Why should Private Equity Funds care about their investees' environmental and social risks?

Environmental and social risks related to an investee's business can translate into direct monetary losses for a Private Equity Fund (PEF). **PEFs thus have not only an ethical but also an economic incentive to fully understand their investees' E&S performance** also in order to identify opportunities**.**

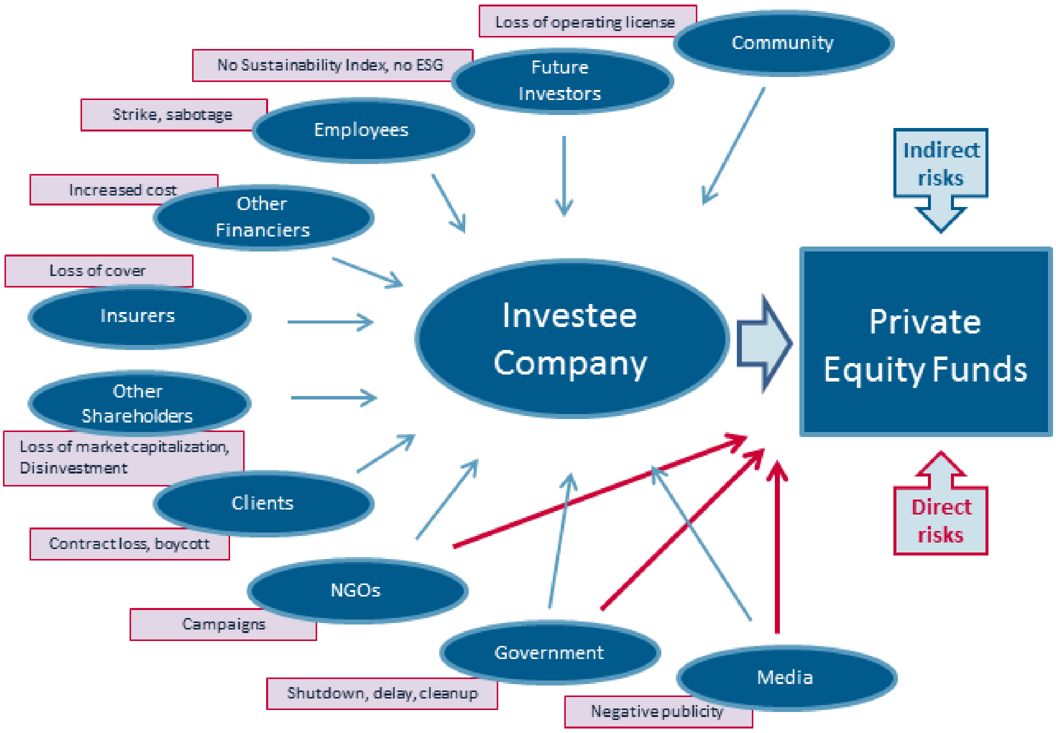
Environmental and social risks related to the financial engagement of a PEF can include:

- Direct operational risks leading to potential financial losses;
- Reduced profitability due to higher costs;
- Substantial clean-up costs;
- Delayed construction and completion of projects;
- Penalties / sanctions levied by local authorities;
- Market loss due to boycott of investee companies;
- Financing risks (lower willingness of financiers to borrow/fund);
- Reputational risks for both the investee company and potentially the investing PEF, such as negative headlines or even NGO campaigns.
- Limited appreciation by potential buyers when exiting from the investment

The number of cases in which PEFs have either lost money or reputation due to improper E&S performance of their investees is rising sharply (for examples, please "click" on or "scan" the bottom of the last page) and is expected to continue to rise, driven in no small part by the increasing importance of social media communication.

It appears that in the past PEFs had to experience such issues at least once before E&S risks were begun to be perceived as "real" business risks that require identification and mitigation like other business risks. At the same time, E&S opportunities often remained (and continue to remain) unexploited. The value of a company with a certified E&S management system or that is part of a sustainability index can increase dramatically.

Moreover, DEG's experience clearly shows that adequate management of E&S issues often correlates with general management capability (e.g. quality, maintenance of equipment). E&S management will help PEFs to get a more comprehensive understanding of their investees and related risks, which are usually not visible when focussing on the balance sheet. Moreover, E&S management has proved to be a valuable tool for exploiting previously unrealised business opportunities.



A changing scenario: New regulators are emerging, resulting in direct and indirect risks and opportunities for PEFs

How can Private Equity Funds manage these risks?

In order to increase the opportunities for sustainability and to avoid and minimise risks of related investments, DEG believes that it is necessary to develop, implement and maintain adequate policies and procedures, usually captured in the form of an Environmental & Social Management System (ESMS).

An ESMS is the part of the overall management system of the PEF that includes organisational structure, planning activities, responsibilities, practices, procedures and resources for developing, implementing, achieving, reviewing and maintaining compliance with local environmental and social laws and regulations as well as internationally recognised E&S standards such as the IFC Performance Standards (www.ifc.org). As such, an ESMS aims to identify and manage environmental and social risks and opportunities in the loan and investment appraisal and management processes of PEFs.

An ESMS typically has the following components:

- Environmental & Social Policy: The E&S Policy is a commitment of the PEF to promote environmental and social sustainability in its business operations, approved by the Partner(s) and communicated to stakeholders;
- Exclusion List[1]: Adherence to a list of activities excluded from financing by the PEF;
- ESMS Manual: The Manual is the core of the ESMS. It defines the organisational structure, key responsibilities and procedures necessary to achieve the E&S Policy commitment and ideally already includes necessary working documents. This requires integration of key processes into core operations applicable in all phases of the investment process, with firm and visible support by the Managing Partners of

[1] e.g. DEG/EDFI Exclusion list: https://www.deginvest.de/DEG-Englische-Dokumente/About-DEG/Our-Mandate/EDFI_DEG_Exclusion-List_en.pdf

the Fund Manager. Required documentation includes:

- E&S responsibilities;
- E&S questionnaires for investee companies to assess E&S, labour and health and safety risks and opportunities associated with their activities;
- Standardised E&S legal language;
- Risk categorisation and screening model;
- E&S guidelines for specific sectors and regions (if specific investment focus is given);
- E&S due diligence procedures, including standard Terms of Reference for commissioning of external E&S experts and ideally a pool of qualified experts;
- E&S monitoring procedures.

Sufficient in-house capacities (depending on size and number of investments - at least one suitably trained E&S officer is required) and resources to enable implementation of a functional ESMS need to be provided by the Fund Manager.

The E&S officer will primarily need to ensure that investee companies manage their operational E&S risks appropriately (resources, procedures, responsibilities, compliance with action plans etc.).

Further references, additional guidance, and good practice materials are made available by CDC (toolkit on ESG for fund managers) through their document library (http://www.cdcgroup.com), INSEAD (ESG in Private Equity: A Fast-Evolving Standard - http://centres.insead.edu/global-private-equity-initiative) and FMO (E&S risk management tool for private equity investments - http://www.fmo.nl/esg-tools)

Key resistance – and how to overcome

1. *"Other funds do not require this"* – Maybe true. But they will sooner than later as it makes business sense
2. *"We are not the environmental authorities"* – Sure, but you better rely on your own risk assessment as you do with other risks
3. *"IFC what Standards?"* – IFC Performance Standards are based on common sense present good business practices and are full of valuable benchmark information
4. *"We are investors and not environmentalists"* – Just know when to involve experts.

Situation today:

- IFC Performance Standards are THE benchmark for E&S risks management by a PEF;
- Adherence to IFC Performance Standards is international good investment practice and contributes to overall risk management;
- An estimated 80% of total project finance debt in emerging market economies is based on IFC Performance Standards;
- Development Finance Institutions and other investors, including pension funds, increasingly demand best practice environmental and social management systems and adherence to E&S standards from their PEFs;
- PEFs increasingly consider E&S management as a "Governance" issue ("ESG");
- Sharply rising number of signatories to the UN Principles for Responsible Investment (UNPRI).

What exactly does DEG require from its PEFs?

DEG's Environmental and Social Policy and the following requirements are based entirely on international standards and are in line with the environmental and social standards set by many development finance institutions such as IFC, EBRD, Proparco, FMO and other European Development Finance Institutions (EDFI):

- Prior to first fund investment: Development, implementation and continuous improvement of an adequate ESMS for the entire portfolio, potentially through an action plan agreed with DEG;
- Assignment of E&S responsibilities to a suitably trained officer and a representative Managing Partner;
- Contractual obligation of all investee companies to comply with the minimum E&S requirements;
- Annual Environmental and Social Monitoring Report and on an ad-hoc basis in case of unusual events.

What support does DEG offer?

DEG supports its PEFs in the process of developing and implementing an adequate ESMS. For this purpose, we have entered into framework agreements with highly qualified international experts in order to provide guidance and advice to PEFs in a five-phased approach:

- Phase 1: Assessing the status quo;
- Phase 2: Supporting the development of policies, procedures, tailor-made tools, checklists;
- Phase 3: Review of policies and procedures, on-site training of key staff; provision of assistance for E&S due diligence of selected project;
- Phase 4: Evaluation of the implementation of E&S policies and procedures;
- Phase 5: Provision of on-going off-site support and final evaluation.

Depending on the chosen expert, DEG can typically cover between 50% to 100% of the expert's professional fees through its Technical Assistance Programme. Speak to us about details.

Travel costs and reimbursables are usually covered by the PEFs in which DEG considers to invest.

Those PEFs can also request direct assistance from DEG's E&S specialists, who have extensive experiences in managing complex deals. Particularly when co-funding deals with DEG, their involvement at an early stage is highly advisable. Please request our "co-investment guidelines directly from the DEG E&S Team.

Observation on costs

"...it appears that the costs associated with ESG analysis during due diligence typically range from US$ 5,000 to US$ 20,000, depending on the size, industry and location of the potential investment. This expenditure is typically for hiring external advisors to map the ESG issues associated with a particular investment. This may include factory site visits, resource utilisation analysis and/or mapping the scope for improvements. The estimated costs put ESG due diligence at less than 10 to 15% of total due diligence expenditure."

Source: PRI, Integrating ESG in private equity: A guide for general partners (http://www.unpri.org/publications)

More information under:

www.deginvest.de

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Proving the business case: Examples for the necessity to properly manage E&S risk in PEFs/FIs