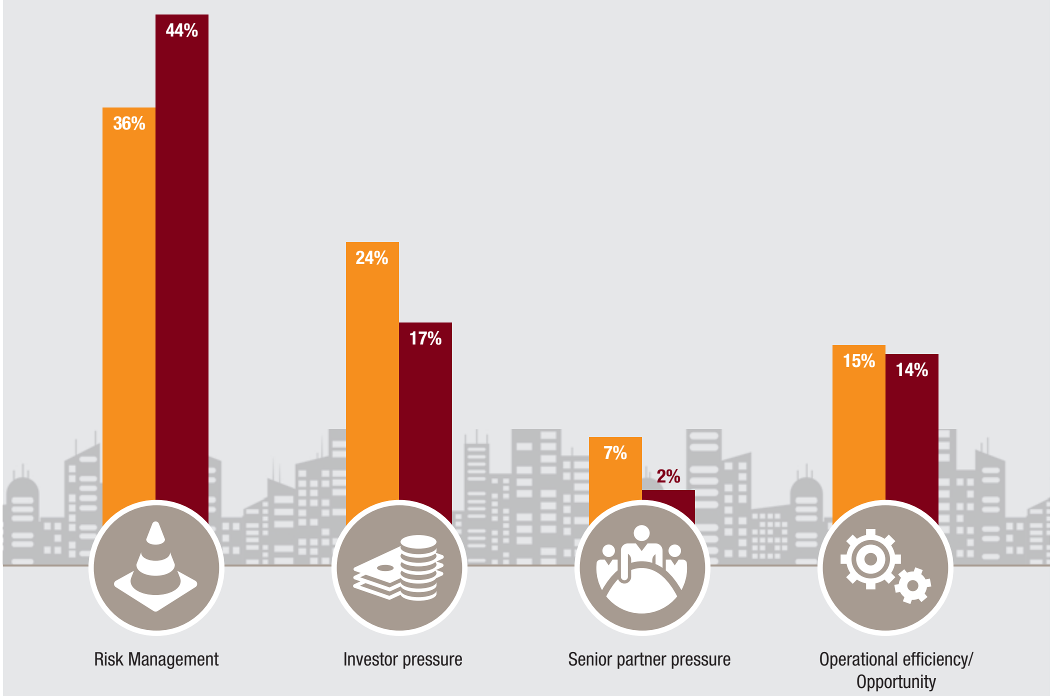
This year's survey has shown a shift in the motivations that PE firms cite when asked about their responsible investment activities. They are somewhat less inclined to refer to pressure from investors – named as the key driver by one in four firms in 2013 – in favour of business drivers such as risk management (See Figure 6: What's driving responsible investment?).

Given that investor interest in the subject is rising, this may be evidence that PE firms feel they are increasingly aligned with investors' expectations regarding RI. Indeed, PE houses report that they take responsible investment extremely seriously. We asked participating firms how they ranked the importance of RI issues compared with a number of other more conventional

"ESG has risen in priority for private equity investors in Asia in recent years. Members of the HKVCA believe that incorporation of strong ESG practices and standards can be vital to value creation in the private equity industry."

Jie Gong
Partner, Pantheon and Chairman of the Hong Kong Venture Capital and Private Equity Association's ESG Committee

Figure 6: What's driving responsible investment?



Source: PwC Global PE Responsible Investment Survey 2016

challenges, including raising finance, competition, tax policy, political interference and pressure to increase transparency (see Figure 7: Investing responsibly is firmly on the agenda).

More than half (57%) deemed responsible investment as, or more, important than pressure over transparency, while more than four in ten considered it at least as important as political interference, future sources of capital, changes in tax regulation, and competition from other GPs. Unsurprisingly, it was deemed less important than hard financial metrics such as fund performance and overly high valuations. Significantly though, 27% of respondents deem that responsible investment issues are as important, or more important than, financial performance of the funds.

This latter point is an interesting one and a real sign of change in approach by the industry. Traditional business models are profit centric, but new business models, considering the needs of wider stakeholders in the mix, are now on the increase. In fact, in our 19th PwC Annual CEO Global Survey, 84% of CEOs say they are expected to address the needs of wider stakeholders and 76% say business success is about more than just financial profit.[4]

Figure 7: Investing responsibly is firmly on the agenda

(those responding that responsible investment is as important, or more important than, ...)

Source: PwC Global PE Responsible Investment Survey 2016

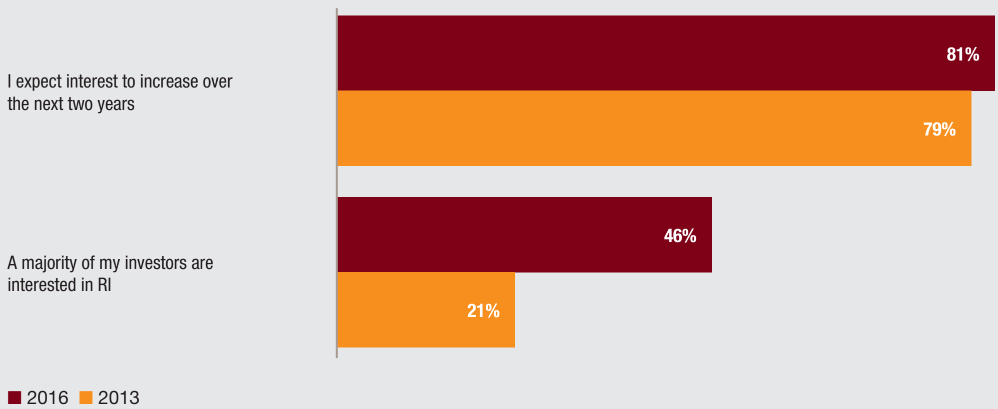
4 Business through a new lens, PwC 2016

But while respondents rate external pressure as a less important driver for RI than in the past, PE houses do not operate in a vacuum. Although they increasingly recognise that ESG management helps to reduce portfolio risk and can help drive operational efficiencies within portfolio companies, an important motivation for their RI activities is still demand from their LP investors. Almost half (46%) of survey respondents reported that a majority of their investors were interested in responsible investment in the previous two years, up from 21% in 2013, and 81% expect this to continue to rise over the coming year (see Figure 8: Growing investor interest in responsible investment). So, on the one hand, we see investor interest increasing but on the other hand, see that investor pressure as a driver for ESG management is less than three years ago (see Figure 6 – What's driving responsible investment?). As thinking on responsible investment between PE houses and investors aligns, is what was once perceived as pressure from investors, now perceived as interest?

Almost half (46%) of survey respondents say that a majority of their investors are interested in responsible investment

Figure 8: Growing investor interest in responsible investment

(respondents saying all, or a majority, are interested)



Source: PwC Global PE Responsible Investment Survey 2016

?

Are you seeing responsible investment and ESG management becoming more important to your PE house and the board?

83% of PE firms now report on responsible investment activities to their investors, up from 56% in 2013.

Disclosure is on the rise, but an industry standard remains elusive

PE firms are responding to greater interest in RI from their investors with greater levels of ESG disclosure. More than four-fifths (83%) of PE firms now report on RI activities to their investors, up from just over a half (56%) in 2013. Of those that currently do not, almost half (47%) expect to do so within the next two years – likely pushing the percentage of reporters above 90%.

ESG reporting to LPs has developed faster than anticipated in the 2013 survey. Then, 60% expected to be disclosing within two years. However, disclosure remains an emerging field, with little consensus around what to report, and how. For example, PE houses tend to use their own, bespoke reporting frameworks, or report to individual investors in line with the LP's specific demands. Such a lack of consistency is likely to lead to inefficient and resource-intensive disclosure practices.

Hopes that the ESG Disclosure Framework, launched in 2013 by a coalition of GPs, LPs and industry associations, would help to rationalise and streamline ESG information requests, have not been realised. In 2013, 42% said they planned to use the framework. This year, just 18% of respondents said they did. Based on our discussion with clients, the feedback is that the framework is is not sufficiently detailed to be particularly useful in informing disclosure.

The Principles for Responsible Investment (PRI), an initiative backed by investors responsible for $62 trillion in assets, is halfway through a project to build upon the ESG Disclosure Framework and provide that detail. The PRI recently produced a due diligence questionnaire template for LPs seeking disclosures from GPs during fund-raising. It aims to encourage standardised due diligence information requests, and early indications are that it is likely to be more widely accepted among investors, with 38% of responding GPs saying that they are already using it. In 2017, the PRI is planning to develop guidance that promotes consistent approaches from LPs seeking disclosures from GPs during the life of a fund.

Meanwhile, there is as yet no consensus on how ESG issues should be incorporated into the contractual arrangements between GPs and their investors. Two fifths (39%) of responding GPs say they always or usually include ESG considerations in the Limited Partner Agreements (LPAs) that set out the terms under which LPs commit capital to funds. Given the difficulty of reaching agreement with all investors on ESG issues, this is a surprisingly high number. Almost as many respondents (35%) say they instead use alternative contracting agreements, such as side letters, with individual investors.

As market observers, we believe that the efforts to create disclosure frameworks are important despite the seemingly low take-up. In conversation with both GPs and LPs, it seems that leading LPs are viewing the frameworks as a starting point, a minimum requirement, and are adapting them to suit their own needs, and to serve as a point of differentiation over their competition.

?

How important is it to have a disclosure framework adopted by all?

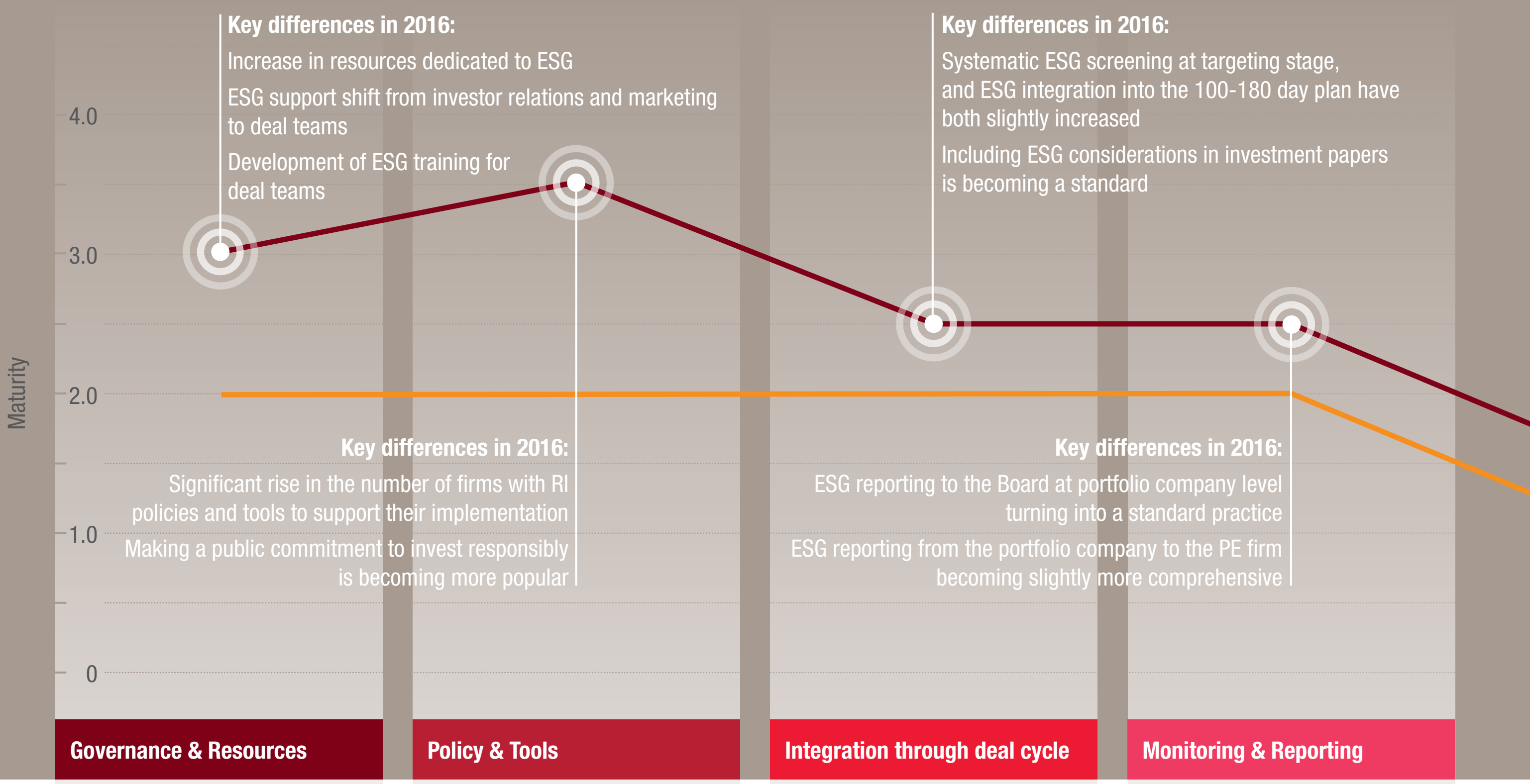
"The rapid growth of ESG reporting practices is extremely encouraging but collaboration between LPs will be absolutely critical to the development of consistent and meaningful disclosure from GPs."

Fiona Reynolds
Managing Director, Principles for Responsible Investment

A maturing approach to Responsible Investment – the PwC perspective

The diagram below represents PwC's view of the evolution of the private equity industry's approach to integrate responsible investment in its activities. It builds on the results of our two surveys and our own experience working with a wide range of clients in the industry across the world. We also share our opinion on what the next stage of maturity could look like.

A maturing approach to responsible investment



Moving to maturity: what does best practice look like?

Governance & Resources

- Formalisation of ESG training for deal teams
- Strong ESG governance building on a partner taking ultimate responsibility, supported by a dedicated ESG team reflecting the size of the firm

Policy & Tools

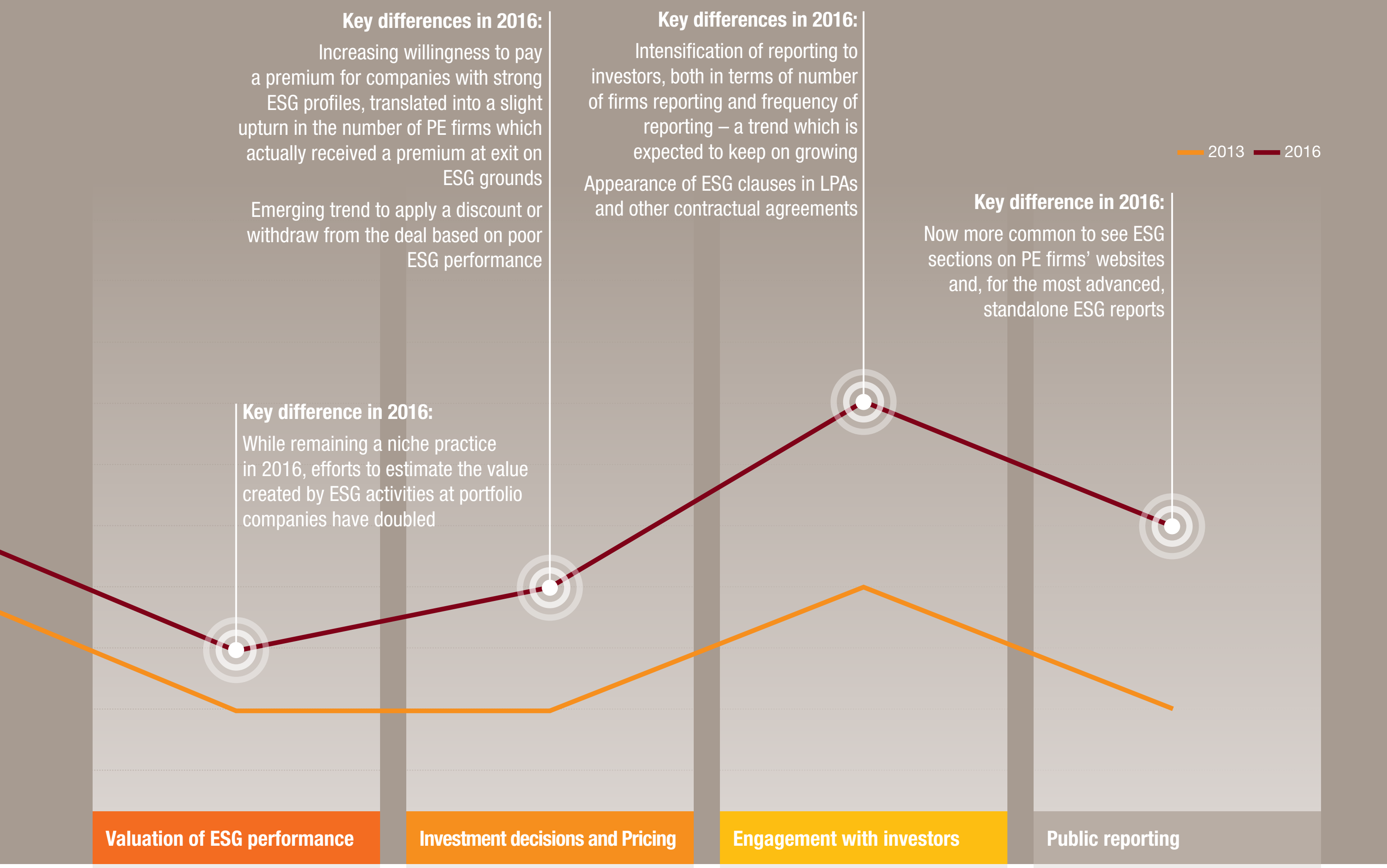
- Ambitious RI policies not only stating the firm's commitment, but describing the processes in place to embed ESG at both deal cycle and house levels
- Development of sophisticated ESG tools to support the implementation of the RI policy. The tools should be adapted to the investment mandate of the firm

Integration through deal cycle

- Systematic screening of target companies for ESG risks and opportunities and documentation of findings in the investment papers
- Inclusion of ESG considerations into the 100-180 day plan, when relevant
- Systematic inclusion of ESG considerations throughout the hold period and in preparation for exit

Monitoring & Reporting

- Systematic review of newly acquired portfolio company's ESG performance to create a baseline, followed by ongoing monitoring during the hold period (i.e. at least annual)
- Formal processes for portfolio companies to report significant ESG incidents to the PE house
- Portfolio company's Board has oversight of ESG activities



Valuation of ESG performance

- Estimation of the value created by ESG initiatives at portfolio companies when relevant

Investment decisions and Pricing

- Value created or protected by ESG initiatives is systematically reflected in valuation calculations or premiums
- Systematic withdrawal from the deal process for poor ESG performance of a target company on material issues

Engagement with investors

- Disclosure of ESG activities to investors at least annually and following any significant ESG incidents
- Systematic inclusion of ESG considerations into contractual agreements with limited partners (e.g. LPAs, side letters)

Public reporting

- Section of the PE firms' website dedicated to ESG matters
- Standalone or integrated ESG report publically available

Going public on responsible investment

From privacy to transparency, private equity houses are on a "journey" to disclose further ESG information to their wider stakeholders. Here are the signs:

- A greater number of private equity firms report on ESG issues to their investors than publicly disclose their approach to responsible investment.
- The vast majority (83%) of PE houses disclose ESG information to their investors, with a third of these providing information more than once a year.
- A smaller percentage (58%) say they report on their RI activities, or on the ESG performance of their portfolios, to the public, either through standalone reports, via their websites or on request. Conversely, 39% do not carry out any public reporting.

This reluctance to report, by some, mirrors broader attitudes towards public disclosure within private equity, which has traditionally shunned public outreach. However, in recent years, PE houses have become more accepting of the need to provide wider stakeholders with a greater degree of disclosure, both in terms of their general business activities and, increasingly, of their non-financial impacts. PE houses have come a long way in the last decade or so to embrace accountability, transparency and reporting as mainstream business practice.

Believing in the value of ESG initiatives

Investors are paying more attention to ESG factors than in the past, due to growing evidence that doing so creates and/or protects value. Academic research shows that companies that manage ESG issues well tend, over the long-term, to outperform those that do not. For example, a recent study undertaken by Deutsche Asset & Wealth Management[5] of more than 2,000 empirical studies, found a positive correlation between ESG performance and corporate financial performance.

It can be challenging, however, to quantify that effect. The benefits of reduced ESG risks, in particular, can be difficult to pin down. Nonetheless, value creation (including operational efficiency, impact on exit value, and innovation and differentiation at portfolio level) is an important motivation for PE firms' RI activities, cited as the primary driver by 25% in this year's survey.

This year's survey finds evidence that more PE houses are valuing the impact of ESG management on their portfolios. This year, 21% say they estimate the value created within portfolio companies by their environmental activities, up from 14% in 2013, 20% estimate social-related value added, more than double the 9% in 2013, and 21% put a value on governance activities, up from 11% (see Figure 9: Valuing the impact of ESG management).

"In 2016, we made a significant breakthrough whereby a selection of firms have implemented key measures to evaluate the P&L impact of their ESG initiatives. This successful initial step confirms the positive impact of ESG on value creation."

Olivier Millet
Chairman of the AFIC – French Private Equity Association

5 Journal of Sustainable Finance and Investment, December 2015

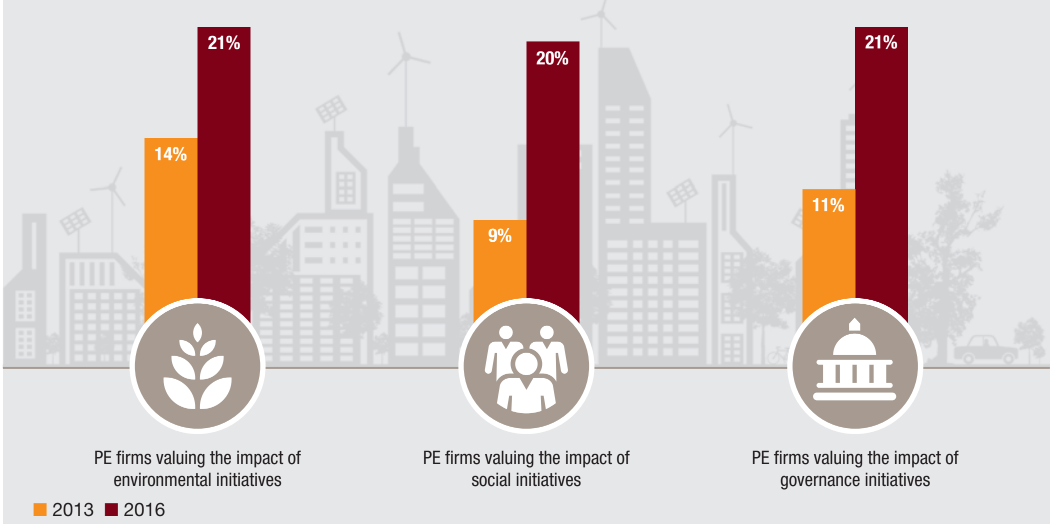
However, these figures remain much lower than those for tracking of ESG issues within the portfolio. Around four-fifths of PE houses say they monitor portfolio companies' environmental, social and governance performance. This suggests that PE firms are still struggling to obtain data and identify robust methodologies to quantify ESG factors in a timely and cost effective way.

There also appears to be limited evidence of PE firms monetising improved ESG performance at exit. 14% of respondents report earning a premium for strong ESG performance when exiting a portfolio company. This shows genuine progress in comparison with the practices we observed in 2013, but at a slower pace than we expected.

In 2013, we saw signs of valuation at exit as an indication of the direction of travel, believing it would become a core activity[6]. We expected to see more PE houses valuing their activities to manage ESG issues to understand the positive difference driven by their efforts and to justify an increase in premium. However, the market arguably moved faster than expected, leap frogging impact assessment and taking a different direction, with GPs seemingly not seeing a benefit in proving or putting a value on ESG management, but simply being convinced of it, and acting accordingly. This change of tack may be because good performance is already factored into the valuation, or it may reflect anecdotal evidence that good ESG management within portfolio companies is simply becoming an expected part of good management more generally.

The valuation of ESG initiatives is most worthwhile when capturing value still to come – that is, when ESG initiatives are not fully implemented at the point of exit, and rewards from investment in them are not fully reflected in the financial results. However, it can also be valuable to identify "valuation pathways" – that is, what specific actions can lead directly to value creation: only when properly mapped can valuation pathways be replicated in future, and/or in other portfolio companies.

Figure 9: Valuing the impact of ESG management



Source: PwC Global PE Responsible Investment Survey 2016

?

How would an understanding of the impact of your ESG initiatives change the valuation of a portfolio company?

Is there a competitive advantage to be had in valuing the impact of your ESG interventions?

14%

of respondents report earning a premium for strong ESG performance when exiting a portfolio company.

6 Putting a price on value, PwC 2013

Horizon scanning: what's on the risk radar?

Any business faces the challenge of identifying risks at speed to remove or reduce their impact on the bottom line. PE houses are no exception, but have to have insight across a broader range of factors. Not only do they need to be aware of risk relating to their direct business and market, but also those that impact upon their individual portfolio companies. In this year's survey, we asked participants for their views on a range of emerging issues and their thoughts on the Sustainable Development Goals (SDGs).

Looking ahead for risks

This year's survey sought to take the pulse of the PE industry regarding established and emerging ESG issues – climate change, human rights, cyber security and gender inequality.

These are all issues that are on the risk radar of some, but certainly not all, PE houses. We polled firms on whether they were concerned about these issues and, where appropriate, whether this concern has resulted in action. (See Figure 10: What's keeping you up at night?)

When it comes to the potential impact of climate change on a business, PE houses recognise that there are consequences for business, and the majority (over 75%) expressed concern about the issue – whether in terms of thinking about climate risk[7] in the portfolio or carbon foot-printing with a view to reducing Green House Gas (GHG) emissions.

This reflects the importance the wider business community places on these issues: failure to respond adequately to climate change is ranked a top-3 risk both in terms of likelihood and impact in the World Economic Forum's annual survey of business leaders.[8] However, only 30% of PE firms say that they are *very* concerned about its impact on their portfolio companies, similar to the proportion (32%) who have implemented measures to address it.

7 **Climate risk** is defined as the impacts arising from climate change driven by the following risk factors:

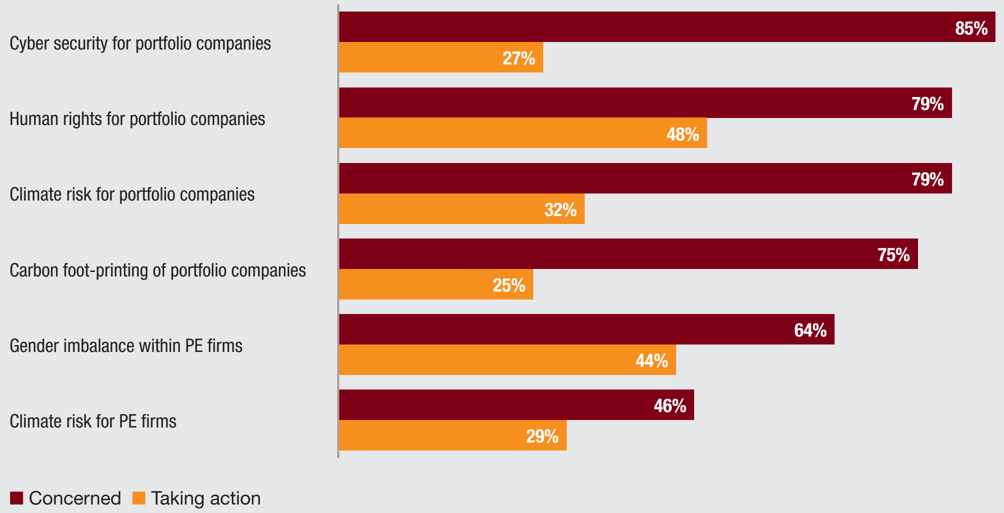
- **Physical risks:** the first-order risks which arise from weather-related events, such as floods, storms and heatwaves. They comprise impacts directly resulting from such events, such as damage to property, and also those that may arise indirectly through subsequent events, such as disruption of global supply chains or resource scarcity.
- **Transition risks:** the financial risks which could arise from the transition to a lower-carbon economy. This risk factor is mainly about the potential re-pricing of carbon-intensive financial assets, and the speed at which any such re-pricing might occur.
- **Liability risks:** risks that could arise from parties who have suffered loss and damage from climate change, and then seek to recover losses from others who they believe may have been responsible.

8 The World Economic Forum, The Global Risks Report 2016

> "Effective governance – and the risk management this brings – has always been at the heart of the private equity ownership model. In terms of ESG issues, most forward looking general partners have moved beyond thinking of them as just risk management; they treat them as levers of value creation."

Toby Mitchenall, Senior Editor, Private Equity International

Figure 10: What's keeping you up at night?



Source: PwC Global PE Responsible Investment Survey 2016

This is a surprisingly low percentage. There is growing concern business wide both about the physical impacts of climate change – in terms of more frequent extreme weather, flooding and rising sea-levels, for example and damage to infrastructure and business disruption – and about the impacts of regulations intended to reduce greenhouse gas emissions. These so-called 'transition risks' have been raised as a threat to financial stability by Mark Carney, Financial Stability Board Chair, who initiated the Task Force on Climate-related Financial Disclosures (TCFD)[9].

Cyber security, meanwhile, is perceived as a more pressing issue by PE firms – 85% say that they are very concerned about its potential impact on their investments. As the business community becomes more reliant on digital technology, so security becomes a greater concern. Information theft can result in reputational and financial damage both at a portfolio company level and for the PE house. However, this concern has not translated into action. Barely a quarter (27%) of PE houses have taken steps to mitigate the risk. (See Box: Tackling cyber security)

PE houses have been more active on social issues. The introduction of the Modern Slavery Act in the UK in 2015, and legislation in development in several other countries around the world, has focused attention on slavery and worker exploitation. It's therefore unsurprising that 79% of respondents say they are concerned about human rights issues in their portfolios, and that 48% have taken action in this area. Our view is that human rights should remain on the risk radar for PE houses, and we expect the introduction of, and compliance with, new legislation to be an ongoing preoccupation for portfolio companies. (See Box: Respecting human rights)

The survey also showed gender imbalance to be perceived as a risk by almost two-thirds (64%) of respondents. PE houses are often accused of being male dominated and some are introducing programmes to encourage better gender diversity. Almost half (44%) have taken action to address the issue.

Overall, the survey has shown quite a gap between concern and action. Fewer than half of our participants are taking action to reduce their risk exposure to climate change, human rights, cyber security and gender inequality, despite the majority in the main recognising them as real issues.

?

Have you quantified your risk exposure across your portfolio companies?

What action are you taking to mitigate these risks?

9 The TCFD is developing "voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders." See https://www.fsb-tcfd.org/

Tackling cyber security

85% of PE Houses are concerned about cyber security – it's not only an IT issue, but also on the Board agenda too

It is not a surprise that 85% of PE houses surveyed feel concerned about cyber security. It's an issue no longer viewed as just an IT problem (in similar fashion to how Tax strategy is no longer confined to the tax team), but an issue that needs to be elevated to the Board, with reputational damage, fines and financial loss as potential consequences. In this way, there is a strong argument to include cyber security strategy as an ESG issue (under 'governance'). It is apparent that many PE houses view it in this way as it is simply about being responsible with data.

It is important to understand the potential risks involved, whether direct threats to private equity houses or indirect ones to portfolio companies. Many PE houses certainly have done so. But sizing the risk isn't enough; action is needed to reduce its likelihood and impact. Taking an integrated approach that not only assesses, builds and manages cyber security capabilities, but also has the ability to respond to incidents and crises, will help private equity houses to respond to the cyber security challenge.

Direct threats

Mergers and acquisitions – M&A activity is a common target of espionage, whether carried out by corrupt competitors or foreign intelligence services. Awareness of an industry's cyber profile is often not included in due diligence so PE houses with limited expertise in a sector can find themselves caught out.

Financial information – private equity houses are at greater risk than most businesses when it comes to higher value fraud attempts via cyber attacks. The financial and business information they hold relating to funds, portfolio companies and investors offers a potentially high value target for an attacker.

Dilution of portfolio value – a cyber attack can have a significant and lasting impact on the value of a compromised business. It may impact the value of the portfolio, and, in some cases, may result in an exit decision. This risk is amplified if the portfolio is not diversified and focussed on a sector which is specifically being targeted.

Indirect threats to portfolio companies

It would be wise to assume that regardless of the type of data held, all organisations will be at risk from opportunistic attacks, including data theft and destruction or targeted fraud. Portfolio companies also present an opportunity to cyber attackers to 'island hop' – exploiting potentially less robust cyber security in place at the portfolio company as a soft access route into the PE house itself.

Three key types of data are particularly attractive to hackers:

Trade secrets – intellectual property, business intelligence and confidential communications are all common targets of cyber attackers. In particular, organisations whose business is underpinned by the development of intellectual property are likely to be targets of espionage. This is particularly an issue for private equity houses as they often invest in emerging technologies and new markets.

Consumer data – including financial information and any personally identifiable information, remains a primary focus of cyber attacks. Holding large amounts of personal data and payment card information, retail organisations in particular are at risk, and are a primary target for organised criminals looking to steal financial databases to sell on the black market.

Government assets or critical national infrastructure – intellectual property theft is a permanent risk to most defence organisations, with state-sponsored espionage a particular threat. Moreover, organisations involved in government or critical infrastructure are prone to hacktivists – those seeking confidential information to raise an issue or advance a political agenda.

For more on this read GUIDE TO: Cyber Security, British Private Equity & Venture Capital Association (produced in association with PwC and authored by James Rashleigh PwC Director, Cyber Security)

Respecting human rights

The issue of human rights has quickly risen up the corporate agenda over the last five years. Once ignored by many companies outside the retail or extractive industries, it's now become important, indeed four out of five GPs are reportedly concerned about it. So what has changed?

The turning point came in 2011 when the UN published its 'Guiding Principles on Business and Human Rights' which unequivocally defined the corporate responsibility to respect human rights and described how responsible companies should respond to this responsibility.

Since then the drivers for action in this area have become more compelling to the PE industry and more broadly – they include:

- **Regulation:** While many human rights have been implicitly protected by law for years, further regulation explicitly addressing specific human rights issues is generating momentum. For example, the last few years have seen new requirements for portfolio companies operating in the US and UK under the California Transparency in Supply Chains Act and the Modern Slavery Act respectively. Similar laws are expected in other countries over the coming years.
- **Legal:** There has been a 'hardening' of the voluntary standards around human rights. For example, in recent legal cases companies have had to defend poor human practices in their supply chains. Also investment managers have been reported under the OECD Guidelines for Multinational Enterprises for human rights abuses in their investments, even where they hold a minority stake.
- **Investor pressure:** As seen elsewhere in this report, investors are increasingly engaged on ESG issues and human rights is a priority within these.
- **Reputation:** Human rights abuses represent significant reputational risks for portfolio companies, particularly where the companies operate in inherently high risk sectors or countries. It is likely that any abuses that do take place may do so in the supply chains, rather than in the companies themselves, and so they may be hard to control. Despite this challenge, customers, prospective investors and employees may turn away from a company in the wake of a human rights scandal – resulting in a direct financial impact.

If it is understandable that PE houses are increasingly concerned about human rights, it is puzzling that less than half of the respondents to the survey have implemented activities to manage these risks. This may well be due to a lack of understanding of the best way to address these emerging issues. We recommend that PE houses implement the following activities as a starting point:

- Ensure that human rights is explicitly addressed within existing ESG practices. For example, human rights should be considered as part of investment due diligence and portfolio company performance should be reported to investors.
- Support the portfolio companies to address human rights in their operations and their supply chains. Key tasks could include:
  - Identifying relevant regulatory requirements, particularly where these are new.
  - Assigning responsibility for managing human rights issues at the company.
  - Developing policy commitments – either in a stand-alone policy or as additional content within existing policies e.g. Codes of Conduct.
  - Assessing the human rights risks in the operations and supply chains.
  - Integrating activities into existing practices, often in relation to supplier selection, contracting and monitoring.
  - Training relevant staff in the identification and management of these risks.
- Address human rights issues at the PE house itself, as appropriate. While risks at the house are likely to be relatively low, there may still be issues to consider in the supply chain (e.g. contracted workers in the offices) and in relation to regulation (e.g. the UK's Modern Slavery Act obligates some PE houses themselves, in addition to the portfolio companies).

SDGs: moving towards action and alignment

Figure 11: The UN Sustainable Development Goals

The SDGs are a series of 17 goals aimed at tackling major world issues, including unemployment, access to clean energy, responsible consumption and production, inequality, environmental degradation (air, land and sea) and human rights (see Figure 11: The UN Sustainable Development Goals). Otherwise known as the Global Goals, the SDGs were agreed by the 193 member governments of the UN in September 2015, and comprise no fewer than 169 individual targets, many of which include quantified objectives to be reached by 2030. Unlike the Millennium Development Goals, agreed in 2000 and which ran until 2015, the SDGs apply to both developed and developing countries and the private sector has helped to shape them.

Investors and the business community are working to understand how the SDGs are likely to create risks and opportunities. It is expected that governments will introduce incentives, policies and regulations, many of which will impact the private sector, to drive progress towards meeting the goals.

Increased pressure from government (and demands for transparency from society) is expected to promote good business behaviours, for example, around water stewardship, living wage, emissions reduction, clean energy usage, environmental management and human rights. This pressure could have a significant impact on product design, corporate operations, productivity, R&D and logistics. It is likely to drive companies to determine what's required of them, to develop a detailed response and to implement it, all of which requires a level of investment and a potential risk to short-term returns. After all, inaction may result in reputational damage and loss of licence to operate.

The SDGs are being seen by many as a driver of 'good' business practice at the same time as being good for business financial performance. For example, index provider MSCI has recently created a Sustainable Impact Index[10] (comprised of constituents of its All Company World Index (ACWI)) which is designed to identify listed companies whose core business addresses at least one of the world's social and environmental challenges, as defined by the SDGs. Nine months, in annualised net returns, are 11.51% for the Sustainable Impact Index (compared to 5.39% for the ACWI).

Our survey found that a sizable proportion of the PE community has acknowledged the relevance of the SDGs. Many recognise that there are benefits from aligning investment practices with the SDGs. More than a third (36%) say that doing so creates opportunities to increase returns, and almost

10 MSCI Sustainable Impact Index https://www.msci.com/msci-acwi-sustainable-impact-index

a third (30%) believe it offers reputational benefits (see Figure 12: PE Houses recognise the benefits of aligning to the Global Goals).

A significant proportion is already incorporating the SDGs into their policies and investment practices (see Figure 13: PE Houses are taking action on the Global Goals). One in four respondents say they are embedding the SDGs into their strategies and the way they do business. Nearly one third (32%) of respondents is engaging with portfolio companies on issues related to sustainability that are incorporated into the SDG framework, as collectively the SDGs cover environmental, societal or governance issues. Almost a fifth (19%) are allocating capital to investments that promote sustainable development.

In many ways this level of engagement is a welcome surprise. Historically accused, by some, of a focus only on short-term value creation, PE houses are not often credited with the longer term thinking which the SDGs demand. We see participants not only aware of and thinking about aligning strategy to the SDGs, but also reviewing and changing business practices to address them.

However, this awareness is not universal by any means and there is also real inertia. This

Figure 12: PE houses recognise the benefits of aligning to the Global Goals

Source: PwC Global PE Responsible Investment Survey 2016

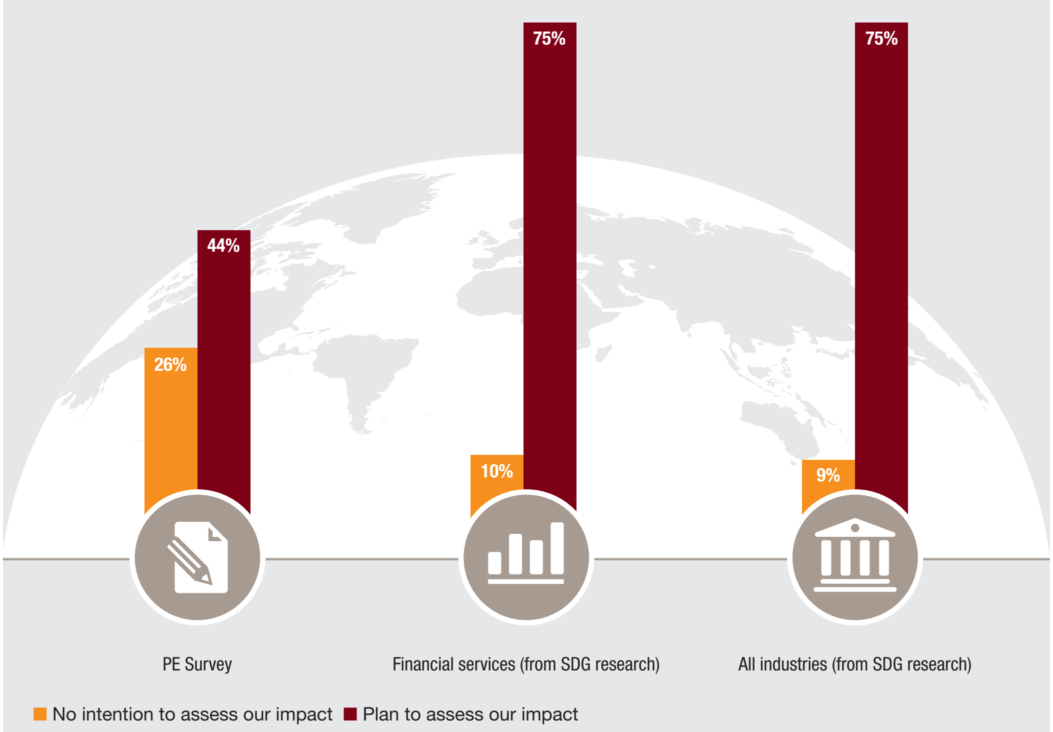
Figure 13: PE Houses are taking action on the Global Goals

Source: PwC Global PE Responsible Investment Survey 2016

is likely a result of uncertainty about how to translate the SDGs into investment practices and outcomes, especially in regard to the SMEs in which PE houses typically invest. Fully 80% of responding firms have not begun planning how to respond to the Global Goals, and only 6% of respondents say that they have identified the tools available to assess their progress towards meeting the goals. But it's evident the ambition is there, with 44% planning to assess their impact in some way (see Figure 13: Assessing impact on the Global Goals). And there is acknowledgement that action will be needed at some point in the future- 44% of the respondents are expecting to increase work around Global Goals within the next five years.

How business engages with the SDGs is one for the PE community to watch. In 2015, when the SDGs were ratified, PwC conducted research to understand how business was planning to engage with the SDGs.[11] We asked several of the same questions of our PE participants in this survey and quickly realised that although there is a good level of engagement there is a gap to bridge in order to keep pace with the wider business community (see Figure 14: Assessing impact on the Global goals). With the potential for significant change, it would seem wise to stay close to the issues and implications that arise from the SDGs for business.

Figure 14: Assessing impact on the Global Goals



Source: PwC Global PE Responsible Investment Survey 2016

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What is the likely impact of the SDGs on your portfolio companies?

How might the SDGs impact the way you value a potential investment?

What's the risk exposure for your portfolio if activity is not in line with the SDGs and hinders governments achieving their targets, or investment is required to meet new government standards?

How are you measuring your impact on the SDGs and your risk exposure?

11 Make it your business: Engaging with the Sustainable Devlopment Goals, PwC, (2015)

Well on the way, but a long way to go

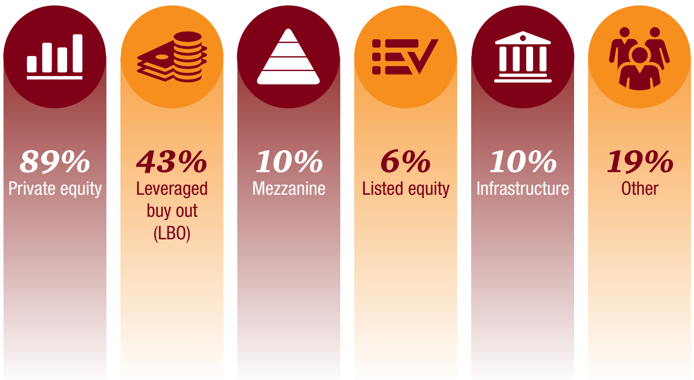
Since we carried out our last comparable survey, in 2013, the PE industry has come a long way on its responsible investment journey, in terms of its adoption of policies, processes and practices to manage ESG issues.

As we show with our maturity assessment on page 16, the market has moved on considerably in the last three years. Governance of ESG issues has been reinforced at PE house level notably through increased resources dedicated to ESG management and responsible investment policies and the tools to support their implementation, becoming more common. In the future, we expect the market to move even further towards a systematic inclusion of ESG considerations at each stage of the deal cycle, including at exit. We also project a reinforcement of ESG monitoring and reporting processes, both between the house and its portfolio companies, and with investors. This enhanced oversight of ESG performance should eventually lead to increased external disclosure from the industry, and stronger engagement with wider stakeholders.

But what is clear is that interest from investors is undimmed, and pressures from regulators and wider society to address sustainability issues are only likely to become greater. There is a growing consensus within the PE sector that addressing ESG issues makes good business sense, and provides opportunities to reduce risk and create value. Our view is that responsible investment is likely to be further embedded within the sector in the years to come, and we look forward to working with both GPs and LPs to help make it so.

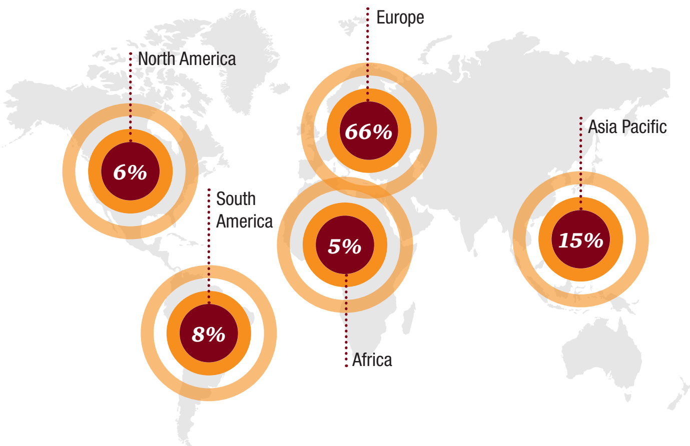
Respondent profile

Respondents' main categories of investment (multiple selections permitted)



Source: PwC Global PE Responsible Investment Survey 2016

Respondents by region

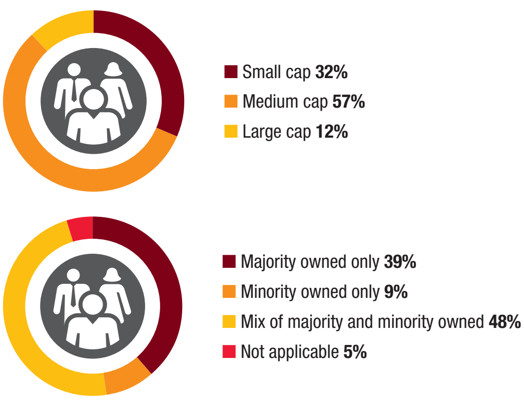


Source: PwC Global PE Responsible Investment Survey 2016

Respondents' total assets under management (in $)

Source: PwC Global PE Responsible Investment Survey 2016

Respondents' investment approach



Source: PwC Global PE Responsible Investment Survey 2016

Contact us

PwC is helping a range of PE houses assess the implications and address the practical challenges of ESG management. If you would like to discuss any of the issues raised in this report, please speak to your regular PwC contact or one of the following:

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We would like to thank all participants in the 2016 Private Equity Responsible Investment Survey, including:

21 Centrale Partners
21 Investimenti
3i Plc
Accent Equity Partners
Actis
Activa Capital
Adveq
Alter Equity
Altor Equity Partners
Ambienta SGR
Ancla 360 I
Apax Partners
Apax Partners UK Ltd
Ardian
Argos Soditic France
Ashmore
ATLAMED
Avenidacapital
Azulis
Bain Capital
Banexi ventures
BC Partners
Bridgepoint
Capital Croissance
CAPITAL INVEST
CapMan Plc
CASEIF III LP
Céréa Partenaire
CLSA Capital Partners
CMS Opus
Coller Capital
Court Square Capital Partners
Cube
CVC
Demeter Partners
Dragon Capital
EBRD
ECI Partners
Edmond de Rothschild Capital Partners
Ekkio
EPF Partners
EQT
Eurazeo
HgCapital

HPEF Capital Partners Limited
Huizheng Investment
Humus Capital
ICG
Intera Partners Oy
J-STAR Co Ltd
Juuri Partners Oy
Lafayette Capital Partners
LBO France
Miura Private Equity
Naxicap
NiXEN Partners
NorthEdge Capital
Norvestor
Omnes
PAI Partners
Paine Partners
Pantheon
Parquest Capital
Pegasus Capital
Permira
Phoenix Capital
Phoenix Private Equity Partners
Pragma Capital
Priveq
Qualium Investissements
Sanlam Investments
Serfinco Agronegocios
Sherpa Capital
SwanCap Investment Management S.A.
TDR
Terra Firma
Tsing Capital
Victoria Capital (former DJL)
Vietnam Holding Asset Management Ltd
Warburg Pincus LLC

A further 31 PE houses participated but chose not to be named.