PRIVATE FUNDS

# MAKING AN IMPACT IN AN ESG WORLD

Private Funds Market Insights 2021

ADDLESHAW GODDARD

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# I. INTRODUCTION

# INTRODUCTION

**ESG IS EVERYWHERE NOW... BUT WE WANT TO LOOK AT IT FROM A DIFFERENT ANGLE..... WE WANT TO GIVE THE FLOOR BACK TO YOU, THE STAKEHOLDERS IN THE PRIVATE FUNDS MARKET.**

**Jan Gruter, Partner,**
**investment Management**

Over the last three months, we have spoken to GPs (both institutional asset managers and specialist fund managers), LPs (including pension funds and funds of funds), lenders in the funds finance market and other key stakeholders, covering a broad spectrum of investment strategies and sectors – from real estate and infrastructure, to renewables, social impact and core private equity.

Our interviews took place against wider market research that saw us speak to 1,000 business and finance leaders across Europe for fresh insights into the intersection between the finance sector – including GPs, LPs and lenders – and the wider corporate sustainability agenda.

In this report, we are sharing some of their key insights on the challenges and opportunities that the heightened focus on ESG has brought in the investment space. These insights are supplemented by our own recent experiences advising clients in this area.

We make no pretence that all of the views expressed by stakeholders in this report are universally shared across the private funds sector. In fact, what makes this area so interesting (and at times challenging to navigate!) is the diversity of views and approaches.

**86%**

**OF BUSINESS LEADERS SAID THAT THEY HAVE BEEN DRIVEN TO ACT MORE SUSTAINABLY BY INVESTORS**

# INTRODUCTION

However, some common themes are emerging.[1] For example, 86% of business leaders said that they have been driven to act more sustainably by investors. Our individual conversations with LPs, GPs, and lenders that informed this publication echoed this finding. As stewards of capital, our clients recognise the role they play in driving change and the need to rise to the challenges of our times, be it climate change, protection of biodiversity or – (increasingly) addressing social inequalities - while still generating financial returns.

One of the most exciting developments we are observing is the shift from viewing ESG simply through the lens of 'risk' or using it to exclude investments, towards investing to make a real-world positive impact and unlocking investment value. We can see this particularly with PE firms. We are grateful to ITPEnergised's and Orbis Advisory's guests contribution to this report and for sharing some of the key findings from their research of 160 PE firms, analysing to what extent ESG considerations are embedded in their business and AUM.

In fact, the theme of 'impact' permeated through many conversations we had – whether in the narrower context of impact investing or GPs, LPs and lenders bracing themselves for the impact of increased regulatory demands, or figuring out how to measure and report on the impact of their investments.

**We hope the following pages can spark a conversation – and we are keen to hear your views. Tell us what resonates with you and what you disagree with. Get in touch with us or any of our Addleshaw Goddard colleagues listed in this report – we will be very happy to speak to you.**


**JAN GRUTER**
Partner
Investment Management



**LEE SHELDON**
Partner
Investment Management


[1] You can find the research findings on Addleshaw Goddard's website here.

# II. THE KEY FACTORS DRIVING CHANGE

# THE KEY FACTORS DRIVING CHANGE

Investing for broader ESG concerns – whether for buying opportunities or risk management – is not a new phenomenon.

However, the events of 2020-21 have highlighted the importance of many ESG themes. The COVID-19 pandemic threw a spotlight on social inequalities and poor labour practices, while the dramatic change in operating conditions has also put some poorly run companies under pressure.

This has coincided with a new push from governments and regulators to develop and enact environmental policies and the asset management industry's embrace of "net zero", with an estimated one third of AUM worldwide now managed by fund managers that are committed to align their investment portfolios to reach net zero emissions by 2050 or sooner.

While these and other developments are moving money towards companies and assets with positive ESG credentials, many asset owners are still hunting for ways in which their allocations can have a real-world positive impact. And unsurprisingly, this is driving trends in the private funds market too, with both existing GPs and new entrants increasingly looking to impact investment strategies.

**"MANY ASSET OWNERS ARE STILL HUNTING FOR WAYS IN WHICH THEIR ALLOCATIONS CAN HAVE A REAL-WORLD POSITIVE IMPACT. AND UNSURPRISINGLY, THIS IS DRIVING TRENDS IN THE PRIVATE FUNDS MARKET TOO, WITH BOTH EXISTING GPs AND NEW ENTRANTS INCREASINGLY LOOKING TO IMPACT INVESTMENT STRATEGIES.**

Jan Gruter, Partner
Investment Management

# THE KEY FACTORS DRIVING CHANGE

### IMPACT INVESTING VS ESG INVESTING

The terms ‘ESG investing’ and ‘Impact investing’ often get conflated – neatly illustrating the challenge in this space where finding a common language is still difficult.

**ESG investing** is an investment approach that incorporates environmental, social, and governance factors that are material to financial performance into decision-making throughout the investment life cycle. ESG factors are used to complement and enhance traditional financial metrics in identifying risk and opportunities. Some ESG investment strategies will go a step further and apply exclusionary screens based on ESG considerations and this is often referred to as '**socially responsible investment**'.

**Impact investing** goes beyond ESG investing because it focusses on positive and measurable outcomes. Again, this is not a static category of investing, impact strategies differ significantly, for example in the weight they place on generating financial returns alongside making an impact.

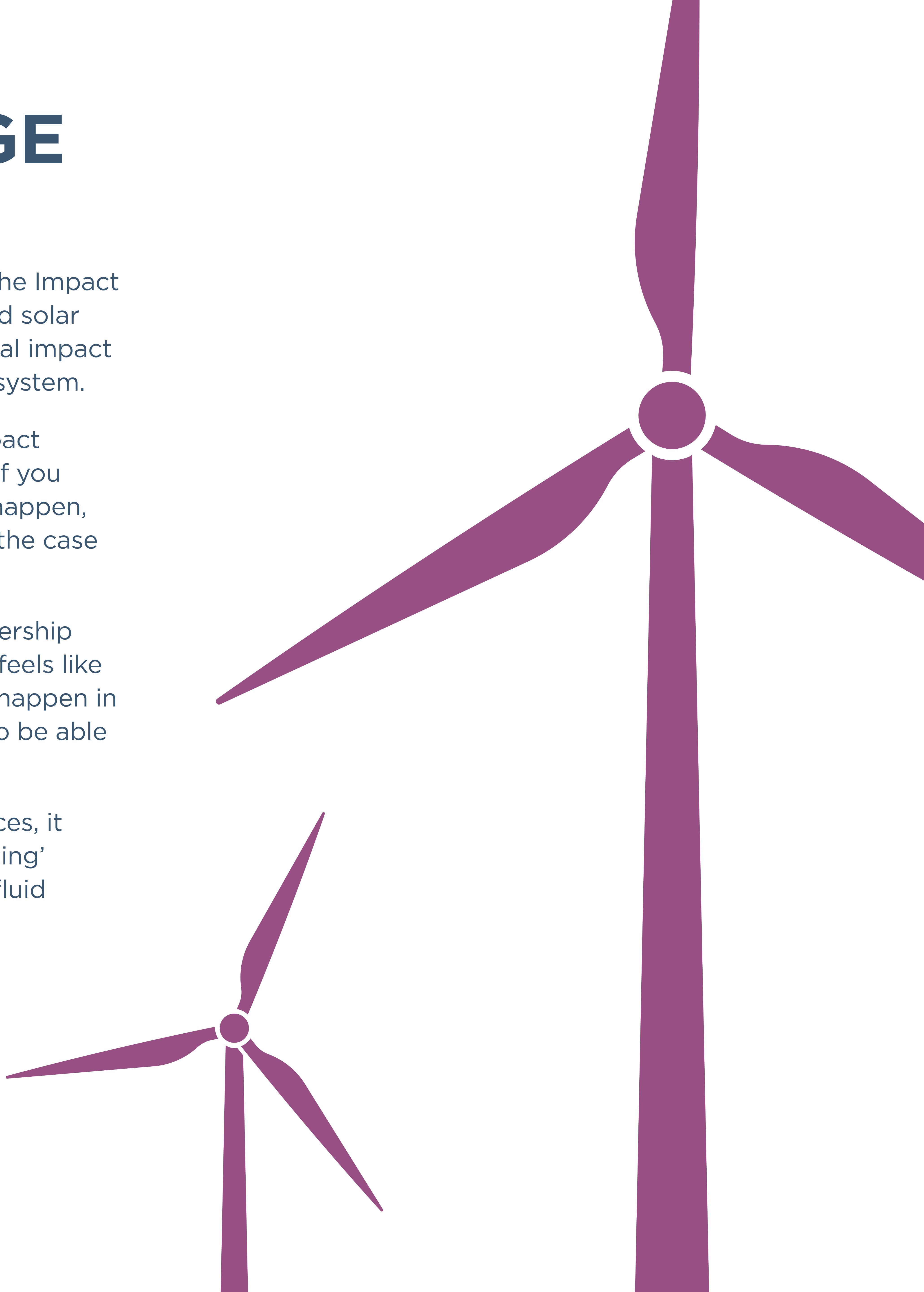
A key part that is common to any impact strategy is “additionality” – i.e. contributing to the impact and ensuring that the investment will have the desired outcome. This is why impact investment is well-suited to investment strategies favoured by private funds that often invest in non-listed investments.

For example, as Jamie Broderick, Director at the Impact Investing Institute, explains, investing in a listed solar power company, is not making a new additional impact because the money invested is already in the system.

In the private markets space, investing for impact is more straightforward. “Generally speaking, if you provide capital you’re allowing something to happen, or happen at a scale that wouldn’t have been the case without your investment.”

“If you invest in an infrastructure limited partnership that builds solar panels or wind turbines, that feels like your capital is making it happen, or making it happen in a larger volume. That’s why it’s so important to be able to access the private markets.”

Ultimately, whilst there are important differences, it is also important to recognise that ‘ESG investing’ and ‘Impact investing’ sit on a spectrum with fluid boundaries.



# THE KEY FACTORS DRIVING CHANGE

## NEW PRODUCT DEVELOPMENT

Approximately $715 billion was invested in impact funds and strategies worldwide at the end of 2019, according to the Global Impact Investing Network (**GIIN**), up from $502 billion a year earlier[2]. Interest in this sector has grown significantly in line with the wider growth in sustainable investing. Fundraising may have stalled somewhat in 2020, according to data provider Preqin[3], but based on our conversations with GPs and LPs that appears more a function of fundraising processes taking longer generally in a year where travel, and hence the ability to meet investors in person, has been severely restricted.

Vishesh Srivastava, Managing Partner at Future Business Partnership (**FBP**), explains that his company is developing its first impact fund after setting up in 2018.

FBP's model focuses on providing private equity-style finance to sustainable retail businesses. Srivastava and his colleagues strongly believe that the success of companies such as Lush, Innocent, and The Body Shop demonstrate that an ethical focus pays off. For FBP, creating a positive impact while delivering strong returns "isn't just financially astute, it's ethically imperative".

Srivastava says private equity firms need to address the widespread concern that they are not aligned with sustainable practices. "We are doing this for profit and purpose, but the profit element is vital since we are largely building our fund to be investable by pension money," he says. "We have an ambition, which is to deliver financial returns and a social and environmental impact. We've built that into every stage and every element of our business."

Other private equity fund managers are already demonstrating the positive effects of investing 'beyond the bottom line'. An example is Bridges Fund Management which specialises in investing in companies with a social purpose. Bridges made a notable financial gain from its investment in The Gym Group when the company listed in 2015. During Bridges' time as investor, it also aided the company's expansion into areas previously underserved by gyms and similar facilities, while one third of its members had never previously signed up to a gym[4].

**"DELIVERING STRONG RETURNS "ISN'T JUST FINANCIALLY ASTUTE, IT'S ETHICALLY IMPERATIVE.**

Vishesh Srivastava, Managing Partner,
Future Business Partnership

[2]Source: GIIN Annual Impact Investor Survey 2020.
[3]Source: Preqin Impact Report: The Rise of ESG in Alternative Assets.
[4] Source: BVCA Spring Journal 2021

# THE KEY FACTORS DRIVING CHANGE

## NEW PRODUCT DEVELOPMENT

A recurring theme from interviewees is that ESG investment whilst involving looking beyond the 'bottom line' does not need to involve sacrificing financial returns.

It's a sentiment shared by Dan Wells, Partner at renewable infrastructure manager Foresight Group (**Foresight**). "The notion of investing in things for a positive financial return OR a positive environmental benefit doesn't really hold any more - you can make green investments and they can be financially sensible". Larger institutional private fund managers are increasingly shifting through the investment spectrum too, with many still closer to the ESG investing end of the spectrum than the impact investing end.

**SHIFTS ARE EMERGING, WITH SEVERAL FUND MANAGERS CONSIDERING HOW THEIR PRIVATE FUNDS STRATEGIES CAN MAKE POSITIVE IMPACTS, ESPECIALLY TOWARDS ENVIRONMENTAL GOALS. IN PARTICULAR, WE ARE SEEING A LOT OF INTEREST FROM LARGER GPs NOW IN REFORESTATION AND BIODIVERSITY FOCUSED INVESTMENT STRATEGIES.**

Jan Gruter, Partner,
Investment Management

# THE KEY FACTORS DRIVING CHANGE

**LPs, LENDERS AND EMPLOYEES – PUSHING FOR CHANGE**

The COVID-19 pandemic has highlighted and propelled several crucial ESG issues to the forefront of agendas of LPs, GPs and lenders. Faith Ward, Chief Responsible Investment Officer at Brunel Pension Partnership (**Brunel**) believes LPs, through the funds they invest in, can have a positive impact on all of these elements. Ward has recently been made a member of the UK's Green Technical Advisory Group that will advise the UK government on the development of the UK's green taxonomy which will set forth standards for green investment.

The £35 billion local government pension fund has sought to raise the profile of investing in water infrastructure, particularly in emerging markets, where such allocations can have significant and wide-ranging impacts.

Ward explains: "One thing we have been told to do is wash our hands. Imagine if you haven't actually got water infrastructure. Three quarters of the population in emerging markets don't have access to water infrastructure that allows them to have that level of sanitation."

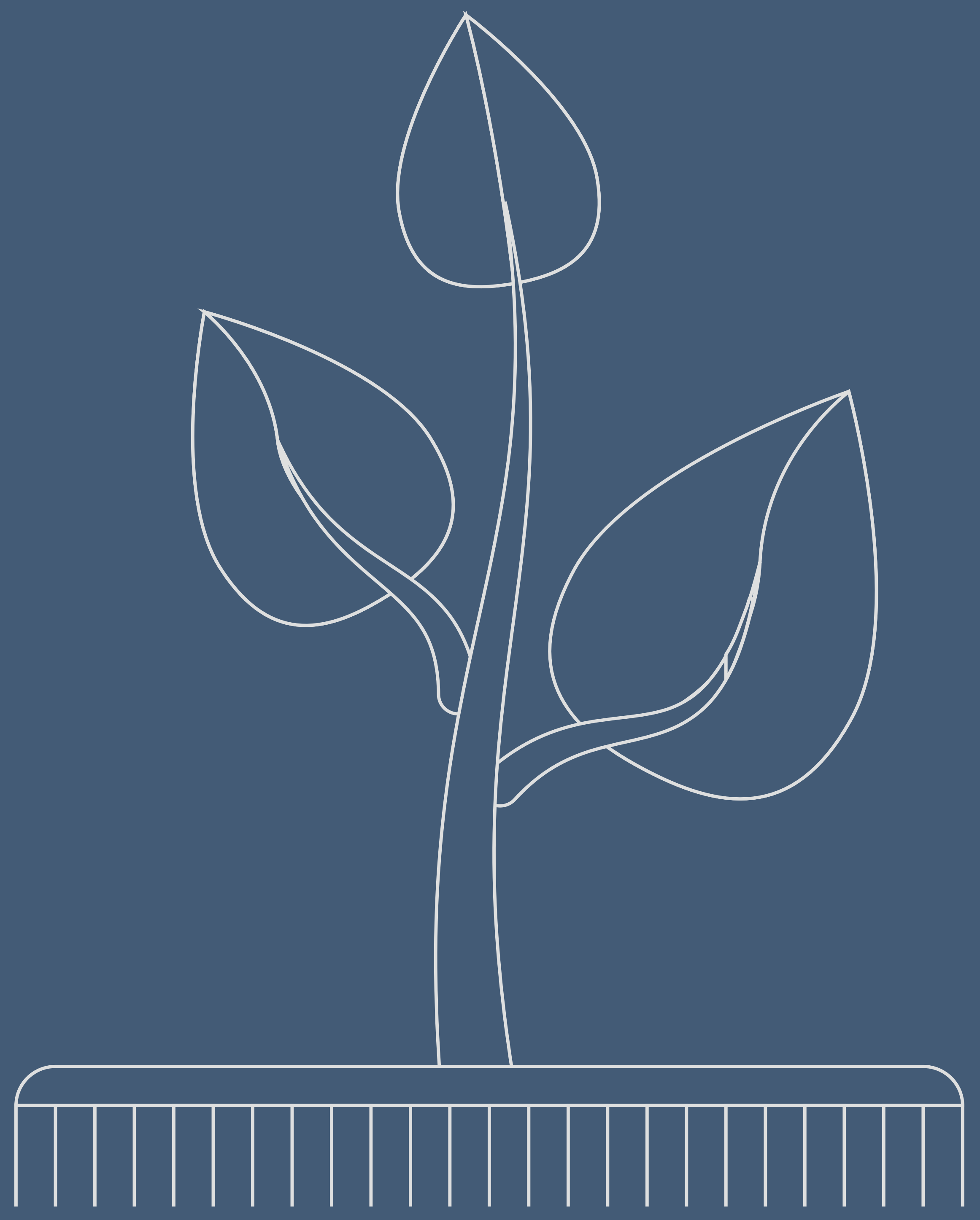
"These regions are usually where your minerals and commodities are coming from. That connects the supply chain to things like hygiene and investment in water infrastructure."

The importance of supply chains is rising rapidly up LPs' agendas. According to Addleshaw Goddard's recent survey of 1,000 business leaders, 63% of lenders and 58% of investors assess the sustainability credentials of a company's supply chain when analysing overall ESG performance. This was up from just 7% and 5% respectively five years ago[5].

Engagement at board level is another important area for investors. Ward says national lockdowns and travel restrictions helped to highlight directors who had stretched themselves across too many positions and were unable to respond to all their boards during the crisis. This has meant Brunel is starting to be "aggressive" on the issue of "overboarding", she adds, including petitioning for directors to be removed if they have taken on too many positions. We can expect pressure from institutional LPs on GPs to more closely interrogate the governance structures of their operating companies.

**"ONE THING WE HAVE BEEN TOLD TO DO IS WASH OUR HANDS. IMAGINE IF YOU HAVEN'T ACTUALLY GOT WATER INFRASTRUCTURE. THREE QUARTERS OF THE POPULATION IN EMERGING MARKETS DON'T HAVE ACCESS TO WATER INFRASTRUCTURE THAT ALLOWS THEM TO HAVE THAT LEVEL OF SANITATION.**

Faith Ward, Chief Responsible Investment Officer, Brunel Pension Partnership



[5] Source: 'Sustainability: Pain to Net Gain – Sustainable Supply Chains', Addleshaw Goddard research report.

# THE KEY FACTORS DRIVING CHANGE

**BANKERS AS ACTIVISTS FOR CHANGE**

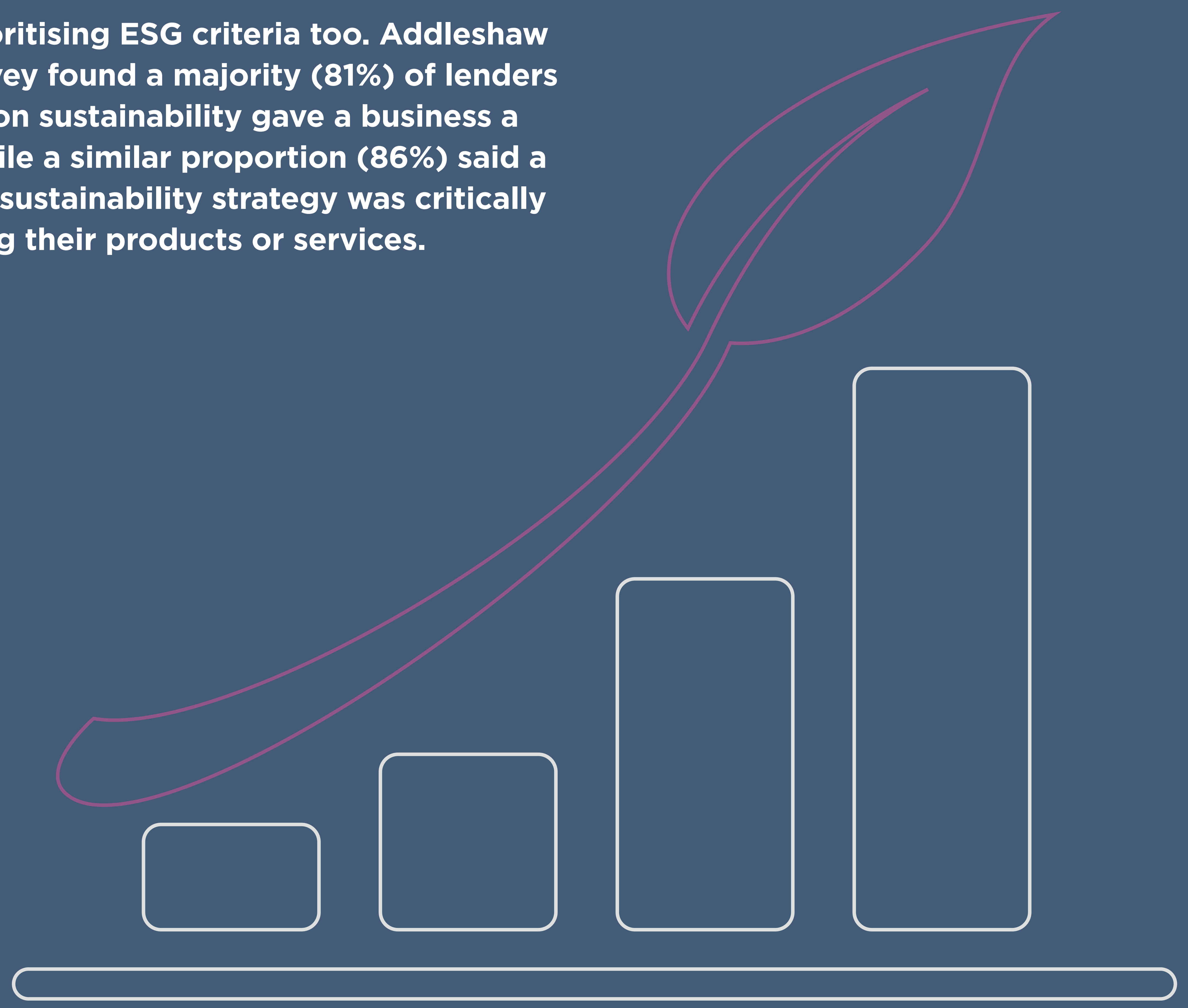
It is not just LPs that are putting more emphasis on ESG processes and commitments. Lenders are positioning themselves to have a greater impact on private funds and investee companies, too.

Angela Marchant, Senior Director for funds lending at RBS International, explains that the bank has been prioritising lending to those funds that are putting money to work to reduce carbon emissions. At the same time, the bank has also pledged to reduce the amount of financing it provides to companies which are heavily reliant on fossil fuels.

"We've been in the market for numerous years, and we are certainly seeing increased investor appetite in the renewable space recently – but renewable energy is just one part of the story," she says.

Private funds may also find some pricing benefits when borrowing by demonstrating sustainability credentials, with sustainability linked pricing being based on bespoke metrics agreed with the lender helping encourage and reward further change.

**Other lenders are prioritising ESG criteria too. Addleshaw Goddard's recent survey found a majority (81%) of lenders said they felt a focus on sustainability gave a business a competitive edge, while a similar proportion (86%) said a company's long-term sustainability strategy was critically important to accessing their products or services.**



# THE KEY FACTORS DRIVING CHANGE

**WORKFORCE DRIVING CHANGE**

The push for greater focus on ESG and meaningful impact is also driven by internal pressure from staff at GPs and LPs.

James Armstrong, Founder and Managing Partner at renewable energy Investment Adviser Bluefield Partners LLP, says that especially for younger employees, the incentives in working in the PE industry for them are no longer just financial. "We attract a lot of people who are young, talented and passionate about the environment", he says. “What goes hand in glove with that is you have to have high levels of employee engagement, support, training and development. The culture that you foster is very important.”

FBP’s Srivastava adds that, as people understand more about the value chains of businesses and the products they consume, they will become “more inclined to associate themselves with businesses they believe in from a social and environmental point of view”.

As Philip Newborough, Co-CEO of Bridges Fund Management observes:  “Employees care and want to feel like they work for a company that cares. This isn’t complicated, it’s just about how you manage and engage your workforce in simple things like reducing waste and setting targets.”

It’s a sentiment shared by LPs and lenders too. Brunel's Ward says staff surveys have shown the company’s responsible investment values are one of the main reasons people want to work at Brunel.

RBS International announced a new “purpose-led” strategy for its business in February 2020, to which staff responded positively. "Our strategy confirms that we all have a role to play in tackling society’s greatest challenges and we’re empowering colleagues to drive change – it's a strategy I am proud to be part of", says Bradley Davidson, ESG Lead at RBS International.

"I think the market is waking up to our role and what financial institutions can do to support this agenda," he says. "When you're discussing this with colleagues, who are maybe less familiar with sustainability concerns, that moment where they really get it and recognise the impact they can have across both their personal and professional life, that’s great to see and a huge motivator for me."

Private fund managers, investors, and lenders are all positioning themselves to make a greater and more positive impact on the world through their investment activities. However, to be able to do this efficiently and at scale, there is a significant hurdle they must all negotiate: data and reporting. Stakeholders are grappling with how investment should be classified on the ESG spectrum, what data is needed, how it can be extracted and how it should be reported and compared. This is no easy feat!

# III.
# DATA & REPORTING
## THE CHALLENGE IS REAL

# DATA & REPORTING - THE CHALLENGE IS REAL

Data has been a key buzzword in a range of businesses for a long time now – throw in the ESG element and you soon realise that the challenge for GPs and LPs is exponential. The information is often unique and complex while public comparatives are scarce. As the world moves from focusing on the 'E' to 'S' of the ESG, the challenge to record, collate and analyse unquantifiable data becomes the next mountain to climb.

To bridge this gap, private fund managers are engaging with companies directly to help them understand the importance and benefits of non-financial data points and reporting.

Palatine PE's £100 million impact fund invests predominantly in smaller companies that often do not record the kinds of data and key performance indicators (**KPIs**) that impact investors require. In these cases, as Head of Impact Fund, Beth Houghton explains, Palatine PE works with company management to find the best way of providing relevant data. This in turn helps the GP report quarterly to investors on the progress made against its impact-specific KPIs.

**“**

**WHEN WE STARTED DOING ESG 10 YEARS AGO IT WAS QUITE FRANKLY A BATTLE TO GET MANAGEMENT TEAMS TO LISTEN TO US AND IMPLEMENT IT... NOW, 10 YEARS LATER, MANAGEMENT TEAMS SEE IT AS A REAL POSITIVE WHEN WE TALK ABOUT THESE ISSUES – THEY GET IT, THEY UNDERSTAND IT, AND THEY WANT US TO HELP THEM WITH IT.**

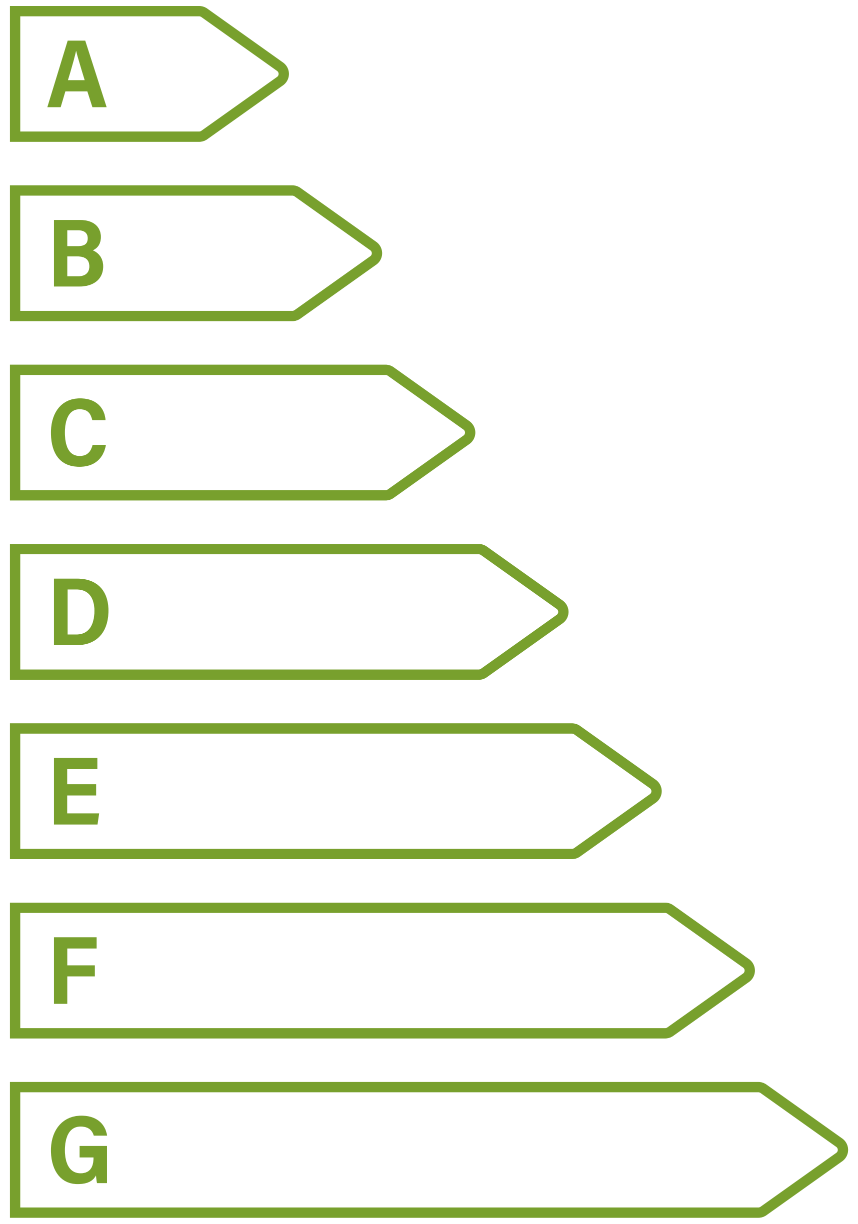
**Beth Houghton, Head of Impact Fund, Palatine PE**

Addleshaw Goddard’s market survey showed that almost every business had been asked by investors to provide evidence of their sustainability performance, while every finance provider respondent said that by 2030 they will have stopped lending to companies that do not embrace ESG concerns[6]. Inevitably, this will negatively impact investee companies that do not report on required metrics as well as GPs that don’t have the data that fund finance providers and LPs will demand.

Our survey also highlighted that it is mid-market businesses that struggle to prioritise sustainability.

To an extent, ESG data providers and rating firms are seeking to plug the gap for both public and private markets. But issues remain around comparability and consistency between different providers.

“There’s an issue with meaningless data and “death by data”. There are a very large number of ESG rating firms and in some of those structures, all energy companies are good, and in others all energy companies are bad. So the most important thing is yes, start recording data, but focus on the meaningful stuff and build out slowly from there rather than saying that more data is necessarily good”, says Foresight's Wells.




[6]Source: ‘Sustainability: Pain to Net Gain – Financial Services: Investor insight’, Addleshaw Goddard research report.

# DATA & REPORTING - THE CHALLENGE IS REAL

### A MAZE OF STANDARDS, FRAMEWORKS AND METRICS

The global reporting landscape is highly fragmented, with the Financial Times recently referring to an ESG "alphabet soup" of different standards and organisations that have emerged, each with their own frameworks and metrics[7]. The reporting and standards landscape is still dominated by private initiatives, such as the Global Reporting Initiative, Task Force on Climate-related Financial Disclosures (**TCFD**) and the Sustainability Accounting Standards Board, to name just a few.

It is widely acknowledged that whilst each and every one of these standards and frameworks has its own merits, it can leave LPs and GPs wondering what information they should gather.

On the institutional LP side, bespoke approaches to reporting and information gathering are still prevalent. Brunel's Ward for example points to the pension fund's own questionnaire for private equity managers. "This is the only way that Brunel can pull together the data points it needs and build a picture of its entire portfolio", she explains.

### LP & GP COLLABORATION

There are many tales of constructive and successful collaborations between GPs and LPs, especially from pension fund LPs.

For example, APG and PGGM have collaborated on an investment framework designed to help LPs and GPs map their portfolios to the Sustainable Development Goals[8]. This has gained traction globally, with Australian and Canadian pension groups signing up to an SDG investment platform launched in 2019 that can be adapted for any asset class and amongst other things, seeks to provide a common data source.

Another product of collaboration between APG and PGGM of course is GRESB, previously known as the Global Real Estate Sustainability Benchmark. This was set up in 2009 by Dutch pension investors along with the UK's Universities Superannuation Scheme and is now a highly regarded global standard-setter.

Brunel has also been collaborating with other UK pension funds on meeting their own responsible investment and

[7]ESG stays on trend despite data minefield, Financial Times 25 June 2021.

[8]APG and PGGM develop AI-powered platform for investing in the UN Sustainable Development Goals'. PGGM press release, 19 September 2019.
[Click here for more.]

# DATA & REPORTING - THE CHALLENGE IS REAL

stewardship reporting requirements efficiently and effectively by developing a tool mapping out the most relevant reporting standards for UK pensions funds.

The Impact Investing Institute is also actively supporting the work of five global sustainable reporting organisations to collaborate and align their standards to provide a unified framework for investors and corporates around the world. The Impact Management Project's members[9] say they aim to provide "robust, effective information to drive better decision-making and capital allocation" through an integrated report. The hunger for information and data can, at times, be overwhelming and there is certainly an appetite for consolidation and a worry that sight is being lost of what is essential at the investment level.

"We're all spending an inordinate amount of time on reporting and the constant stream of different ESG measures and standards and data requirements externally. It's getting in danger of having an adverse effect. While the increased emphasis on ESG standards is critical, consolidation is necessary now. It's in danger of taking away from what we should be focusing on: where's our material impact? What are we doing about it? Are we investing in the right activity? Is it core to our strategy rather than a side-show?" says Kirsty Britz, Director of Sustainable Banking at NatWest Group.

"Often the reporting standards mean more to the investor than the business operations", remarks one interviewee.

**WHILE THE INCREASED EMPHASIS ON ESG STANDARDS IS CRITICAL, CONSOLIDATION IS NECESSARY NOW. IT'S IN DANGER OF TAKING AWAY FROM WHAT WE SHOULD BE FOCUSING ON: WHERE'S OUR MATERIAL IMPACT? WHAT ARE WE DOING ABOUT IT? ARE WE INVESTING IN THE RIGHT ACTIVITY? IS IT CORE TO OUR STRATEGY RATHER THAN A SIDE-SHOW?**

Kirsty Britz, Director of Sustainable Banking, NatWest Group

[9]The five members are CDP, the Climate Disclosure Standards Board, the Global Reporting Initiative, the International Integrated Reporting Council, and the Sustainability Accounting Standards Board. https://impactmanagementproject.com/

# DATA & REPORTING - THE CHALLENGE IS REAL

### IS MORE REGULATION THE ANSWER?

For some interviewees and stakeholders the answer lies in greater regulation and standardisation.

The EU of course has set out its stall with the EU's Sustainable Finance Disclosure Regulation and the EU Taxonomy Regulation and the further various technical implementing measures that will supplement these regulations and to an extent remain to be finalised.

Many interviewees commend the EU's bold move and its efforts to become a world leader on sustainable investment policy – and its significant contribution to the 'mainstreaming' of ESG criteria in investment. Yet, it is also an example that regulation will always be playing catch-up to an extent, neatly illustrated by the fact that key parts of the EU's green taxonomy are not yet settled.

Impact Investing Institute's Broderick highlights in particular discussions around nuclear power. The taxonomy is designed to define environmentally friendly investments, but French and German representatives disagreed on the issue of nuclear. The subject is still being discussed.

"One of the interesting things when you try to regulate something that isn't finished yet is that you end up with odd situations like this," says Broderick. "The taxonomy is an example of the regulator trying to catch-up with an immature industry that itself hasn't decided how it feels about this kind of thing." Dan Grandage, Head of ESG, Private Markets, RE Global Listed & Investment Strategy, Aberdeen Standard Investments (**ASI**) also voices concern, that the proliferation of regulation will create more conflicts rather than deliver standardisation. "Language is a massive issue," he explained. "I don't think the SFDR is necessarily helping, although it's been designed to. It's almost had the opposite effect because it's created a new language of Article 6, 8 and 9 funds."

There are also concerns that regulation will not differentiate clearly enough between different sectors of the private investment market.

In private real estate, as ASI's Grandage explains, the market is far more mature and has been ahead of regulation for some time. In this space it is the GPs that are leading the push to net zero – meaning environmental rules can be a hindrance if regulators are playing catch-up.

In contrast, he says, SFDR will help the private equity market to mature by setting new transparency and data requirements.

There is also a worry that national regulation may lead to further fragmentation in approaches and add layers of reporting rather than simplicity. We may well be

# DATA & REPORTING - THE CHALLENGE IS REAL

about to see this play out in the UK where the FCA has recently issued draft rules mandating climate-related disclosures by asset managers (including private fund managers) and pension fund LPs. Whilst these had been dubbed in advance as the UK SFDR, there are significant differences in approach and coverage in terms of information required to be disclosed.

“We need to establish a common language across all market participants,” says RBS International’s Davidson. “The solutions and the areas of focus for our customers will vary, and it will have to be bespoke to their businesses – but we need to get to a point where all market participants are speaking the same language.”

ASI’s Grandage thinks that this will be better led by international agreements rather than regulations, as the latter tends to create more jargon and new terminology, rather than standardisation.

Data and reporting on ESG, sustainability and impact metrics will continue to be a building site in the private funds market for some time to come.

“

**WE NEED TO GET TO A POINT WHERE ALL MARKET PARTICIPANTS ARE SPEAKING THE SAME LANGUAGE.**

Bradley Davidson, ESG Lead,
RBS International

# IV.
# TRENDS IN FUNDS TERMS

# TRENDS IN FUNDS TERMS

ESG criteria are becoming critical to portfolio construction, asset selection, and mandate awards. As a consequence they are also becoming embedded in the legal commercial terms struck between GPs and LPs – and it is an area that is developing fast.

### WHERE ARE THE ESG TERMS LOCATED?

Only a few years ago, the inclusion of ESG provisions in fund terms was relatively rare.

Times have changed and ESG commitments are now more routinely referenced in the PPM. Individual LPs often seek to include additional comfort in the side letter, be it around an acknowledgement of the LP's own ESG commitments, excuse rights in relation to certain investments or reporting requests.

Certainly, GPs that are subject to the SFDR will find that through the SFDR's requirements on pre-contractual investment disclosures (both in relation to the GP itself and the funds managed), more ESG disclosures will become embedded in the PPM itself. In fact, even before SFDR, a trend to move disclosure on GP's ESG policies into the PPM was underway.

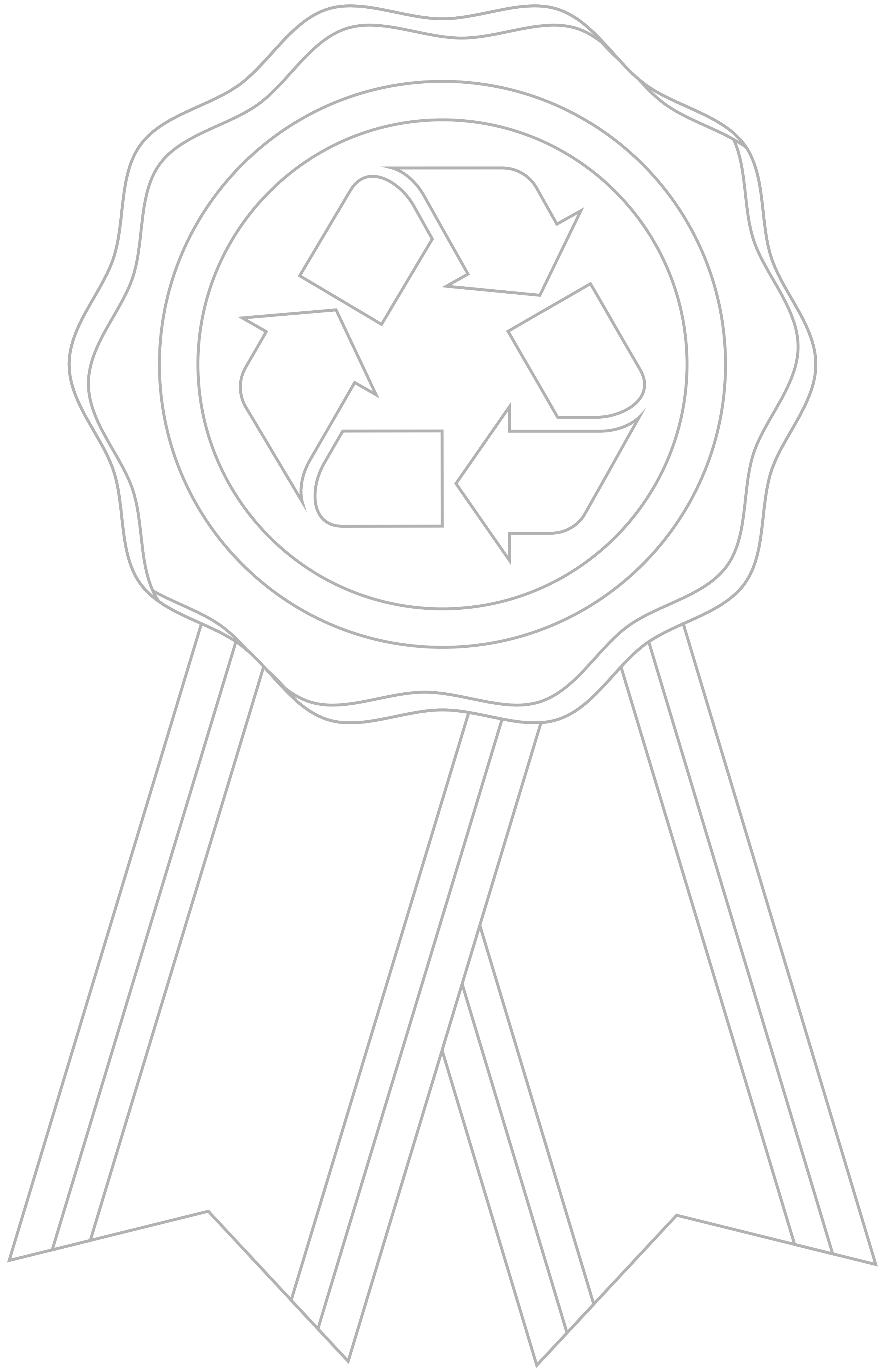
A legal adviser at an institutional GP recalled a recent situation where an LP had a policy prohibiting certain investments that mirrored a similar group policy at the GP group level. Historically, this may have been acknowledged in a side letter but in this instance, following dialogue between the LP and GP, the GP agreed to provide more granular disclosure on its group level investment restrictions in the PPM itself.

Arguably the PPM is a natural vehicle for narrative disclosure and can become a legally actionable document where such disclosures turn out to be misleading.

However, it's the limited partnership agreement (**LPA**) that sets out more directly the contractual enforceable responsibilities on the GP (including restrictions on the exercise of portfolio management discretion) and we are seeing changes here, too.

Again, SFDR will bring changes to the LPA and this will predominantly be felt by GPs seeking to market their funds as article 8 funds (so-called "light" green funds) or article 9 funds (so-called "dark" green funds) where we can expect that specific and granular commitments as to investment policy and portfolio restrictions will now be referenced in the LPA.

Reporting standards are becoming ever more important and are increasingly finding their way out of side letters



# TRENDS IN FUNDS TERMS

and into LPAs themselves. LGT Capital Partners, as a fund-of-funds manager, is working with GPs to "get closer" to ESG data of private equity portfolio companies, says executive director Keimpe Keuning.

Ideally ESG reporting is arranged at LPA level which instinctively makes sense as it can help to arrive at greater standardisation and transparency for the benefit of all investors. It may also reduce time and costs in negotiating multiple side letter agreements with multiple LPs.

### ECONOMIC TERMS

> **MY SENSE IS THAT THE STANDARD LEGAL TERMS – LEGAL LIABILITY, INDEMNIFICATION, REMOVAL OF GPS, ETC. – I DON'T THINK THAT WILL CHANGE... THE ECONOMICS, BOTH TO THE INVESTOR AND TO THE GP, AND THE RE-PORTING AND THE INVESTMENT RESTRICTIONS ARE PROBABLY THE KEY AREAS THAT WE'RE EXPECTING TO BE DIFFERENT.**
>
> **Interviewee, institutional GP**

Trends are emerging in the public markets to link executive compensation to ESG metrics, as recently featured in the Financial Times[10].

We may well see similar trends emerging in private funds when it comes to incentive arrangements and in fact, looking at the impact investments segment of the market, this is already happening.

FBP's Srivastava plans to embed impact targets into the allocation of carried interest to the GP and its staff. This means that the fund management team is incentivised to hit pre-agreed goals outside of financial returns, which are externally verified according to B Corporation standards[11].

For Brunel's Ward, this type of innovation is exactly what the private markets sector needs if it is to be taken seriously on sustainability issues. "I'd very much like to link the financial incentive component to the impact in a more creative way," she says.

More broadly, Brunel is beginning to build into contracts legal requirements related to climate change. These relate to factors such as emissions intensity, for example, and are linked to both performance assessment and the manager's likelihood of attracting further assets in the future.

> **I'D VERY MUCH LIKE TO LINK THE FINANCIAL INCENTIVE COMPONENT TO THE IMPACT IN A MORE CREATIVE WAY.**
>
> **Faith Ward, Chief Responsible Investment Officer, Brunel Pension Partnership**


[10] See The Rise of ESG-linked pay package, Financial Times, 30 June 2021
[11] See here for more details.

# TRENDS IN FUNDS TERMS

## FUNDS FINANCE TRENDS

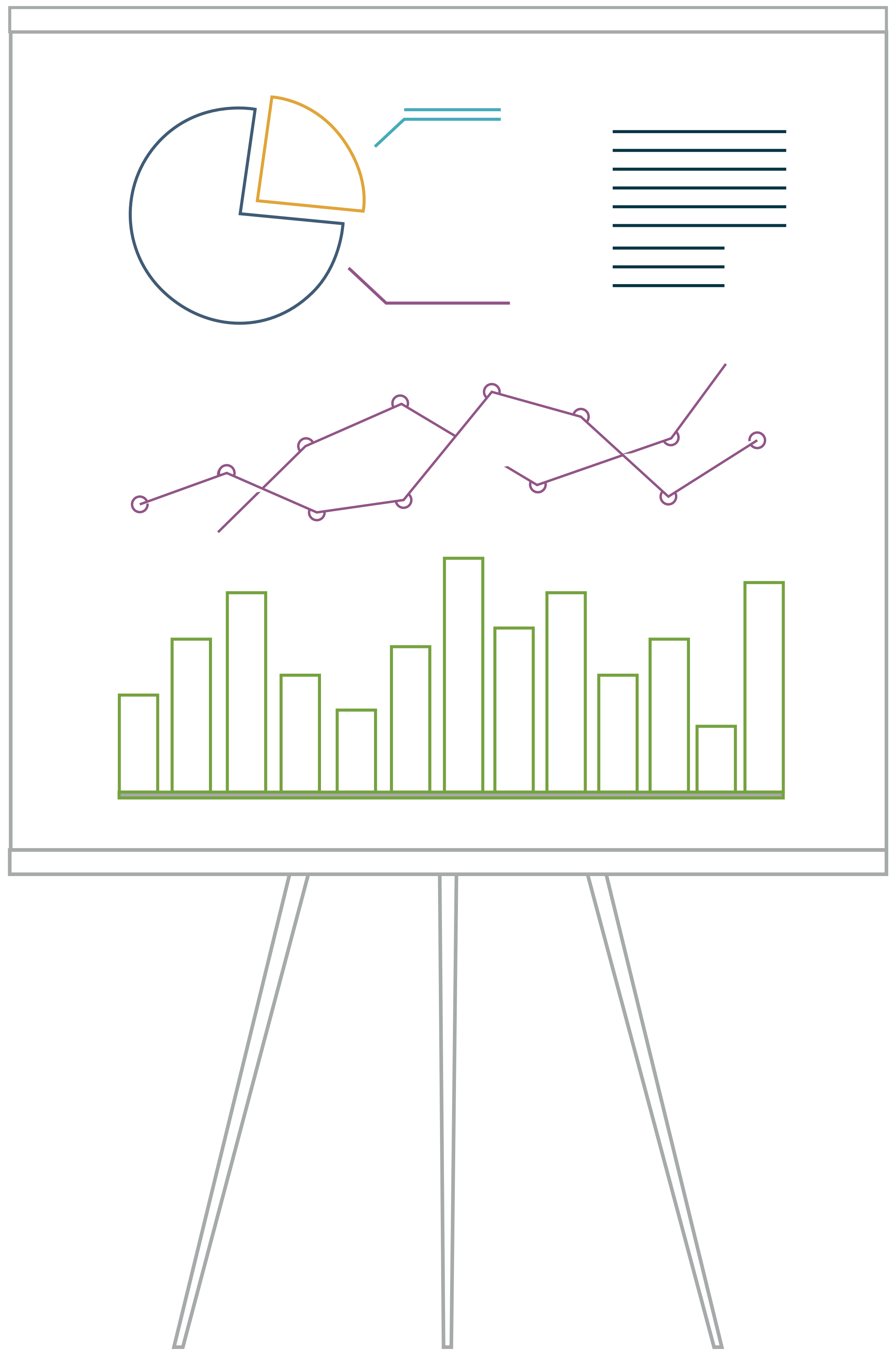
Sustainability fund financing in the private funds market largely falls into two categories: green loans (where the proceeds are used by funds which are focused on investing in green assets) and ESG/ sustainability-linked loans (which are capital call and NAV facilities and include certain ESG-related metrics between the fund and the lenders).

Whereas green loans, by their very nature, are only suitable for those funds that pursue a green strategy, ESG or sustainability-linked loans can help encourage and reward funds across a wider range of strategies.

It is in the sustainability-linked loan space where the most interesting developments are occurring at the moment. Whilst this is a market in development, some lenders are able to draw on their experience gained from other areas of finance (such as in social housing where sustainability-linked loans have been provided for a number of years).

Pricing benefits are being linked to agreed metrics, with margins that can potentially move upwards and downwards during the life of the facility, depending on whether KPIs are met during relevant measurement periods (and depending on the nature of the fund and duration of the facility, KPIs may be reassessed during this period).

Sustainability-linked loans in the funds finance market are quickly emerging as an important way for both GPs and lenders to work together to translate their commitment to sustainability principles and targets into practice. The effect of this can be powerful, given the multiplier effect that results from most private funds making a significant number of investments, each of which may be supplemented with additional funding supplied by equity co-investors and debt providers.



# V. LOOKING INTO THE CRYSTAL BALL

# LOOKING INTO THE CRYSTAL BALL

The next decade will be crucial for LPs, GPs and governments and regulators alike in attaining goals whether it be achieving the Sustainable Development Goals by 2030 or reaching "net zero".

As the geopolitical, regulatory and commercial landscapes continue to evolve, providers throughout the value chain – GPs, LPs, banks, custodians, and law firms – will have to invest significantly in upskilling their workforces.

As Brunel's Ward outlines, there are big challenges facing service providers when adapting to incorporate non-financial requirements. "These are not normal topics within their field... There is some quite challenging advice circulating around climate and net zero, which when you consider the policy backdrop, makes things difficult."

### WILL IT TURN OUT TO BE A FAD? LPs AND GPs DON'T THINK SO

"This year again, there is a lot of attention on climate change and the focus is now on the COP26 in November 2021 in Glasgow" says LGT Capital Partners' Keuning. "That attention is not going to go away. Things like the net-zero initiatives and decarbonising portfolios, are not things that people are starting and then three years from now will say let's not bother any more. The pressure will increase; actually decarbonisation goals will increase year over year."

As Bluefield's Armstrong outlines, solar and wind energy are now cost-competitive with fossil fuels, boosting the attractiveness of the sector at a time when many major economies are looking to radically decarbonise over the next 10 years.

**LPs are seeing significant opportunities in infrastructure investments that will need to be balanced with decarbonisation goals and this is translating into increased interests in afforestation investment strategies. Within the 'E' of ESG we are expecting to see much greater interests in strategies linked towards protection and restoration of biodiversity.**

### LITIGATION

Greater commitments to and disclosure around ESG will invariably bring with it alleged breaches of promises to align with stated goals. And the emphasis on data points and measure of non-financial metrics will invariably lead to disputes over the accuracy of non-financial reporting. GPs will want to look carefully at how they present their commitment to certain ESG goals and the process they put in place to ensure accuracy of data.

# LOOKING INTO THE CRYSTAL BALL

**SOCIAL CONSIDERATIONS RISING UP THE ESG AGENDA**

It is not just in the environmental space where private markets LPs and GPs see the opportunity set. The EU is working on a social taxonomy to address human rights and related issues from a financial perspective.

The COVID-19 pandemic has highlighted weaknesses across companies, economic systems, and supply chains, as well as emphasising income inequality and the vulnerability of certain communities.

**Focus on social issues is still far behind environmental concerns. Our survey of 1,000 business leaders found that 11% of investors viewed social issues as a financial risk to organisations, compared to just 5% of banks and 5% of insurers[12].**

But we are also picking up that this focus is starting to change.

As Bluefield's Armstrong says: "People have looked at what's happened and said, how do we take a really awful situation and create something good out of it?"

"Social aspects and the realisation of human rights in this respect is something that we have probably been a little bit blind to in the past," says ASI's Grandage. "I think that's really going to start to come into focus."

The EU is working on a social taxonomy to complement its green taxonomy embedded in the EU Taxonomy Regulation but this will bring quite a different challenge in how to define socially valuable activities.

ASI's Grandage adds "For socially conscious investing to succeed, there will have to be significant work carried out on how to measure the value that society gains from different activities". Any taxonomy will require a methodology and metrics, which currently do not exist – at least not in mainstream financial markets.

**SOCIAL ASPECTS AND THE REALISATION OF HUMAN RIGHTS IN THIS RESPECT IS SOME-THING THAT WE HAVE PROBABLY BEEN A LITTLE BIT BLIND TO IN THE PAST, I THINK THAT'S REALLY GOING TO START TO COME INTO FOCUS.**

Dan Grandage, Head of ESG, Real Estate, ASI

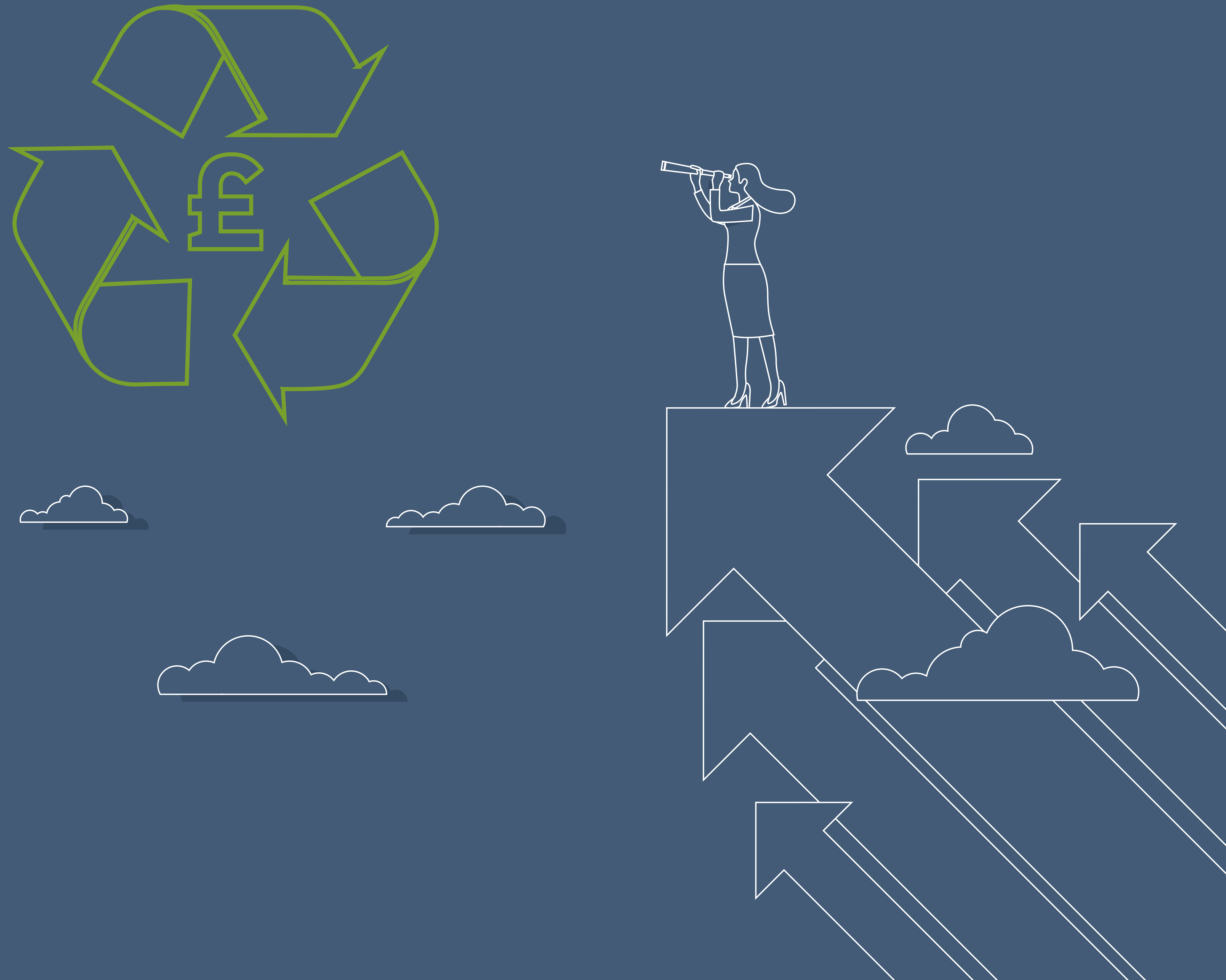
[12]Source: 'Sustainability: Pain to Net Gain – Financial Services: Investor insight', Addleshaw Goddard research report.

# LOOKING INTO THE CRYSTAL BALL

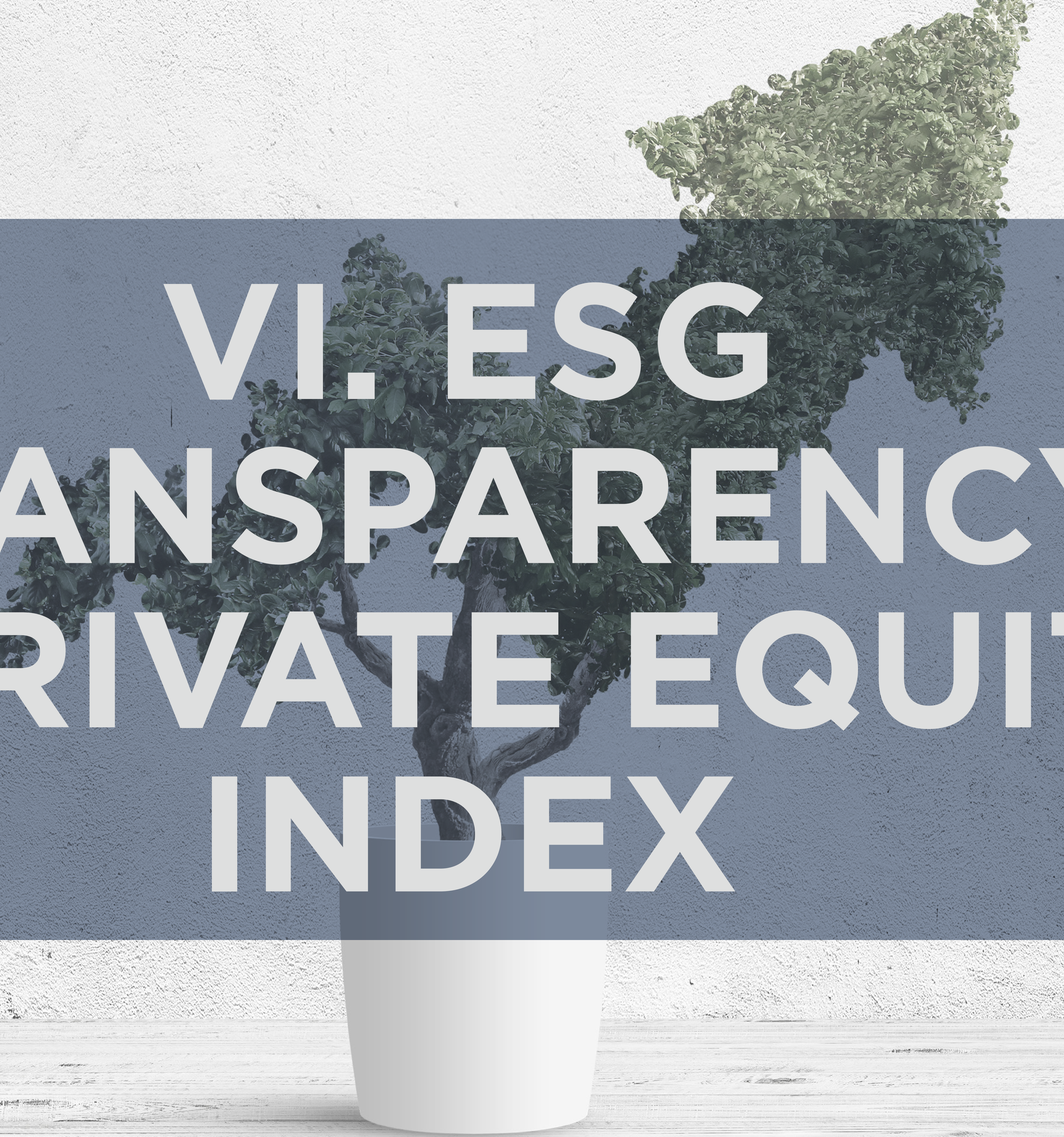
## OPPORTUNITIES ABOUND ACROSS ALL ASSET CLASSES

Impact Investing Institute’s Broderick explains that investors do not need to limit themselves in their opportunity set when seeking to make an impact as well as a return.

“You can do impact versions of all asset classes,” he states. “You can elect to be concessionary in your investing, or you can elect to look for market returns... You can find opportunities anywhere, but I think you do have to focus on situations where you can deploy the influence of capital to get change to happen.”



# VI. ESG TRANSPARENCY: A PRIVATE EQUITY INDEX



# ESG TRANSPARENCY: A PRIVATE EQUITY INDEX

**ITPEnergised's Holly Backhurst explains a new index launched by ITPEnergised in partnership with Orbis Advisory, and how it can help PE fund managers embed ESG considerations into their investment process and business operations.**

The mandate for financial markets to address ESG issues is becoming increasingly hard to ignore. Resilient and sustainable market participants are best placed to respond to some of the most pressing challenges arising today including the COVID-19 recovery, the energy transition, net zero, and social movements demanding diversity and inclusion. The data tells the story – ESG - aligned funds outperformed the market in 2020, one of the most volatile years on record[13].

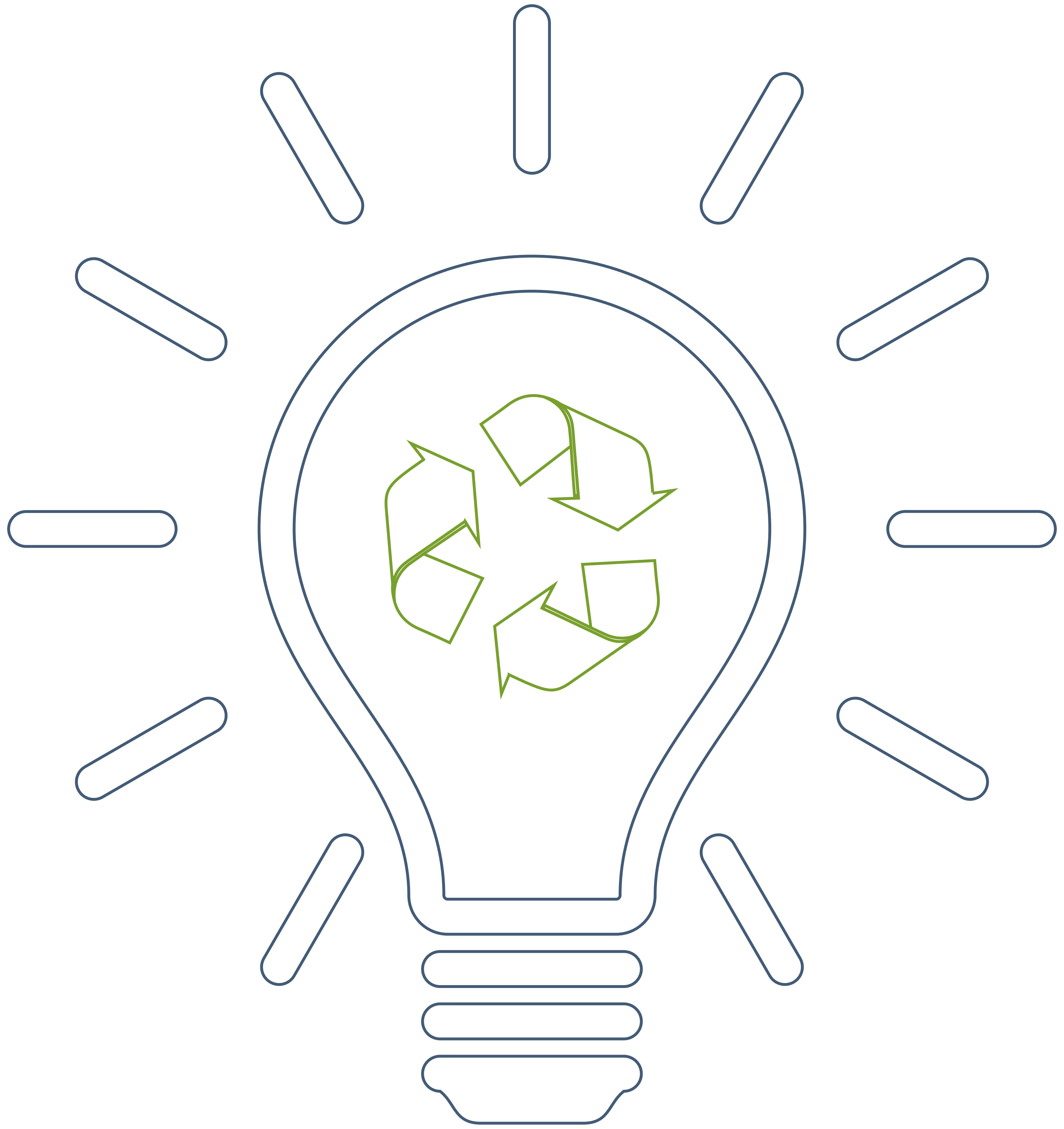
The rise of ESG represents both a challenge and an opportunity for private equity (**PE**) firms, who are increasingly making ESG central to their investment decision making and internal management processes. ITPEnergised's and Orbis Advisory's inaugural report, ESG Transparency: A Private Equity Index, examines the ESG disclosure of 160 PE firms with BVCA membership, excluding self-described venture capitalists and impact investors, in order to celebrate top performance, outline industry trends and recommend key areas for improvement.

Measuring the disclosure of ESG information gives us a valuable insight into the overall ESG activities of firms given that it is in their interest to communicate good ESG performance and strategies to investors and other key stakeholders.

The top 5 performers share an impressive integration of ESG considerations:

1. 3i Group plc
2. Epiris LLP
3. Cinven Partners LLP
4. Macquarie Infrastructure and Real Assets
5. Brookfield Asset Management.

Through illuminating best practice and giving industry leaders a platform to share learnings, the index is a tool to drive further ESG integration. This year's leader, 3i Group plc, encourage firms at the early stages of ESG integration to "view this as a long-term value creation driver, rather than just a risk management tool" – Simon Borrows, Chief Executive of 3i Group plc.



[13]Morningstar. (2021). Sustainable Equity Funds Outperform Traditional Peers in 2020. Online here.

# ESG TRANSPARENCY: A PRIVATE EQUITY INDEX

The following observations summarise the current trends in the PE industry:

### POLARISATION ACROSS THE INDUSTRY

The data is encouraging, with two thirds of PE firms disclosing their ESG or responsible investment practices to some extent. However, while the industry leaders stand out for their exceptional performance, one third of firms are yet to disclose any ESG-related information.

### IMPORTANCE OF IN-HOUSE SUSTAINABILITY

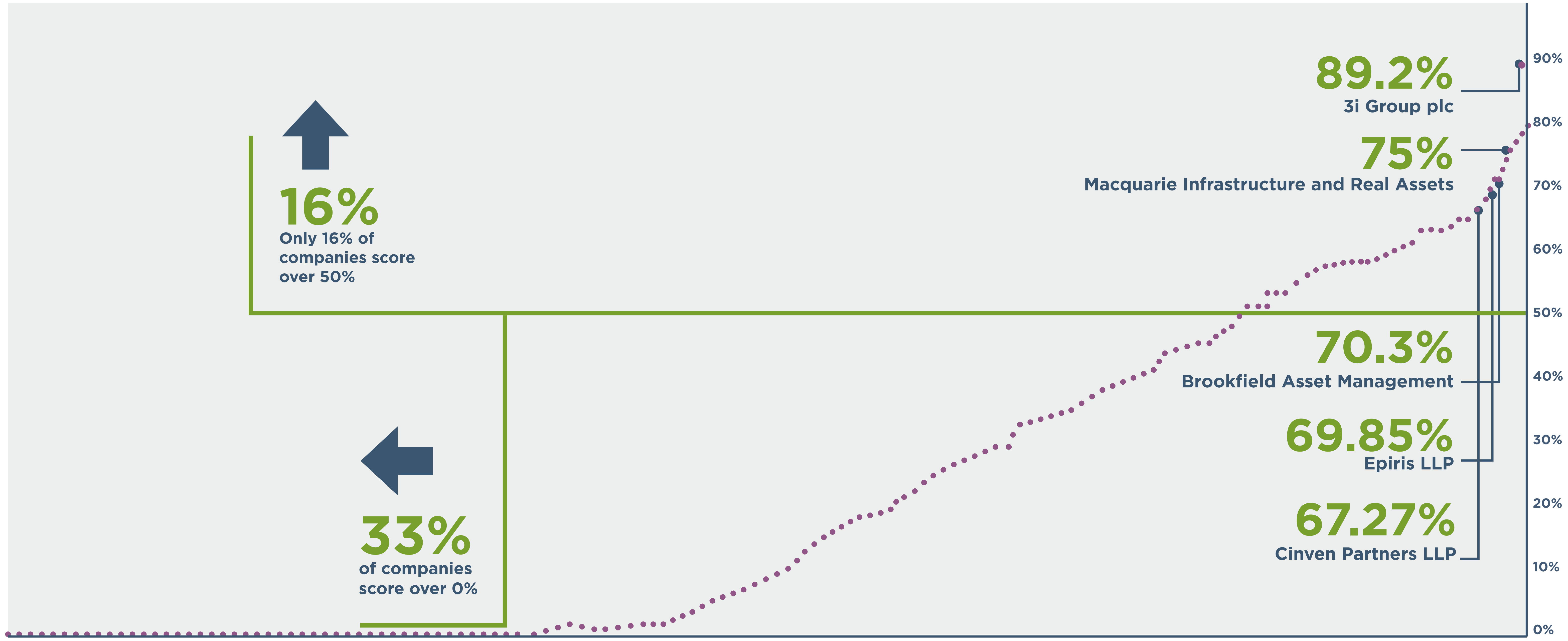
Effective management and monitoring of ESG vectors in-house is correlated with stronger performance against the responsible investing criteria, implying a causal relationship between realising the importance of ESG internally and for portfolio companies.

### COMMON STRENGTHS

Across the board, PE firms scored highest on the 'post-investment engagement' indicator, which covers collaboration with acquisition companies to consider material ESG factors. Leaders in this area set E, S and G key performance indicators (**KPIs**) for their acquisitions, provide workshops to share best practice and develop ESG expertise, and monitor performance regularly against ESG metrics.

### COMMON WEAKNESS

Only a handful of PE firms consider ESG when strategising an exit approach and just 7% encourage their investments to assess climate risk. This trend should change as reporting on climate risks through TCFD becomes mandatory in the UK.

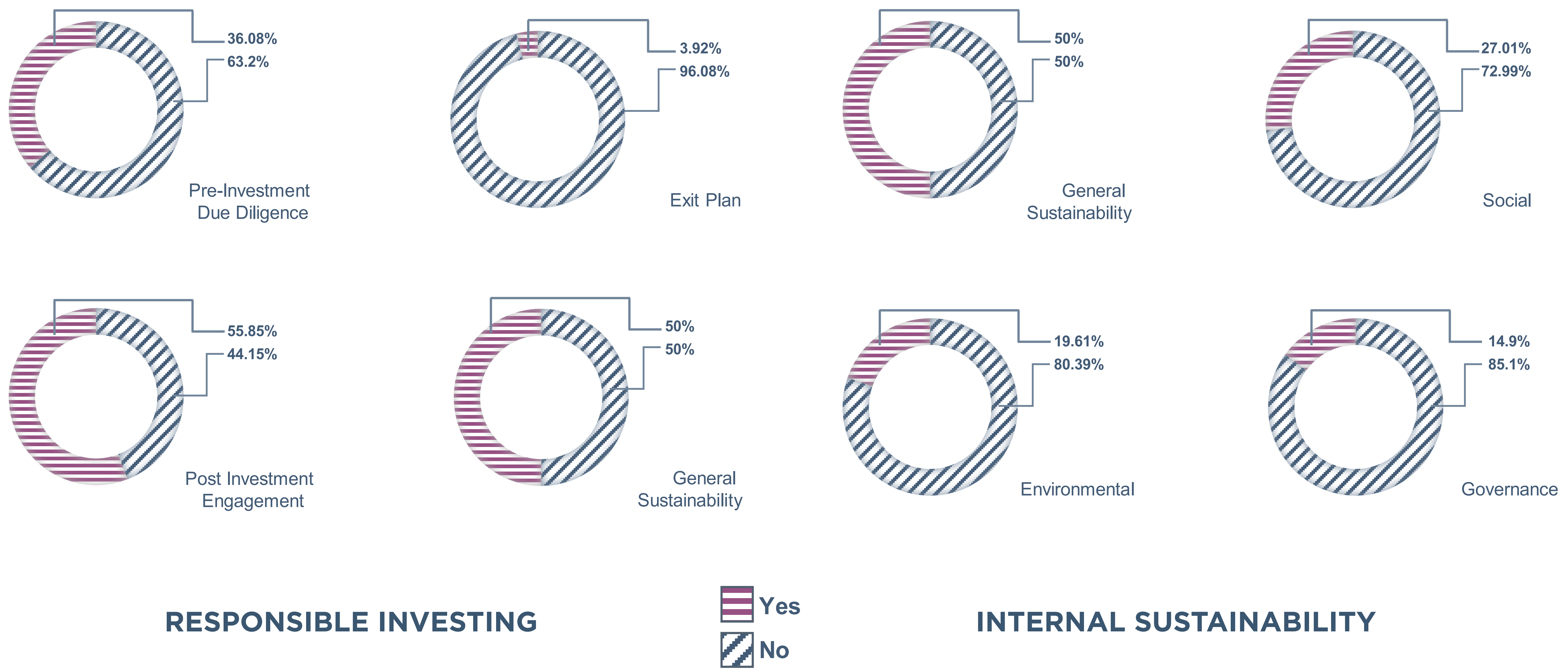


# ESG TRANSPARENCY: A PRIVATE EQUITY INDEX

Based on the key observations from the study, the ESG disclosure of PE firms can be enhanced by following these eight recommendations:

1. Peer Review to understand industry best practice in terms of ESG.
2. Materiality Assessment to identify relevant ESG risks and opportunities.
3. ESG Roadmap to set milestones aligned with best practice and strategic objectives.
4. Governance Structure for the oversight, assessment and management of ESG.
5. KPI Evaluation using a platform or database to measure and monitor performance.
6. ESG Strategy Integration which focuses on long-term risk management, opportunity creation and incorporation of ESG considerations into the investment life cycle.
7. Benchmark Selection to evaluate performance against peers and a standardised framework.
8. Communication Plan to define how ESG policies and performance are disclosed to stakeholders.

ITPEnergised and Orbis Advisory have produced this index to present a picture of ESG disclosure in the PE industry. It is hoped that this tool will encourage PE firms to further advance their ESG performance to manage risk, build resilience and ultimately create opportunity and add value. The full index and report can be accessed [here](#).

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