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Integrating ESG

‘If you stand still, you’ll get left behind’

Alan Gauld, investment director of Aberdeen Standard Investments, and **Jamie Govan**, senior ESG analyst, explain why a commitment to responsible practices is important throughout the investment lifecycle.

Q LPs are increasingly demanding to see evidence that GPs integrate ESG from the beginning to the end of an investment. What does best practice look like?

Alan Gauld: From our point of view as an LP, the first thing that we look for at the GP is ESG buy-in at a senior level. That is absolutely key. Without it, it becomes difficult to encourage others to follow any sort of ESG procedures day-to-day. That buy-in at the top permeates through to the investment professionals that are transacting deals and performing due diligence and monitoring the portfolio companies.

If you go to the large and mega funds, they might have a team of two, three or more individuals dedicated to ESG. Realistically, a lower mid-market fund of say $300 million is never going to have that luxury. Having someone who is at least accountable at mid-level, whether that’s an ESG specialist or investment manager who believes in ESG as a value creation lever, is important.

And there needs to be a holistic approach. GPs can’t simply undertake a transaction and ask in the 100-day planning, what’s your approach to ESG? In due diligence, they’ve got to have that focus. Having defined procedures on how you incorporate ESG into your analysis both pre- and postinvestment is very important. We see that from the best managers in the market. It isn’t a box ticking exercise. Managers have to figure out how ESG fits their firm size and investment strategy, and how it can help create sustainable returns.

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Q Why is considering ESG issues important in due diligence?

AG: The focus on operational value creation has increased quite significantly over the past 10 years. With competition being so fierce and record levels of dry powder, particularly at the larger end of the market, GPs are trying harder to find an edge that gets them to the front of the pack. These days you can rarely win a highly competitive deal at a price that makes private equity returns based solely on what company management are telling you. You have to find ways to create value over and above the management plan. It’s about finding every value creation lever you can to differentiate yourself. That’s part of the reason why people are focusing more on ESG during due diligence rather than approaching it as a reporting requirement post event. ESG is being seen more and more as a value creation lever rather than just being about risk mitigation.

Jamie Govan: Part of the drive for more consideration of ESG in investment decisions comes from the rise of institutions like the Principles for Responsible Investment, more regulations and guidelines such as those promoted by the TCFD (Task Force on Climate-related Financial Disclosure) and better disclosure of companies’ impact on aspects like carbon emissions, their workforce or the communities in which they operate. These issues resonate closely with the person on the street and, in turn, investors are more cognisant about what their money is actually doing. We certainly see it in the terms of Requests For Proposals (RFP) that come in from our clients and pass through our ESG team. Every single one has ESG-related questions in there, asking how we think about it, how we implement it and to what level. The RFPs are getting more specific and detailed and more time consuming to carry out. As an LP, we are concerned with specific risks relevant to the GP, where they are exposed, what’s the material issue, rather than focusing on any one particular theme.

Q Surprisingly, Aberdeen's annual survey of GP engagement with ESG revealed that fund size and resources are not a determinant of ESG commitment.

AG: It was striking that there is no real correlation. The survey was sent broadly to similar numbers of large and mid-market GPs. Most have delivered an ESG policy or made improvements to their ESG standards in the last year, most are paying more attention to it in due diligence and portfolio monitoring. Lower mid-market GPs should be commended for taking this topic seriously, despite typically having less resource than large GPs.

Q Mid-market funds are looking to set themselves apart through ESG?

AG: Exactly. If you stand still, you'll get left behind. We are seeing more funds that are trying to use specific elements of ESG as part of their investment strategy, not impact funds per se but funds like Summa Equity in the Nordics that specifically focus on mega trends and ESG when they decide on investment criteria.

Q What obstacles are there to rising ESG standards and bridging the gap between LP demands and GP engagement?

AG: In the last five years there's been a clear investor drive for ESG and generally GPs in Europe have taken that on board. But there is still a blockage around data. In Europe we're not really seeing many GPs push through ESG data proactively or voluntarily. With certain GPs we know they would be happy and able to provide it. With others, less so. More and more, LPs like ourselves have their own clients who want to know what's happening in their portfolio regarding ESG, not just financial metrics. The next stage is getting quality ESG metrics frictionlessly pushed through from the portfolio company to the GP and on to LPs so they have a clear understanding of what's happening in their portfolio across a number of areas.

JG: Better technology is definitely facilitating the unearthing of data. There's been a lot of data out there for a number of years but the issue has been to extrapolate that in a digestible fashion so you can then report it – whether you're a company or a GP.

Then you can start to compare and contrast regarding your peers and accurately measure performance. Third party providers [of ESG data] are increasing their interest in the private market space which is less competitive than public markets.

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>
> **Alan Gauld**

Q Why does North America lag Europe in terms of ESG engagement?

AG: Of those that responded, only 19 percent of North American GPs said they had a clear process in place, substantially below the level in Europe and Asia. In private equity, the genesis of ESG was in Northwest Europe. Culturally the US has a different view on creating returns and ESG's role. Investors in the region have a role to play in increasing the emphasis on ESG.

JG: North America is often treated with a broad brush but there are regional discrepancies. In Canada, ESG integration is far more established, and in certain states in the US as well.

Q Asia, in contrast, seems to be making progress on ESG. Why?

JG: It is difficult to say for certain but part of it is cultural. In addition, there has been a number of large steps taken in regards to regulations and corporate governance in places like Singapore, Malaysia and Japan. China as well is taking environmental issues much more seriously in recent times. While there is, of course, plenty of progress still to materialise, these are drivers that have had an affect across all asset classes.

Q The Wates Corporate Governance Principles for Large Private Companies were published in December after a consultation launched in June. How has Aberdeen participated in their development?

JG: Its goal is to promote ESG considerations in private companies that don't have to abide by the same kind of guidelines that stock exchanges around the world have increasingly laid down for listed companies. Much of the basis for it has been taken from the UK Corporate Governance Code but it has been appropriately adapted to be more applicable to private companies. It is not a legal requirement but it is expected to become best practice. It is an "apply and explain" regime, rather than "comply and explain", and a significant step in the right direction.

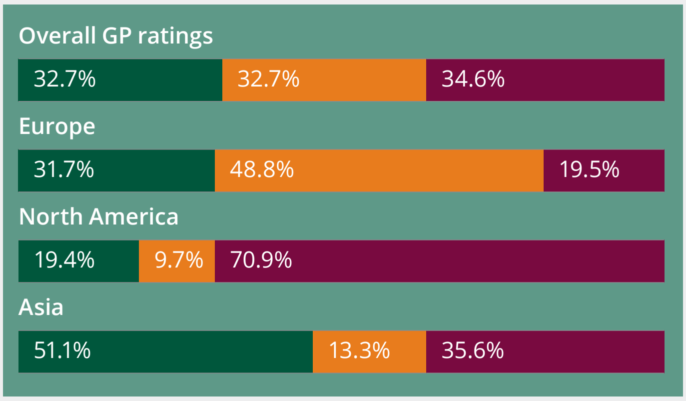
We were asked to give feedback during the consultation. One of the issues that came up was in regards to principle two that addresses board composition. There was a reference to diversity and we asked for some more specifics on that. We highlighted the objectives established by the 30% Club [the global market initiative to promote diversity on boards and in senior management] and suggested that private companies use these as aspirational targets. This is an area where we've been active and Aberdeen Standard Investments' investment director, Deborah Gilshan, co-chairs the 30% Club's UK Investor Group.

Surveying the ESG scene

Since 2014, Aberdeen Standard has surveyed its European GPs on their ESG practices. In 2018, it expanded the geographic scope to include managers in North America and Asia for the first time.

Q You contacted more than 150 of your core GPs last year to ask about ESG. What's the purpose of the survey?

AG: We use this as a portfolio-monitoring tool. It also allows us to proactively share best practice and add value to our GP relationships. For example, we can go back to GPs that lag behind their peers and let them know where they stand. Perhaps we can encourage them to look at what other people might be doing and what they could improve. As a GP, listening to your investors on this topic is important to make sure that you're best in class in integrating ESG into your business. The industry is moving forward with ESG and it is important to not be left behind.



Clear process in place | Partially in place | No process

Source: Aberdeen Standard Investment 2018 Private Equity ESG Survey.

Have you implemented any significant initiatives to improve ESG standards in the GP and across the portfolio in the past year?

Clear process in place | Partially in place | No new initiative

Source: Aberdeen Standard Investment 2018 Private Equity ESG Survey

Q Since you began the survey, what key trends have you seen?

AG: When we started our ESG survey in Europe four years ago, far fewer GPs had their own policy and really considered this topic. The big difference now in Europe is that the majority of those that we surveyed are engaging with ESG at a high level and integrating it into their investment strategy. The question now is, how do GPs take ESG to the next level? The answer could involve exploiting technology and data, in order to improve investment due diligence, portfolio monitoring and investor reporting in relation to ESG factors.

Q What significant initiatives to improve standards were you expecting to find?

AG: We were more concerned about tracking GPs' quest for improvement. To check people aren't standing still, and they can evidence what they're doing. European GPs have a solid ESG foundation and the response rate to the survey was high. But when we asked about the specifics and the metrics, the standard of responses noticeably dropped. Technology is part of the answer. We're seeing some GPs implementing ESG software that allows portfolio company chief financial officers to push KPIs [key performance indicators] through to them on a regular basis, which provides them with more information about their businesses and where they can potentially make changes. That's certainly something a number of GPs have talked about in response to the survey.

"ESG is not just a box-ticking exercise"

Alan Gauld
Investment Director

"Investors care more about what their money is doing"

Jamie Govan
Senior Analyst - Responsible Investing

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