ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG)
for Private Equity: The Basics
RPS developed this publication in response to frequently asked questions by our private equity clients, which include: “What is ESG?” and “How can my firm benefit from integrating ESG into our investment process?”

This publication is intended to help answer these questions and provide the basic knowledge and understanding required for private equity firms to start an informed conversation about ESG and how it may enhance the firm’s existing investment process.

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OVER 2,500 asset owners, investment managers, and service providers are UN Principles for Responsible Investment (UNPRI) signatories. i

61% OF INSTITUTIONAL INVESTORS have developed ESG strategies, according to a recent survey. ii

$12 TRILLION of US-professionally managed assets at year-end 2017 focused on sustainable, responsible, and impact investing. iii

38% GROWTH of sustainable investments between 2016-2018. iv

181 CEOs have signed a new Statement on the Purpose of a Corporation and are committed to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders. v

rpsgroup.com/esg
INTRODUCTION

What is ESG?
ESG is an increasingly popular concept across the investment industry, and integration has spread across institutional investors, private equity firms, wealth managers, and retail investors. While ESG is a simple acronym for environmental (natural resource use efficiency and impacts), social (stakeholder engagement) and governance (oversight and management topics), in capital markets has become a term that refers to an investment strategy accounting for these factors.

Investors realize that understanding a company’s environmental impacts, social performance, and governance practices can have material impacts on the business’s bottom line. Generally, ESG matters are connected to value creation and protection through costs (e.g. regulatory drivers and resource saving initiatives), revenues (e.g. product innovation), assets and liabilities (e.g. natural resource reserves and litigation), and risk management (e.g., supply chain governance).

Select ESG Factors

Environment
- Biodiversity Impacts
- Emissions and Air Quality
- Energy Consumption
- Extreme Weather Events and Vulnerability Analysis
- Fuel Efficiency
- Hazardous Materials
- Waste Management
- Water Quality
- Water Rights & Availability

Social
- Community Engagement
- Conflict Minerals
- Employee Engagement and Retention
- Fair Disclosure & Marketing
- Health and Safety
- Human Rights
- Internal Labor Relations
- Product Stewardship

Governance
- Anti-Bribery and Anti-Corruption
- Anti-Sexual Harassment and Anti-Bullying
- Board Composition and Diversity
- Business Ethics and Transparency
- Business Interruption
- Consumer and Enterprise Customer Expectations
- Supply Chain

Though ESG, impact investing, and Socially Responsible Investing (SRI) strategies are often conjoined, the methodologies are not synonymous. Unlike impact investing and SRI, ESG integration is not predicated on limiting the investment universe. An investor can review any company’s ESG standing, regardless of its industry, product offering, or operational footprint. Integrating ESG factors into an investment strategy supplements investment decision-making and ownership strategies across asset classes by providing an additional lens to account for factors traditionally underemphasized in the investment analysis process and asset ownership.
ESG INTEGRATION IN PRIVATE EQUITY: WHY NOW?

Since the United Nations Principles for Responsible Investment (UNPRI) was founded in 2005, ESG integration has grown significantly and continues to do so today. Many private equity firms can no longer ignore ESG as an investment consideration. A number of trends and developments have accelerated ESG uptake across the private equity investment space.

Limited Partner Scrutiny
Typically, the conversation around ESG integration arises during the fundraising process, when some limited partners (LPs) provide general partners (GPs) with an ESG questionnaire used to evaluate if and how ESG factors are considered during the investment process. These requests are manifestations of LP value alignment and enhancement strategies; by considering ESG during the fund manager selection process, LPs aim to increase returns, meet stakeholder expectations, minimize headline risk, and foster transparency in the financial industry.

LPs increasingly view a manager’s approach to ESG as a differentiating factor when committing capital. European LPs have established track records of ESG requirements, and over the past 10 years, US-based LPs have increased their ESG expectations of fund managers. Whereas initially, a simple ESG policy would have sufficed, LPs now seek to understand how that policy is being implemented across the investment cycle and which Key Performance Indicators (KPIs) are tracked against performance. For more information, see Appendix A - Institutional Limited Partners Association (ILPA) ESG Due Diligence Questionnaire for General Partners.

Regulatory Frameworks
Governments around the world continue to enact new ESG rules and regulations⁴. Some have broad implications on how companies disclose ESG data, such as the recent Subcommittee on Investor Protection, Entrepreneurship and Capital Markets hearings on Building a Sustainable and Competitive Economy: An Examination of Proposals to Improve Environmental, Social and Governance Disclosures in the US.

Other rules and regulations have specific applicability but affect a company’s performance and liability exposure. From international (e.g., European Union Restriction of Hazardous Substances Directive [RoHS]), to national (e.g., Federal Trade Commission [FTC] Green Guides), to regional (e.g., carbon emissions trading schemes), to state (e.g., California Proposition 65), it is paramount for investors to investigate target investments’ adherence to these regulations given such requirements impact a company’s bottom line, operations, and relationship with stakeholders.

Changing Consumer Preferences
According to Nielsen’s 2018 Evolution of the Sustainability Mindset report, “81% of global respondents feel strongly that companies should help improve the environment... Millennials, Gen Z and Gen X are the most supportive...”⁷. Consumers vote with their dollars, and millennials represent a growing portion of consumers. Trends such as growing numbers of ESG, impact investing, and SRI investment vehicles, eco-friendly products, and alternative healthy food choices are manifestations of products and services designed to capitalize on these changing consumer preferences.

Increasing transparency from corporations directly and through media outlets allows consumers to monitor a company’s environmental and social impacts and stances. Whereas historically companies chose not to address negative externalities, commitments to these matters, such as human rights exposures in supply chains or carbon emissions reduction targets, now serve as differentiators to stand out from competitors.

Increased Scrutiny from Enterprise Customers
Ignorance of ESG-related factors in recent years demonstrates the business value impact mismanagement can cause. Volkswagen’s emissions scandal⁸, Foxconn’s employee mistreatment⁹, and Monsanto and Johnson & Johnson’s product liability cases¹⁰ are all examples of incidents that impacted share value and cost millions of additional dollars in legal fees and settlements. Given these risks, 86% of the S&P 500 now publishes some type of sustainability report¹¹. While publishing a sustainability report does not necessarily indicate a strong corporate sustainability program, this trend indicates an uptake of sustainability strategies across enterprise corporations aimed at reducing environmental and social impacts.

Financial Industry Trends
ESG integration has already spread across players in European capital markets, and those trends, combined with the growing realization that ESG adds value for financial institutions, are beginning to spill over into the European and US pension funds (e.g., APG, PGGM, OMERS, and CalPERS, among others). This is one of the driving forces especially relevant to the private equity community. Also, various lenders, insurers, and equity asset managers now employ in-house ESG teams to analyze these factors as part of the investment decision-making process.
TAKING THE FIRST STEPS ON ESG

GPs are learning how to create and protect value through ESG management.

Exit
Communicating ESG accomplishments can help:
- Highlight growth opportunities;
- Increase brand value;
- Establish competitive advantage;
- Meet public market investors' expectations.

Ownership
Implementing ESG initiatives can help:
- Increase ROI;
- Minimize risk;
- Reduce expenses;
- Improve employee retention;
- Avoid business disruption;
- Reduce regulatory liability;
- Meet customers' sustainability expectations;
- Increase market share;
- Satisfy LPs expectations; and
- Enhance GP and company reputation.

Fundraising
Establishing an ESG policy and implementation framework can help:
- Satisfy LP ESG expectations;
- Enhance relationship with new and existing LPs;
- Secure access to funding;
- Create a competitive advantage.

Due Diligence
Conducting an ESG review can help:
- Eliminate deal issue threats;
- Highlight deficient standards;
- Pinpoint key ESG opportunities for improvement post-acquisition;
- Highlight enterprise customers' sustainability expectations;
- Analyze changing consumer expectations;
- Evaluate industry-level trends;
- Identify regulatory liability.

Step 1. Formalize an ESG Policy
A formal policy can take many different forms depending on a firm's values, goals, and existing practices. Whether pull together disparate ESG-related elements and practices or building a program from scratch, an ESG strategy should be designed to fit into existing operational procedures to facilitate implementation. Enacting a formal policy represents the first step a firm can make to address LP expectations.

For more information, see Appendix B - Components of an ESG Policy.

Step 2. Develop an Implementation Framework
A policy is often insufficient to satisfy LP expectations and fully integrate an ESG strategy. Therefore GPs should consider creating an approach for practical implementation. This framework can include a list of training materials to provide to staff, the contents of the ESG due diligence questionnaire, guidance on materiality, what data will be provided to LPs, which KPIs will be tracked, and when advisors should be engaged.

Step 3. Incorporate ESG into the Due Diligence Process
Integrating ESG into the due diligence process is a crucial element of an ESG program for several reasons, such as identifying deal issue threats, benchmarking to peers and industry standards (where possible), highlighting deficient practices (distinguishing between legal requirements and best practices), and pinpointing key ESG opportunities for improvement post-acquisition.

When conducting an ESG due diligence review, it is important to understand that there is no single standard that directs the ESG evaluation. Given the short timeline of the due diligence process and since a target company may have a dozen ESG factors that could be applicable, it's important to focus on ESG factors that are mission-critical to the company's success. Ideally, the ESG review should be customized to the prospective investment based on its industry, product or service offering, geographic reach, and other factors.

For more information on the ESG value proposition, download RPS's ESG brochure.
SPOTLIGHT:
DUE DILIGENCE SUPPLY CHAIN REVIEW

In today’s global economy, companies engage suppliers from around the world to purchase goods and services. By understanding their suppliers’ environmental and social standing, companies can help ensure compliance with local laws and regulations, identify operational gaps (e.g., single-point-of-failure), pinpoint unsafe working conditions at suppliers’ facilities, align with universally-accepted human rights principles, ensure business continuity, and help maintain brand integrity.

Download RPS’s Supply Chain Review brochure for additional information.
ABOUT RPS

RPS has the expertise and experience to assist clients integrate ESG in ways that make the most sense for the firm, portfolio companies, and LPs. We review risk and opportunities that could have direct financial, operational, and reputational impacts on active or prospective investments. We then help manage these risks and capitalize on opportunities by implementing initiatives and providing value-added services to firms and their portfolio companies. RPS can help implement an ESG strategy that will bolster an investment strategy, satisfy LPs’ expectations, create short and long-term value across the portfolio, and strengthen the firm’s reputation.

LEADING MINDS

Our team of ESG professionals helps enhance our clients’ investment process by identifying ESG matters within active and prospective investments while addressing LP expectations.

PEOPLE & CULTURE

5600 Talented People
250 Diverse Services
125 Countries
6 Continents
1 Secure Company

To learn more about the benefits of ESG management, please visit our website or contact:

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APPENDIX A

Institutional Limited Partners Association (ILPA)

ESG Due Diligence Questionnaire for General Partners

Select questions from Section 10.0 Environmental, Social, & Governance (ESG):

1. What are the Firm’s ESG-related policies and how do ESG factors influence its investment beliefs?

2. Does the Firm have a policy that describes its approach to identifying and managing ESG factors within the investment and portfolio management processes?

3. Does the Firm make formal commitments relating to ESG integration in fund formation contracts, Limited Partnership Agreements, or in side letters when requested by investors?

4. How does the Firm identify and manage material ESG-related risk and use ESG factors to create value?

5. Describe the Firm’s process for identifying and understanding (i) potentially material ESG risks, and (ii) ESG-related opportunities during due diligence.

6. How does the Firm contribute to portfolio companies’ management of ESG-related risks and opportunities?

7. How does it ensure that portfolio company management devotes sufficient resources to manage ESG factors that have been identified?

8. How can LPs monitor and, where necessary, ensure that the Fund is operating consistently with agreed-upon ESG-related policies and practices, including disclosure of ESG-related incidents?

9. Which channels does the Firm use to communicate ESG-related information to LPs?

10. Does the Firm provide training, assistance, and/or external resources to staff to help them understand and identify the relevance and importance of ESG factors in investment activities?
APPENDIX B
Components of an ESG Policy

The components of an ESG policy typically include the following elements:

1. General Approach
   a. Will the firm align with an established framework, such as the UNPRI?
   b. Does the firm believe that considering ESG factors will help create value?
   c. What is the firm’s management view on the value of ESG?

2. Goals
   a. What motivated the firm to consider developing a policy?
   b. What goals are the firm trying to accomplish by creating a policy?
   c. Is the firm trying to identify risk, opportunities, or both?

3. Roles and Responsibilities
   a. What resources will be dedicated to ensuring proper implementation of the policy?
   b. Who will be responsible for implementing the policy?
   c. Who will provide training to staff members?

4. Implementation
   a. How will the firm integrate ESG into its due diligence review?
   b. How will the firm engage companies’ management team on ESG?
   c. What data will be provided to LPs?
APPENDIX C

Endnotes

1 UNPRI, Signatory Directory, https://www.unpri.org/signatories/signatory-directory


xii Institutional Limited Partners Association (ILPA), Due Diligence Questionnaire version 1.2, https://ilpa.org/due-diligence-questionnaire/