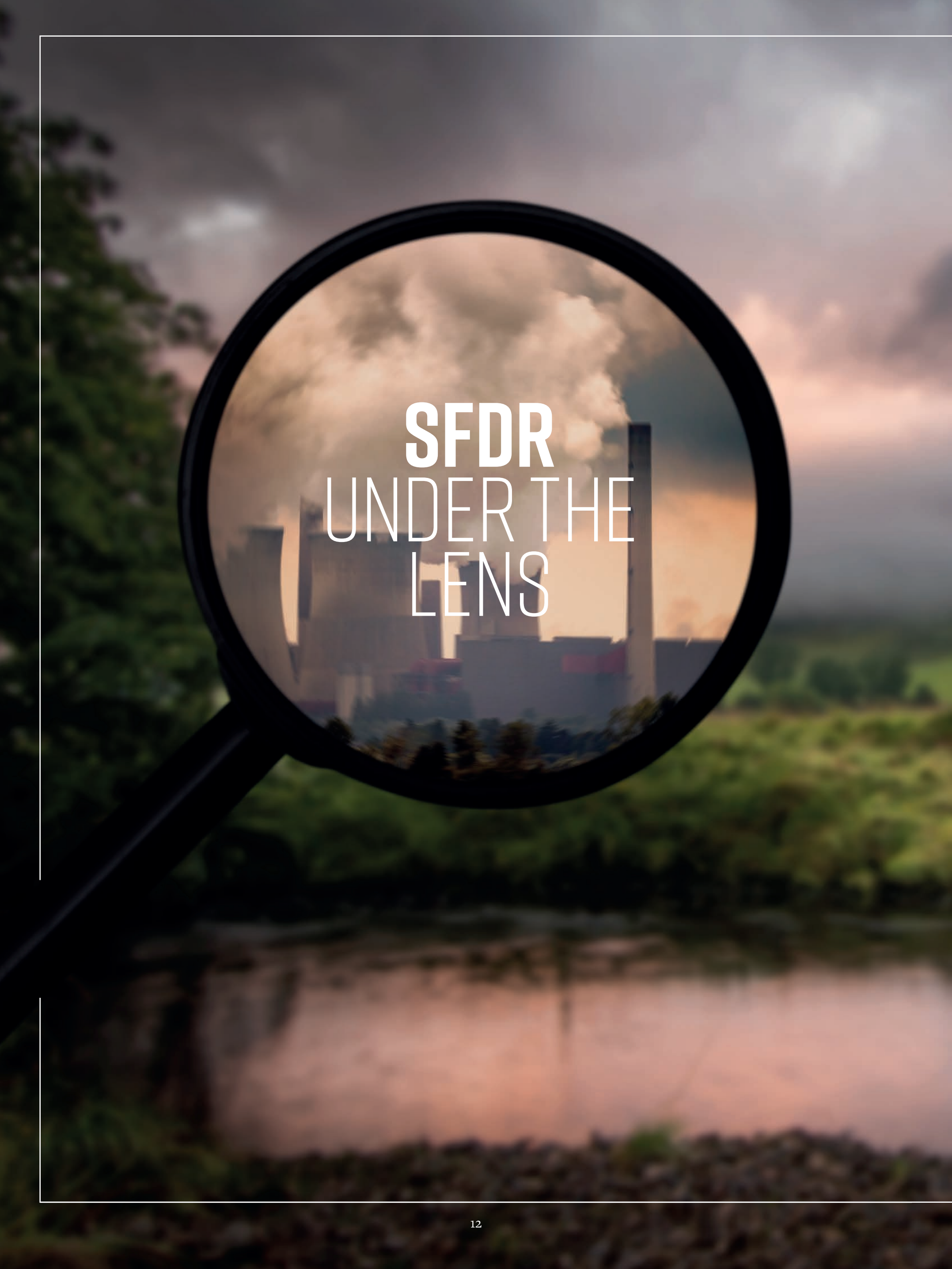


SFDR UNDER THE LENS

While ESG and the European Commission's recently introduced SFDR are largely a force for good, some GPs have voiced their concerns as to how sustainable and beneficial the requirements of regulation may actually be. *Jennifer Forrest writes.*

ESG and sustainability has been rising up the agenda for almost a decade and it is about to become a necessary consideration for PE firms. According to Cambridge Associates' recent survey, there has been an approximate 150 per cent increase in institutional sustainable investments in the last four years, and it is likely that this figure will rise in the years to come.

As ESG becomes more and more commonly placed within private equity, why is it so important?

HarbourVest's managing director Carolina Espinal highlights that her firm uses evidence of ESG as a contributing factor to manager assessments. "We see solid ESG practices as a proxy for fund excellence - it's typically an indicator of how managers think about risk and opportunity more holistically, and of how they stay competitive," she says.

Joana Castro, principle and head of primary fund investing at Unigestion, agrees with Espinal, claiming that ESG will be "critical for future growth" and navigating PE in the next few years. "PE firms should take this opportunity to fully integrate ESG considerations into their investment strategy as this is very likely to be critical for future growth in the years to come," Castro says.

LEGAL FRAMEWORK

With that in mind, the Sustainable Financial Disclosure Regulation (SFDR), will have a large impact on how managers consider and report ESG. Set out by the European Commission, the regulation came into effect on 10 March this year. As part of the EU Commission's Sustainable Finance Action Plan, the framework essentially aims to streamline how financial markets define, market and report on how their investments and activities are sustainably conscious.

In practice, the regulation will mean that private equity firms and fund managers will need to adhere to periodic reporting, at both firm and portfolio level.

Transparency and accountability are at the forefront of the SFDR's ultimate goals and will assist with greater visibility in the industry.

Elin Ljung, director of comms and sustainable investment at Nordic Capital, says: "It's always good to increase awareness, that's where all change management programs start... you need to prioritise a set proactive plan to get started on making people accountable to drive that progress."

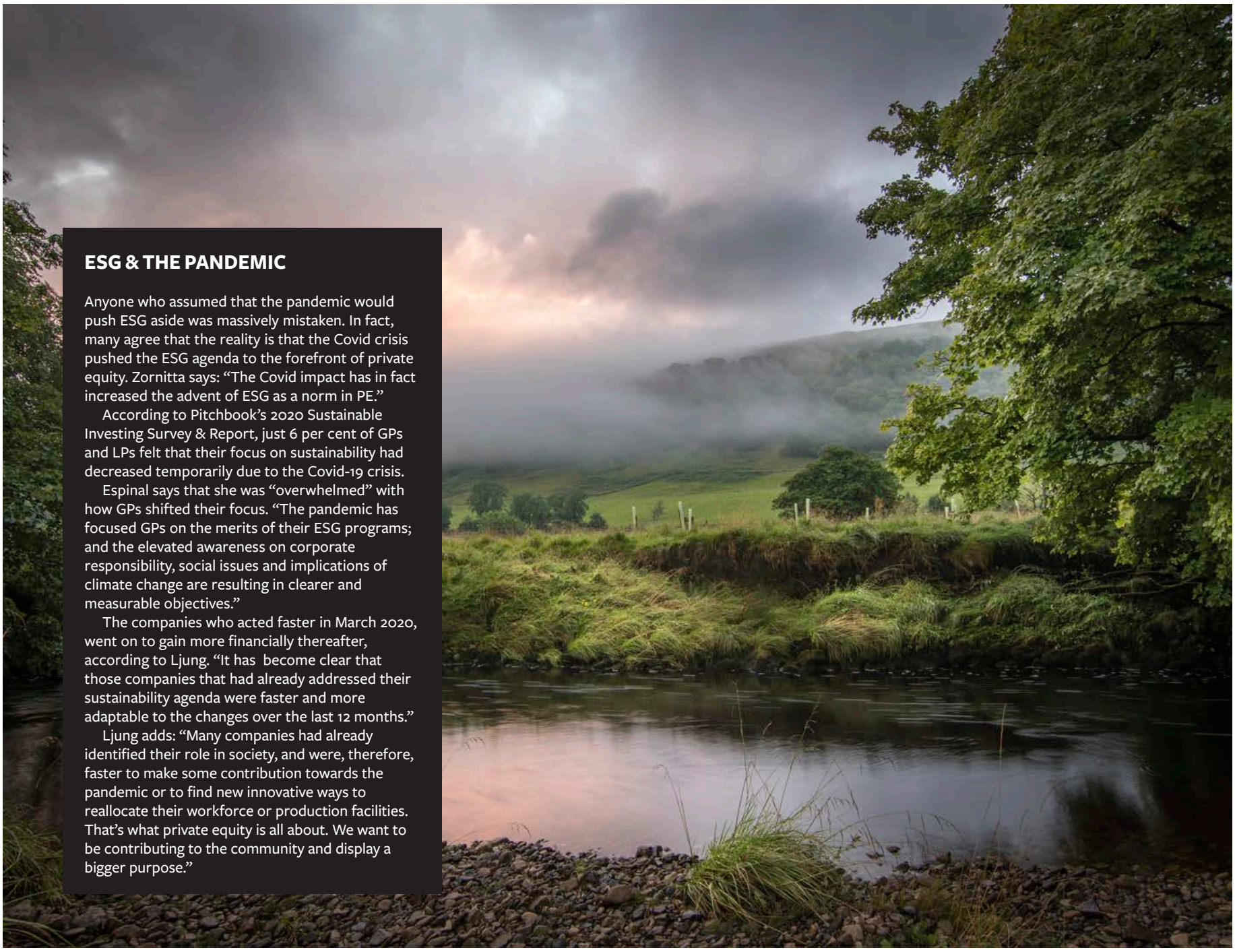
However, whilst transparency of PE funds is ultimately a good thing, Nicole Downer, managing partner and head of investor relations at MV Credit, is worried that the fear of being "caught out" could eliminate transparency altogether. Speaking at a Natixis Investment Managers' webinar in February, Downer said: "It's just a matter of making sure that the regulation doesn't inadvertently make things less transparent, because everyone might just go for the safe-zone to avoid being caught out by regulation."

Since SFDR has been criticised for taking a 'one size fits all' approach, there are worries about how severe of an impact it will have on smaller PE firms too. Maria Carradice, portfolio director- ESG at Mayfair Equity Partners, notes that firms that aren't prepared to take up the detailed reporting will see the regulation as a "compliance burden, rather than something that's of real value".

But, with the recent launch of the regulation, there will naturally be some teething problems. There has been confusion surrounding how to go about ESG reporting. Neil Brown, chief risk officer at Earth Capital, worries that the regulation itself tries to tackle financial markets as a whole, making it "too prescriptive" for PE.

"To capture bonds, money-markets, equity, real estate, private equity and everything else all under one regime is very prescriptive. You either focus it on one to get it right, and it fits that quite well but doesn't do a very good job elsewhere, or you try to be all things to more people and it could end up a bit of a mess," Brown says.

There are concerns about a lack of clarity from an advisory point of view too. Eve Ellis, a funds regulatory partner at Ropes and Gray, says: "Another area where clarity is needed is around the different product categories, in particular, what funds fall within the category of funds which promote environmental or social characteristics."



ESG & THE PANDEMIC

Anyone who assumed that the pandemic would push ESG aside was massively mistaken. In fact, many agree that the reality is that the Covid crisis pushed the ESG agenda to the forefront of private equity. Zornitta says: "The Covid impact has in fact increased the advent of ESG as a norm in PE."

According to Pitchbook's 2020 Sustainable Investing Survey & Report, just 6 per cent of GPs and LPs felt that their focus on sustainability had decreased temporarily due to the Covid-19 crisis.

Espinal says that she was "overwhelmed" with how GPs shifted their focus. "The pandemic has focused GPs on the merits of their ESG programs; and the elevated awareness on corporate responsibility, social issues and implications of climate change are resulting in clearer and measurable objectives."

The companies who acted faster in March 2020, went on to gain more financially thereafter, according to Ljung. "It has become clear that those companies that had already addressed their sustainability agenda were faster and more adaptable to the changes over the last 12 months."

Ljung adds: "Many companies had already identified their role in society, and were, therefore, faster to make some contribution towards the pandemic or to find new innovative ways to reallocate their workforce or production facilities. That's what private equity is all about. We want to be contributing to the community and display a bigger purpose."

LEVELS OF ENGAGEMENT

An element of this lack of clarity could come down to the fact that Level 2 measures of the SFDR have not yet been set by the European Commission. The current framework of SFDR is considered Level 1, and should be complied with at its "high level and principle-based requirements", according to the Commission. However, the Level 2 measures should aim to supplement the methodologies in greater detail.

Bregal Investments' head of ESG and responsible investing Alvar de Wolff says that his firm is already preparing for this next stage: "With Level 2 rules coming into place next year, we are now also actively working to ensure that all our data collection processes are in line with regulatory expectations." The Level 2 measures are expected to come into place in early 2022.

Some hope that the Commission will take onboard grievances, so that the next level can be better mapped out. Carradice adds that she would expect the authorities to consult and make any necessary changes. "I would expect there to be a series of reviews and refinements, so hopefully we end up in a place in a couple of years' time where the data is useful and you can then start to see the value of investing in businesses with good ESG profiles," Carradice says.

In terms of making investments, Carradice and Beth Houghton, head of ESG and impact at Palatine, are in agreement that just because SFDR encourages investments in "good" ESG funds, it doesn't mean that funds are necessarily going to be deterred from making deals with the "bad" ones.

Carradice says that as long as the financial criteria is favourable, there is "significant opportunities to add and create real value, by working alongside management to put in place bespoke ESG strategies and sustainability programs that will give them the competitive edge.

"We could perhaps use SFDR data to argue a reduction in price on the way in," Carradice adds.

While "bad" ESG deals could be negotiated to a lower price, the reverse of that is that investments with particularly "good" ESG will be in higher demand and so, can average at a higher price point.

Castro predicts this will go on to cause a "polarisation" within PE: "It should also be expected that investment opportunities that are beneficial for the transition to a lower carbon economy will be in higher demand. This may create a polarisation of the PE investment universe where the ESG-friendly or neutral opportunities will command a premium versus the rest of the market."

WHAT THE FUTURE HOLDS

So, as SFDR begins to take its course, what is next for ESG and what should managers be considering? We know that better all-round ESG leads to better returns, but what will be next on the agenda for ESG and sustainable investments going forward?

Firstly, SFDR will bring an element of reputational risk in this next year. Managers are going to need to prove that they are in fact ESG-conscious, especially as investors become increasingly conscious of which funds they choose to deploy capital too. Investec's Michael Zornitta says that this could be a risk for managers when they look to invest in new companies too. "There's a potential for inability to deploy capital, as potential target companies may not wish to be associated with the manager should they not uphold strict ESG criteria," Zornitta says.

Secondly, SFDR is likely to raise the bar as to what qualifies as "good" ESG, and how we differentiate the good from the bad. De Wolff says: "It is no longer enough to have an ESG policy or a high-level programme. It is becoming increasingly important to be able to demonstrate how exactly ESG is integrated and how actions drive progress."

The Cambridge Associates Survey, released in February, found that resource efficiency and climate change were listed as the top priorities for its respondents in 2020, closely followed by social equity and inclusion.

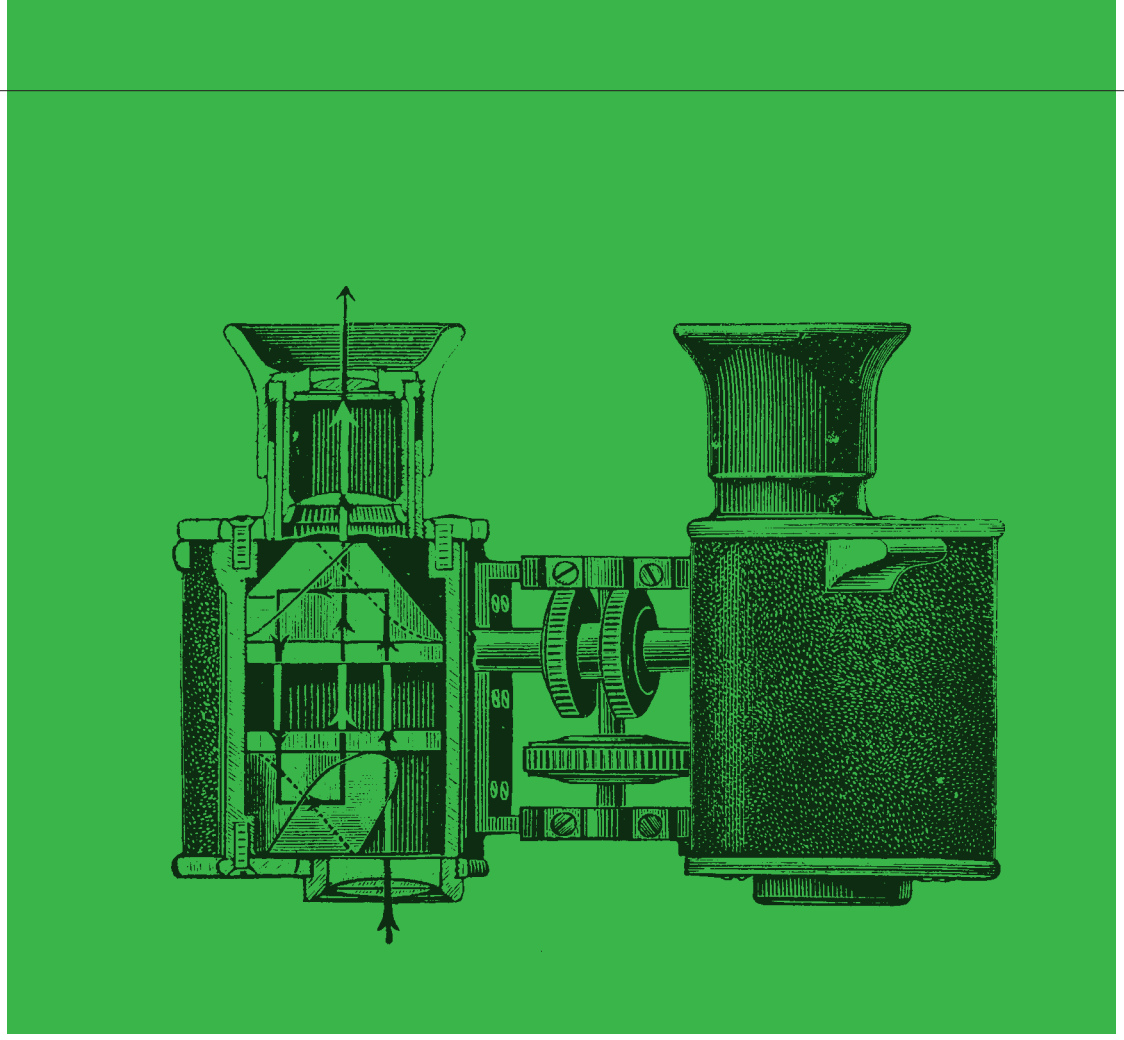
Meanwhile, Houghton predicts that the cyber-space will be a key element for many portfolio companies: "We'll see a lot more focus on cyber-security and data protection and making sure people are doing the right thing along those lines. Since we're all working from home and we're all on remote systems, it seems even more important."

CONFERENCE ROUND-UP

RealDeals ESG and Impact Management 2021

Amid the chaos and uncertainty of the last twelve months, one thing has been made abundantly clear; ESG has been catapulted to the top of private equity firms' agendas. As new regulations and standards sweep through the market and impact investing grows ever more popular, both the opportunities and speculation around ESG have never been greater.

Real Deals
8.4.21/481
realdeals.eu.com



At *Real Deals'* 2021 ESG and Impact Conference, global industry experts came together to share their insights. Here is a round up of the key themes and topics discussed during the conference.

Selecting the right ESG framework

As new reporting standards and ESG frameworks enter the market, GPs must make assessments on which one is fit for purpose.

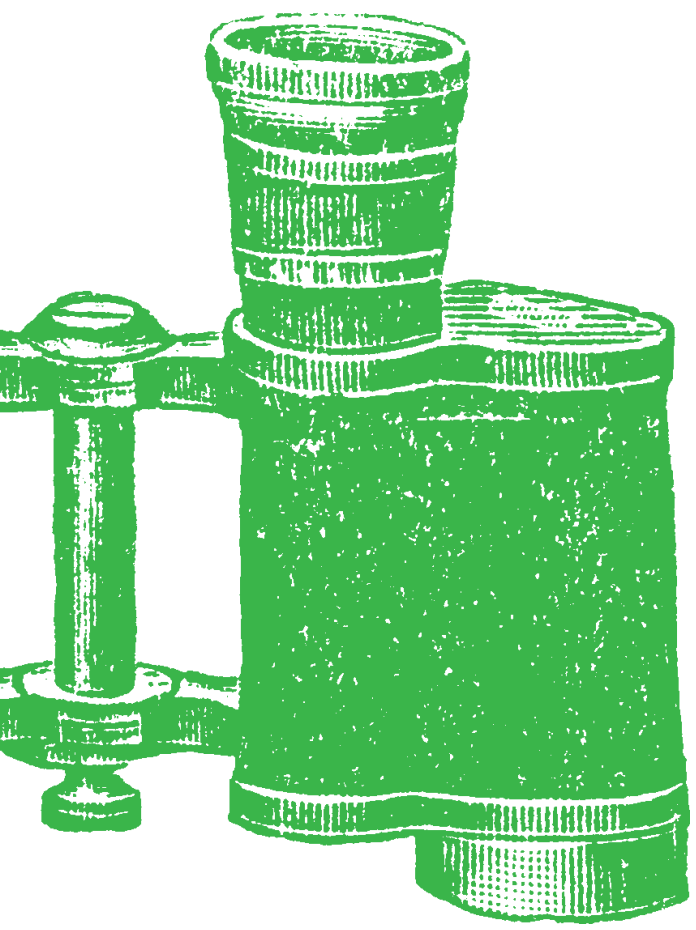
The sheer number of frameworks and voluntary standards that already exist for ESG reporting is part of the problem, according to Maria Carradice, portfolio director at Mayfair Equity Partners. To remedy this, Carradice said firms should focus on collecting as much relevant data as possible. "We try to collect data in a consistent way that is repeatable and the companies that collect themselves. This isn't as simple as it sounds, as some of the smaller companies aren't set up to do that."

Each company will have different ESG objectives, Carradice added. "There's no point looking at greenhouse gas data if you have a small group of people sitting in an office working on a software product. We try to pick out key metrics and standards that make sense to that particular business and report on that, with the view that at some point they will become more standardised."

When advising clients on how to select the right ESG framework, Hari Bhambra, global head of compliance solutions at Apex Group, said: "It comes down to where the investors are based and which markets the managers want to access. This is a key driver in understanding which standards will be most applicable."

Panelists noted that there is a growing appetite among GPs to voluntarily apply a set of standards that may not usually apply to that manager or distributor in their home country.

This is because there are certain competitive and commercial advantages to picking an ESG framework, Apex' Bhambra explained. "If we have managers who are looking at investors in the EU, they are going to look at the SFDR. Therefore, they are then approaching the same kind of investors who are used to prescribed levels of disclosure from managers and advisors, in terms of the details of their internal processes (investment process and product governance) including remuneration processes, and therefore such investors may not be comfortable with a manager who doesn't deal with that level of transparency."



SFDR complications

The recently announced Sustainable Finance Disclosure Regulation (SFDR) aims to address greenwashing, transparency in terms of ESG reporting, and to promote long-term sustainable investments across the financial services sector. GPs and LPs, however, are already experiencing challenges with the new regulation.

Elmear Palmer, ESG director at ICG, said the problem with the SFDR comes down to the fact it is a 'one size fits all' approach, despite the large variety in financial products within private debt and financial equity. "I'd say that the key challenge that we've faced, alongside most of our peers, has been that the SFDR came into force on March 10th, and the regulators themselves seem to be unclear on the implementation," Palmer said.

Jessica Arrol Caws, senior associate at Charles Russell Speechlys, agreed with Palmer's criticisms, saying that "the implementation of SFDR has been really unsatisfactory."

In particular, the rigid articles within the regulation are causing positive impact decisions to be double-guessed, according to Neil Brown, chief risk officer at Earth Capital. "Under some of the taxonomies, some of our products don't actually qualify. "That seems crazy because we have picked products and investments that are meant to have an impact and meant to be positive and are meant to have a positive score," Brown said. "This idea of getting rid of greenwashing is a good idea and we all believe in that, but perhaps it's just too high a step up."

Confusion around consistency with data reporting was another issue pointed out by Brown. "Until we get some sort of consensus on the metrics or the information, there's just going to be this massive amount of data out there, and people offering their own solutions, which may well work, but will be different from other people's [offering]," Brown said.

Panelists also recognised that smaller PE houses are likely to be the ones hardest hit by SFDR. "It's quite onerous for those small PE firms who just don't have the internal bandwidth, and at this stage, just don't know what they're signing up to," ICG's Palmer said.

Public interest

As private equity appears more frequently in the public eye, the media, as well as other external forces are helping to shape firms' ESG agendas. The BLM movement last year for example, has helped push the issue of diversity and inclusion into the spotlight for PE managers and their investors.

Cilian Jansen Verplanke, co-founding partner of Karmijn Kapitaal, said the firm's strategy of investing only in gender diverse management teams has become a big selling point for LPs. "Everyone is talking about it now, which wasn't always the case," she said.

The fundamentally private nature of private equity, however, can make it difficult for GPs to communicate ESG achievements to an increasingly critical general public.

Marta Hervas, investment director at Arcano Partners, said it is often a question of open and effective communication. "It is a matter of using transparency as a way of telling investors and the general public what they are doing. Either through the portfolio or them as a private equity firm. It is important for stakeholders to share information and to refer to frameworks in terms of certain KPI's and to demonstrate materiality. Both are ways for people to be able to get that information and understand it as much as possible," she said.

Alistair Watson, senior investment manager at Aberdeen Standard Investments, went further. He explained that GPs have to counter some of the negative perceptions of how the private equity industry has used ESG in the past. "There is a perception of ESG being a marketing tool, a lot of what you see from GPs is all the fantastic things that have happened but there tends to not be too much admission of some of the weakness. We don't expect GPs to say they are terrible, but when you are engaging your LPs, it is talking about factors and areas for improvement. It is acknowledging what is weak today, is where they can commit to improving tomorrow."

Panelists acknowledged that a lack of standardised KPIs and ESG metrics compound the challenge of communicating ESG success and progress to the public and investors alike.

Impact investing: A tricky business

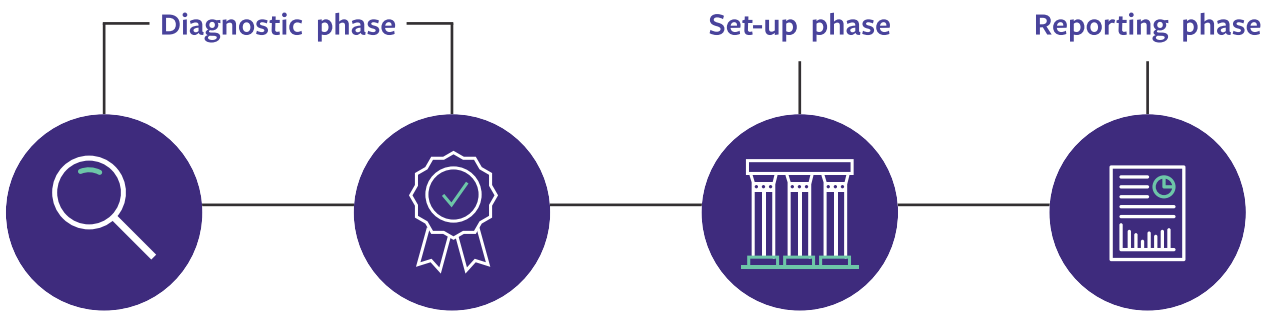
The industry is in the midst of an impact revolution, driven by changing societal values, advancements in technology and a regulatory push

IQEQ COMPASS

Actionable intelligence for ESG compliant investing

IQ-EQ has developed an integrated service offering that incorporates client insights, sector expertise and a powerful technology platform to simplify ESG compliance and help build sustainable value and reputational resilience.

We work with you to create an integrated ESG strategy tailored to your requirements.



ESG Health Check

An ESG analysis that enables managers to fully understand their position on the ESG spectrum

ESG Reputational Assessment

Comprehensive ESG reputational reports on funds, portfolio companies and their leadership teams

ESG Foundations

ESG policies, frameworks and procedures

ESG Reporting

ESG data compilation and ESG and impact performance reports

Our team

Justin Partington
E justin.partington@iqeq.com

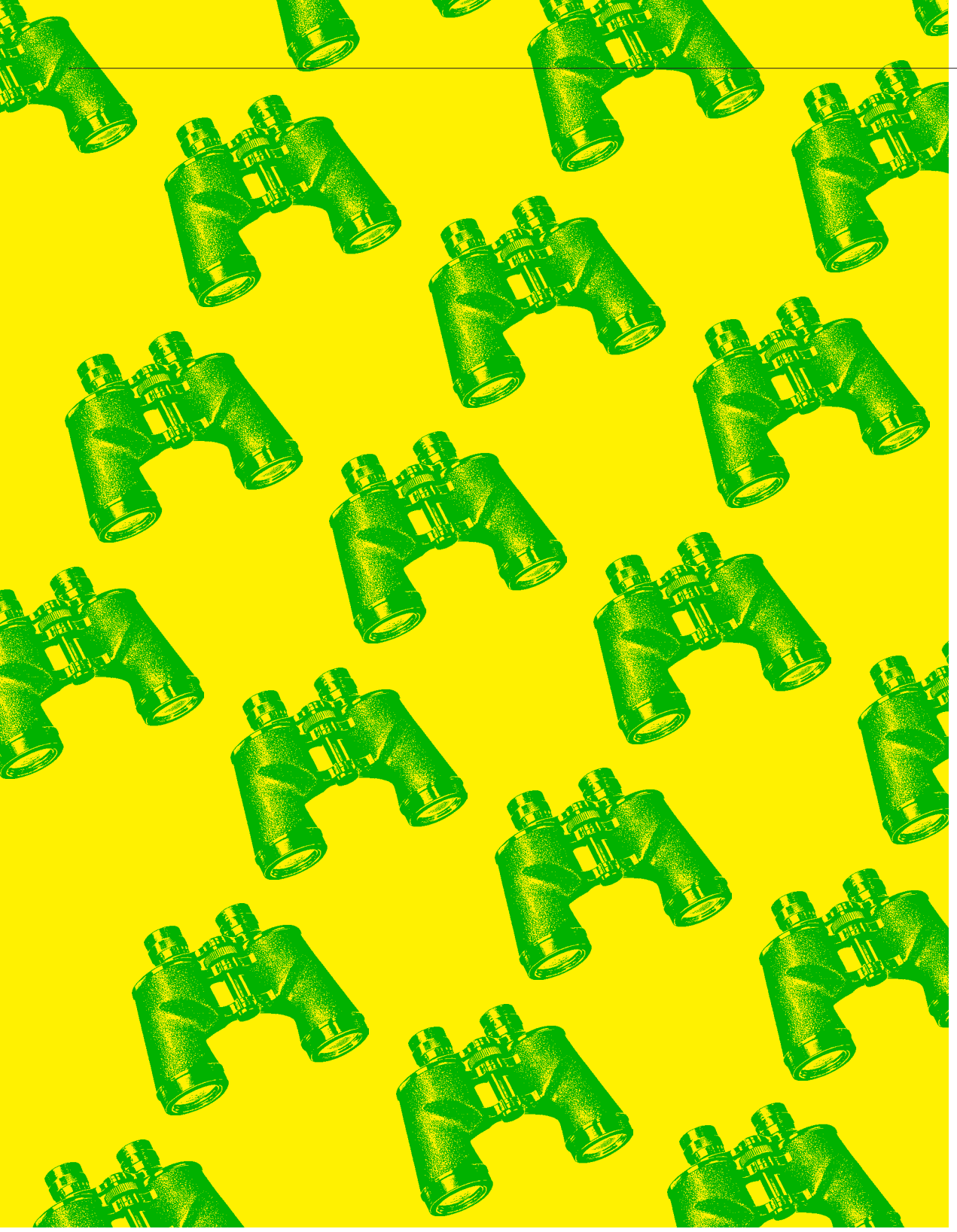
Sarmad Naim
E sarmad.naim@iqeq.com

Francesco Cavallini
E francesco.cavallini@iqeq.com

Alex Stickler
E alex.stickler@iqeq.com

Emmanuelle Dotezac
E emmanuelle.dotezac@iqeq.com

Find out more
www.iqeq.com/esg



towards greater transparency on what investment managers have to report on. Impact measurement, however, is a tricky business and it is hard to find quantitative proof points that demonstrate the correlation between impact and greater profitability of companies.

Speaking on this, Sir Ronald Cohen, chairman of the Global Steering Group for Impact Investment, said: "If we want to have this information, we need to have more transparency. We need to be able to make correlations between the impact delivered and future growth." Cohen, together with Professor George Serafeim at Harvard Business School, has developed a system of impact-weighted accounting, which adds the impact companies create through their products and their employment practices to an accounting system. Cohen said this system will become an important way of valuing companies in the future and it is important that investors and governments mandate companies to publish impact-weighed accounts.

There are industry concerns, however, that impact investing means having to sacrifice returns. Speaking on this, Karilien De Bruin, global head of ESG at Sanne Group, said: "I get the question quite a lot, people claiming there is no empirical evidence that impact funds outperform traditional funds. But, there is lots of research that shows sustainable funds have better survivorship, which says a lot."

Bridges Fund Management partner Maggie Loo said, as an LP, she is careful to make it clear that taking impact into account in your investment strategy does not mean a financial trade off, nor does it mean you will get market rate returns. "It's a spectrum and this should be made clearer to both LPs and GPs."

Fulfilling data expectations

With a litany of different ESG regulations, goals and KPIs for each industry sector, now being demanded from LPs with varied ESG priorities, a number of conference guests opined about the need for standardisation of ESG metrics.

Fulfilling ESG data expectations in an industry without standardisation is especially complex and cumbersome for firm's operating across different jurisdictions, as Jessica Williams, associate at Charles Russell Speechlys, explained. "With different countries and different regulators coming up with their own new regimes, my hope is that with time, things will line up enough so that it doesn't become a nightmare for people operating in all of those jurisdictions."

GPs that can't shift or work between different jurisdictions' standards may find themselves on the back foot, when it comes to competing for LPs allocations. Williams lamented that the longer the industry works without broader standardisation, the more divergent duplicate standards GPs will have to juggle and work with. She highlighted Brexit as an example of a market driver pushing the UK, Europe's largest PE market, out of step with mainland European ESG standards. "The UK appears to be doing its own thing and that appears to be more of a climate-focused direction."

A natural evolution

With robust and rampant ESG growth and adoption in the last four years, LPs are seeing increasingly higher standards of ESG outcomes being delivered by GPs. As firms move through the ABC of ESG; acting to avoid harm, benefiting stakeholders and then contributing to solutions, LPs like Marta Hervás Melgarejo, investment director at Arcano Asset Management Private Equity & Impact Investing, are witnessing a "natural evolution" from GPs towards impact investing.

"Impact is going one step further and getting to the 'C', which is actively contributing to solutions and what can be addressed through impact investing." She continued, "for us, it is a bit of a natural step, it doesn't mean that everyone with an ESG policy needs to do it, but for those that want to move ahead with ESG growth, they can definitely use impact investing." However, the path for ESG-focused firms into impact investing, may not be so well paved or clear of obstacles, according to Karlien de Bruin, global head of ESG at Sanne Group. Especially when considering how impact investing prioritises positive outcomes over profits. "For a traditional non-impact fund, these decisions are easy; obviously go for the highest return. But, for an impact fund, it is not always as clear cut... you have to have a different strategy and a different skillset in order to get to that goal," de Bruin said.

Hervás Melgarejo, noted that one of the strongest drivers behind GPs' evolution into more impactful ESG outcomes have been the demands of emerging investors. "There is a whole new generation, trying to do something else with their time and their money. They are thinking about what kind of society they want to build and live in and what kind of investor they want to be... they want to have a positive impact through their investments."

New firms

The quantity, rigour and mix of overlapping ESG goals and metrics now demanded from different LPs can make ESG requirements a major barrier to progress and initial fundraising success for new and emerging firms in the market.

Nathalie Chollet, CFA at European Investment Fund (EIF), works with first time teams as well as large and established managers. She revealed that the quality of ESG reporting is often a question of resources. "We work with a lot of larger firms, [where] it is more obvious for them and they can afford to have some people working full time on the reporting, compiling and tracking KPIs of different portfolio companies." Chollet continued that it is much less straightforward for new managers, both in terms of time, human resources and the establishment of systems. "They may have launched their fund three years ago and now they have all these requirements that they have not really foreseen and are now emphasised even more."

While the EIF is an European Union agency with a mandate to back European firms and companies, more commercially driven LPs, like Alistair Watson, senior investment manager, at Aberdeen Standard Investments, have a view to support new managers as they develop their ESG performance. "We see our GPs as partners, so we see the ESG KPIs they are asking their portfolio companies to report on and we see that standard raising over time. We are often dealing with small companies that can't answer those questions on day one. But, the idea over time is that they are able to and the underlying companies are training their employees to understand ESG and where these questions are coming from." He emphasised that they are seeing a similar level of positive progression with these newer GPs, as with those that are more established.

Chollet noted an upside of working with new firms, is having a clean slate to start and get modern ESG systems built in from day one.

COMMENT

Mental Health in PE: More than a moral imperative

Provision of quality mental health assistance within firms and portfolio companies is not just the right thing to do, it has a range of commercial benefits too. Lucie Mills, head of business transformation at NorthEdge Capital discusses why improving mental health provisions should be at the centre of every PE firm's value creation plans.

It's a sobering fact that more than one in five of us are struggling with some form of mental health issue. The impacts of lockdowns have heightened the situation in the workplace too, with 41 per cent of employees reported to have experienced mental health symptoms caused, or made worse, by work over the last year, according to Business in the Community.

Thankfully, the awareness of the challenges around mental health have come a long way over the last decade. Employers are increasingly rolling out preventative and supportive provisions to help staff, and charities like Mind, have spearheaded the movement to normalise talking about our feelings. But there's still a lot more to do – particularly in the business community, and the PE industry has an increasingly important role to play in that.

Mental health opportunity

If one in five people in the UK have some form of mental health issue, that means a portfolio of our size at NorthEdge, which collectively employs 6,900 people, will have over 1,000 members of staff affected by mental health concerns. Looking at the PE industry as a whole, which employs 972,000 people according to the BVCA, almost 200,000 employees will be affected.

We are responsible for supporting the management teams we back to grow their businesses sustainably – helping and encouraging them to focus on creating cultures where people feel motivated, empowered, and supported plays a critical role in achieving that success. In addition, research consistently shows there is a strong business case for investing in this area. A recent study from Deloitte found that for every £1 spent on company culture awareness and wellbeing, it delivers a ROI of £6.

With lockdown, and the imminent easing of Covid-19 restrictions, creating new everyday pressures for people, now is a crucial time to embed mental fitness and wellbeing into company culture and processes.

Commercial benefits

It's estimated that poor employee mental health costs UK businesses between £42bn and £45bn each year, according to another study by Deloitte. The average cost per employee is £1,652 in private sector organisations, rising to £3,300 per employee in the finance, insurance and real estate industries. Only £18bn of the cost to UK employers is caused by absence and staff turnover, two thirds is caused by an increasing rate of presenteeism – where employees turn up to work despite poor mental health, but are unproductive in the work that they do.

It goes without saying that we must not look at mental health through the lens of financial impact only. However, without putting the correct strategies in place to ensure employees feel supported, motivated and engaged at work, the cost of absenteeism and presenteeism – and the mental health challenges that underpin them – will only continue to rise. Mental health is potentially costing a business in the private sector with 100 employees £165,000 per year, with costs disproportionately high among young employees as a proportion of their earnings.

That's why PE firms have a responsibility to work with their portfolio businesses to ensure company culture and wellbeing remains on boardroom agendas, alongside the financials.

Creating value

As part of our regular portfolio-wide communications, we seek out the areas our leadership teams want support with or are proactively trying to tackle. Increasingly over the last six months mental wellbeing has been high on the agenda.

To date, we have focussed on harnessing the power of the portfolio, encouraging teams to connect and share learnings in this critical area. We're ensuring that people's development, health and wellbeing, are at the heart of the value creation plans – because we know that those plans will only ever deliver long-term results if the people who drive the business are aligned, engaged and feel motivated to perform.

A study by Harvard Business Review found that there is a statistical link between employee wellbeing and customer satisfaction, which is supported by a recent *Forbes* article that states "while it's good to have a 'customer is king' mindset, it's just as important to remember the other people whose happiness is vital to your organisation's success. Becoming a customer-centric business is always worthwhile, if you want to add a serious competitive edge, but concentrate on offering a great employee experience first."

There are practical steps we can take across the PE industry to support this. For instance, we have invested in mental health first aiders for our business and are encouraging our portfolio to do the same.

We invest in personal leadership training, giving our people the confidence and opportunity to take ownership and think for themselves. We're also continuously working with our management teams to share ideas and insight, as well as creating a support network for them to access, ensuring that we all understand the importance of proactively looking after mental fitness and that support is easy to access whenever it's needed.

We have also enlisted the support of specialist mental wellbeing partners to facilitate sessions on mental health.

With the majority of businesses now planning their return-to-work, we believe reviewing their culture and wellbeing strategy is a must. Some people across our network may have had the most challenging year of their lives – therefore we are committed to learning about and supporting this increasingly important area.