Reporting on Environmental, Social, and Governance Considerations in the Private Equity Sector

A Report for General Partners

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About This Report

This report was written by BSR associate Charlotte Bancilhon, with support from the following staff members from BSR's global team: Laura Gitman, David Korngold, Peder Michael Pruzan-Jorgensen, and Virginia Terry.

This report is based on a literature review as well as a review of the environmental, social, and governance (ESG) public reporting practices of the 10 largest private equity (PE) firms in the United States and the 10 largest PE firms in Europe in 2012, based on the Private Equity International (PEI) 300 2012 ranking.[1] This report is also based on interviews with general partners (GPs), limited partners (LPs), and stakeholders of PE firms, including:

» Paulus Ingram, APG Asset Management
» Christopher James, Blackstone
» Garrett Moran, Blackstone
» Don Anderson, Blackstone
» Thomas Murray, Environmental Defense Fund
» International Union of Food (IUF)
» Elizabeth Seeger, Kohlberg Kravis Roberts & Co (KKR)
» Chris Davison, Permira
» David Russell, Universities Superannuation Scheme (USS)

The authors would like to thank the interviewees for their valuable input into the findings of the report. Any errors that remain are those of the authors. Please direct comments or questions to Charlotte Bancilhon at cbancilhon@bsr.org.

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[1] PEI 300, Private Equity International, published May 2012, accessed July 16, 2012, www.peimedia.com/Pages.aspx?pageID=3391

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Executive Summary

Private equity (PE) firms are facing increasing scrutiny and greater demand for transparency from investors and stakeholders at large.
To secure long-term success, the PE sector needs to adopt a more transparent and open approach to demonstrating how it contributes to social and economic welfare. In this report, we provide fund managers a set of recommendations on how to take a robust and proactive approach to reporting on ESG management.

ESG reporting in the PE sector is in its early stages, lagging behind sustainability reporting in other financial services sectors. Based on a review of the ESG public reporting practices of the 10 largest PE firms in the United States and the 10 largest PE firms in Europe in 2012,[2] as well as interviews, BSR found that:

» Although ESG issues are increasingly on the agenda of discussions between limited partners (LPs) and their general partners (GPs), **the quantity and quality of ESG reporting by GPs overall fails to adequately meet the needs and requirements of LPs.**

» Proactive reporting to stakeholders, including trade unions and employees, civil society and the public is **only emerging, embraced by a few select leaders.**

PE firms should adopt an approach to proactively communicate about ESG management to their stakeholders. The PE industry is facing **increasing scrutiny and greater demand for transparency from its stakeholders,**

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[2] Based on the Private Equity International (PEI) 300 2012 ranking.

including investors, labor unions, regulators, and civil society. Stakeholders will likely continue to expect increased accountability from firms, notably:

- **LPs** are asking for more transparency around and disclosure of ESG information from GPs, in an aim to mitigate investment risks and increase long-term returns.
- PE firms increasingly face pressure from **civil society, including the media and labor unions,** for greater transparency and accountability, as witnessed during the 2012 U.S. presidential campaign.
- **Voluntary initiatives and regulations** that encourage transparency and financial and nonfinancial disclosure are emerging in the sector.
- ESG factors are increasingly seen as **fund value drivers** through performance improvements and operational efficiencies, such as eco-efficiencies in portfolio companies.

Investors increasingly see strong ESG management as a differentiating factor, and developing a robust ESG reporting approach will enhance fund managers' ability to meet the demands of investors and attract new capital. Public ESG reporting will allow PE firms to respond to public criticism regarding the social and economic impact and track record of the industry, and will contribute to building public confidence and trust in the sector.

In defining an ESG reporting approach, fund managers will come across some challenges: How can you report to such a diverse audience of stakeholders, including investors and the public at large? How can you report on such a diverse portfolio of companies across different geographies and sectors?

In this report, BSR provides fund managers a set of recommendations on how to define a robust and proactive approach to reporting on ESG management. Fund managers should:

- Seek to understand stakeholder expectations, and define reporting strategies that meet these expectations. Identify the issues that are most material to your company through a **materiality assessment, and engage with your stakeholders** to inform this materiality assessment.
- **Report on the process** by which you actively integrate ESG considerations at all stages of the investment life cycle, including investment, ownership, and divestment decisions. Here, define annual objectives and targets, and report your results against these targets each year.
- **Report on the ESG performance** of your fund, including how your responsible investment approach leads to real sustainability improvements and value creation in their portfolio companies. As part of this process, consider reporting on a core set of key performance indicators (KPIs) applicable across the portfolio (e.g., net employment, investment in research and development [R&D], contribution to taxes).
- **Collaborate with your industry** to define a reporting framework for the PE sector, and apply reporting best practices as defined by standard-setting organizations, such as the Global Reporting Initiative (GRI) and the UN-backed Principles for Responsible Investment Initiative (PRI).

Introduction

Recent studies[3] show that PE firms are increasingly considering ESG factors to create long-term business value throughout their investments' life cycle. An increasing number of PE firms are defining policies for responsible investment and dedicating in-house expertise to monitor and improve portfolio companies' sustainability performance.

This report uses the following abbreviations:

- **PE:** Private equity
- **GPs:** General partners (also referred to as fund managers)
- **LPs:** Limited partners (also referred to as investors)
- **ESG:** Environmental, social, and governance
- **KPIs:** Key performance indicators

However, these studies also show that very few PE firms regularly and effectively report their ESG achievements and challenges to their stakeholders, including investors and the general public. The PE sector lags behind other financial services sectors in ESG reporting. According to a recent survey by PricewaterhouseCoopers, 47 percent of the 17 PE firms surveyed did not report on or provided limited reporting on ESG management.[4] The British Private Equity and Venture Capital Association (BVCA) found that only 20 percent of its members had established a formal reporting of ESG activities in 2011, representing an eight-point increase compared to 2009.[5]

At the same time, the PE sector is facing increasing scrutiny and greater demand for transparency from stakeholders, including investors, civil society, employees, and regulators. The global economic crisis and the 2012 U.S. presidential election have stirred up a public debate around the economic and social impact of the PE sector, while regulators are proposing new frameworks to regulate PE and hedge fund markets, notably in Europe. These growing stakeholder expectations for increased accountability of the PE sector are likely here to stay.

Reporting on how PE's active management of companies leads to societal benefits is a key part of responding to stakeholders' concerns. For long-term success, the PE industry will need to adopt a more transparent and open approach to demonstrating how it contributes to social and economic welfare. This should include a full accounting of how firms integrate ESG into all stages of the investment cycle, how it approaches an active ownership role in its portfolio companies, and the impact of its efforts to add value to the businesses it owns.

Intended for GPs, this report provides insight into the current state of ESG reporting in the PE sector. Then, the report identifies the factors that drive ESG reporting among GPs and discusses stakeholder expectations. Lastly, the report provides GPs a set of actionable recommendations about how they can report their ESG performance.

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[3] "Evolving Views of Sustainability in Private Equity and Venture Capital," British Private Equity and Venture Capital Association, November 2011, accessed August 21, 2012, http://admin.bvca.co.uk/library/documents/EvolvingViewsSustainability_Nov11.pdf

[4] "Responsible Investment: Creating Value from Environmental, Social, and Governance Issues," PricewaterhouseCoopers, March 2012, accessed August 21, 2012, www.pwc.com/en_GX/gx/sustainability/research-insights/assets/private-equity-survey-sustainability.pdf

[5] "Evolving Views of Sustainability in Private Equity and Venture Capital," British Private Equity and Venture Capital Association, November 2011, accessed August 21, 2012, http://admin.bvca.co.uk/library/documents/EvolvingViewsSustainability_Nov11.pdf

Current State of ESG Reporting in the PE Sector

Given that there is a rising trend of PE firms reporting on their ESG activities, BSR reviewed the current ESG reporting practices of PE firms, and sought to answer the questions who, how, and what:

» To whom do GPs report?

» How do GPs report on ESG?

» What does GPs' ESG reporting cover?

To Whom Do GPs Report?

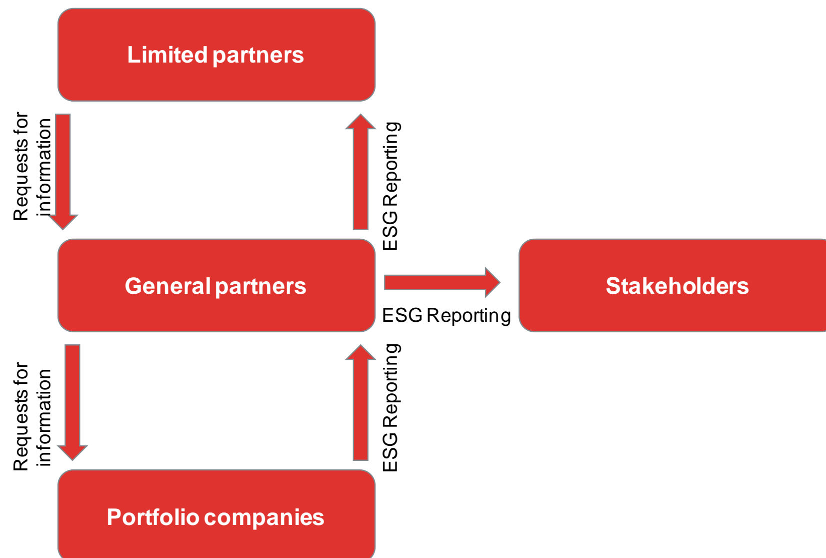
Key Fact
GPs report on ESG issues to two audiences: LPs and other stakeholders.

PE firms report on environmental and social issues to two distinct audiences: (1) their LPs and (2) a more general audience made up of internal and external stakeholders, including trade unions, employees, civil society, and the media. These two audiences have distinct needs, and GPs cater to each audience via different means and channels.

While LPs benefit from privileged access to information through two-way dialogue with GPs, other stakeholders receive one-way communication through public reporting. Meanwhile, GPs collect ESG information from their portfolio companies.

"The overall objectives of our reporting strategy are to share the lessons learned from our ESG management efforts as well as answer the rising number of questions on ESG issues we get from our investors. Our goal is to have more thorough and detailed ESG reporting, although this is a work in progress."
—Permira

Figure 1: ESG information flow



How Do GPs Report on ESG?

REPORTING TO LPS THROUGH ON-GOING DIALOGUE

Before investing in a fund, an LP will seek guarantees that the GP has implemented adequate systems to integrate ESG factors in investment and management decisions throughout the investment cycle (due diligence, ownership, and exit). During this due diligence phase, the LP may send out a detailed ESG questionnaire, focused on the governance process, procedures,

"We want our limited partners to be at the forefront of our communication. If something happens at one of our portfolio companies, our limited partners will know first rather than finding about it in the press."

—Blackstone

and resources that the GP has implemented to systematically consider ESG factors in decisions.[6]

Once an LP has invested in a fund, the GP provides on-going ESG information to the LP through structured means such as annual or quarterly reports and on an ad-hoc basis through information events or following a controversial event at a portfolio company (e.g., a labor dispute or a serious health and safety incident).

Some examples of ESG dialogue between LPs and GPs on ESG issues are the following:

» Before investing in a fund, Dutch pension fund APG defines requirements of GPs' ESG disclosure during the fund life.

» KKR organizes regular ESG roundtables with 10 to 15 LPs and portfolio companies to discuss challenges and lessons learned of each of their ESG management efforts.

» The U.K. pension fund Universities Superannuation Scheme (USS) requests that GPs provide immediate updates if a potentially controversial event has occurred at a portfolio company.

During our interviews, GPs stated that providing the right level of disclosure to LPs can be tricky. A GP must determine whether an issue or an event at a portfolio company is material enough that they should share it with their LPs. LPs' expectations are not always clear.

Figure 2: Means of ESG reporting to LPs

[6] These ESG questionnaires are often based on a tool guide published by the UN PRI entitled Responsible Investment in Private Equity: A Guide for Limited Partners.

Key Facts

- Sixty-five percent of PE firms provide public reporting on ESG management, ranging from a high-level commitment to extensive reporting.
- Only two firms out of the 20 surveyed have published a dedicated ESG report.

REPORTING PUBLICLY TO OTHER STAKEHOLDERS

BSR reviewed the public ESG reporting practices of the 10 largest PE firms in the United States and the 10 largest PE firms in Europe, based on the Private Equity International (PEI) 300 2012 ranking.[7]

Sixty-five percent of firms reviewed publish some information about their approach to ESG management, spanning from a high-level commitment to a structured, dedicated report. Of the firms that do report, all mention their approach to ESG issues on their website, and 38 percent provide ESG information via their annual report or review. Only two of the 20 surveyed, KKR and Carlyle, publish a dedicated ESG report.

PE firms also use third-party channels to report on their ESG performance. For example, as a signatory of the PRI, Doughty Hanson (not included in the survey) discloses its responses to the annual PRI Reporting and Assessment Survey on the PRI website. Also, some PE firms have published case studies on the Private Equity Council website.

What Does GPs' ESG Reporting Cover?

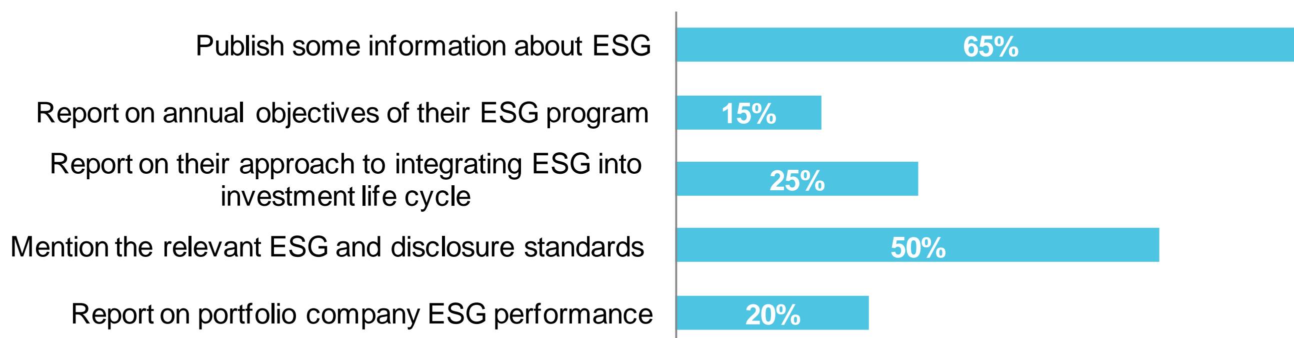
REPORTING ON TARGETS

Only three firms in the survey report on the annual objectives or targets of their ESG management approach.

REPORTING ON MEASURES IMPLEMENTED

Twenty-five percent of PE firms in the survey provide insight into their approach to considering ESG factors in investment and management decisions, such as information about governance systems, processes, dedicated human resources, or ESG improvement programs at portfolio companies. Half of the PE firms reviewed mentioned relevant standards on ESG reporting and disclosure, such as the PRI, Private Equity Council Guidelines for Responsible Investment, or the voluntary Walker Guidelines for Disclosure and Transparency in Private Equity.

Figure 3: Public reporting practices among the 10 largest U.S.-based and the 10 largest European PE firms



[7] PEI 300, Private Equity International, published May 2012, accessed July 16, 2012, www.peimedia.com/Pages.aspx?pageID=3391.

"The level of reporting on social and environmental responsibility issues by private equity funds across the industry at both the fund level and underlying portfolio company level is overall not sufficient to allow us to assess whether practices are in line with our expectations and requirements. APG typically requires additional ESG-related disclosure and reporting before it will make an investment. The general level of disclosure by the industry is inadequate and general partners should work to improve their reporting practices. This would help boost public perception and enhance the license to operate of the private equity industry, an industry that can do a lot to support innovation, economic growth and prosperity."

—APG

REPORTING ON PERFORMANCE

Twenty percent of the surveyed firms provided insight into environmental and/or social performance of portfolio companies, although almost all of them rely on case studies to do so.

Among the PE firms surveyed, KKR aims to measure the value created by its ESG programs by providing an aggregated overview of some of the environmental and social impacts of its portfolio. KKR publishes aggregated results of several portfolio companies enrolled in its Green Portfolio Program in terms of avoided greenhouse gas emissions, waste and water consumption. KKR also publishes KPIs on its portfolio's socio economic contribution including estimated 2011 net-employment and research & development dollars across its portfolio.

Key Observations

LPs SAY THE INDUSTRY' ESG DISCLOSURE IS INADEQUATE

A notable trend is that ESG issues are increasingly on the agenda of discussions between LPs and their GPs. Despite this positive trend, the level and maturity of ESG reporting by GPs across the industry fails to adequately meet the needs and requirements of LPs. According to a survey among PE and venture capital firms carried out by the British Private Equity and Venture Capital Association (BVCA) in November 2011, 55 percent of survey respondents had answered questions from their LPs on ESG management, while only 19 percent of respondents proactively communicated about ESG to LPs, showing a gap between expectations and results.[8]

PROACTIVE REPORTING TO STAKEHOLDERS IS ONLY EMERGING

Over the past two years, we have seen ESG reporting emerge among PE firms, with the publication of some firms' first dedicated ESG reports. However, BSR's review found that PE firms' public reporting lacks overall in quantity and quality. Of the PE firms under review, 35 percent of firms did not mention ESG considerations in their public reporting. Of the 65 percent that did, less than half present their objectives and/or provide insight into how they integrate ESG considerations into their investment decisions.

[8] "Evolving Views of Sustainability in Private Equity and Venture Capital," British Private Equity and Venture Capital Association, November 2011, accessed 21 August, 2012, http://admin.bvca.co.uk/library/documents/EvolvingViewsSustainability_Nov11.pdf

Stakeholder Expectations and Future Needs

The PE industry is facing increasing scrutiny and greater demand for transparency from its stakeholders, including investors, labor unions, regulators, and civil society. Facing increasing stakeholder expectations related to accountability, the PE industry will need to understand stakeholder demands for transparency and define proactive strategies to report how the industry contributes to social welfare and economic growth.

Key Finding
LPs seek to ensure that their GPs effectively integrate ESG consideration in fund management because they believe that this will benefit long-term returns by mitigating risks and improving competitive opportunities of investments.

Drivers of ESG Reporting among GPs

Although sustainability reporting in the PE sector remains an emerging practice, PE firms are increasingly devoting resources to effectively communicating their responsible investment strategies. ESG reporting among GPs is driven by pressure from LPs, civil society, and regulators, as well as an increasingly convincing business case.

DRIVER 1 | DEMAND FOR INCREASED TRANSPARENCY FROM INVESTORS, ESPECIALLY LPs
LPs are asking for more transparency around and disclosure of financial and extrafinancial risks from GPs. For example, the Institutional Limited Partners Association has published reporting guidelines to help standardize information flow in the PE industry between LPs and GPs.

"We expect General Partners to actively address ESG issues in portfolio management because this makes long-term business sense. GPs should also report back to limited partners and provide us with assurance that ESG factors are being considered in investment decision-making and asset management."
—Universities Superannuation Scheme (USS)

LPs will seek to ensure that their GPs effectively integrate ESG considerations into fund management because:

» LPs believe that this approach will **benefit long-term returns on investments by mitigating risks and improving competitive opportunities.** Leading investors argue that ESG factors may impact a company's bottom line, whether it is a private or public company, through the company's ability to access capital, avoid operational disruption, create demand for goods and services, or manage its liabilities.[9]

» Many large pension funds and other LPs are **signatories of the PRI** through which they commit to build ESG considerations into their investment process. The PRI has produced an aspirational guide that outlines how LPs can seek to ensure their GPs work consistently within these guidelines.[10]

» There is a growing view among LPs, especially pension funds, that they have **a fiduciary duty to their beneficiaries** to ensure that their funds are managed in line with internationally recognized standards.

Although GPs have discretion over investment decision making and ownership management, LPs typically commit capital to the fund based on their judgment of the GPs' ability to create long-term returns over the fund life. Strong ESG management may be a differentiating factor to raise funds, especially in a hypercompetitive industry and economic downturn, in which fund-raising is competitive. In addition, as more PE firms become publicly traded, listed firms must respond to increased investor scrutiny and focus on reporting.

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[9] "Responsible Investment in Private Equity: A Guide for Limited Partners," UN Principles for Responsible Investment, 2nd edition, June 2011, accessed August 21, 2012, www.unpri.org/files/lp_guide_2.pdf
[10] Ibid.

DRIVER 2 | PUBLIC PRESSURE FOR INCREASED ACCOUNTABILITY AND TRANSPARENCY IN THE INDUSTRY

PE firms increasingly face pressure from civil society for greater transparency and accountability. Reporting on how PE's active management of companies leads to societal benefits is a key part of responding to these stakeholders' concerns.

Civil society and the media

The PE industry has recently been the object of considerable negative media attention. In the United States, Mitt Romney's candidacy at the 2012 presidential election has stirred a debate[11] around the industry's economic and social impact, notably job creation.

Dominique Sénéquier, CEO of AXA Private Equity, states that the PE sector "has a pervasive image problem."[12] She summarizes the main points of public criticisms as follows:

» Through leveraged buyout deals, PE firms lead companies to take on more debt than they can manage.

» PE firms unfairly exploit tax advantages. Since interest payments on debt are tax deductible, a highly leveraged company will pay very little tax. Almost all its profits will go toward interest on its debt, resulting in losses for governments and fewer social welfare contributions.

» To improve a portfolio company's productivity, PE firms use cost-cutting methods that lead to redundancy plans and job destruction.

She states that "the industry's image has suffered a serious blow and must promptly take the necessary corrective actions, for example, by increasing its transparency through information openly provided not just to clients but also to the public, the financial community, and regulators." The public debate around the PE sector's impact provides the industry with an opportunity to measure its social and environmental impact and proactively communicate on its positive contribution to economic welfare.

Labor unions

Labor unions, such as the International Union of Food, demand greater disclosure and reporting from PE firms and portfolio companies. This process includes access to the full disclosure of the mechanisms behind the debt financing, the impact of investments on employment and public finances, and other information that unions require for effective collective bargaining.[13]

Employees

In a sector marked by strong competition for talent, reporting on its ESG management approach can prove an effective tool to engage employees and recruit and retain talent.

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[11] Peter Lattman and Annie Lowrey, "As Romney Advances, Private Equity Becomes Part of the Debate," January 20, 2012, *The New York Times,* accessed July 30, 2012, www.nytimes.com/2012/01/11/business/as-romney-campaign-advances-private-equity-becomes-part-of-the-debate.html?_r=4

[12] Dominique Sénéquier, "Does Private Equity Have a Future?," June 3, 2012, *ParisTech* Review, accessed July 30, 2012, www.paristechreview.com/2010/06/03/does-private-equity-have-a-future/.

[13] "The Commissioner, 'Transparency', and Codes of Conduct: the Last Refuge of a Scoundrel?," February 6, 2009, *The IUF's private Equity Buyout Watch*, accessed July 30,2012, www.iufdocuments.org/buyoutwatch/2009/02/the_commissioner_transparency.html.

"In reporting to our stakeholders, we aim to explain how KKR creates shared value to our investors and to society. The private equity industry has a unique opportunity to create shared value and we aim to demonstrate how this is done."

—KKR

"Private equity firms have a long history of measuring and improving financial performance. Applying the same rigor to ESG efforts could improve portfolio company operations, create value for investors, and ultimately help generate higher returns at exit. We expect to see this become a best practice across the industry."

—Environmental Defense Fund

DRIVER 3 | SOFT- AND HARD-LAW FRAMEWORKS ARE EMERGING AND INCREASINGLY RELEVANT

Although regulation is seen to have a marginal impact on driving change and improving disclosure in the PE sector, it is important to note the emergence of voluntary initiatives and regulations in the sector.

Voluntary soft-law initiatives include the following:

- The **Walker Guidelines for Disclosure and Transparency in Private Equity** is a voluntary set of recommendations for PE firms related to disclosure and transparency. These guidelines apply exclusively to U.K. portfolio companies and include a recommendation to provide information on environmental and employee matters.
- The **PRI** is currently piloting a new reporting framework for PE firms. PRI signatories commit to complete the reporting framework annually.

New regulatory frameworks affecting the PE sector include the following:

- The **European Commission Directive on Alternative Investment Fund Managers** (AIFM) is the first attempt in any jurisdiction to create a comprehensive framework for the direct regulation of hedge funds and PE funds, in response to the global financial crisis. The directive includes requirements to publicly disclose such information as the business plan. The European Parliament voted the law in late 2010, which is scheduled to become national law by 2013.
- In the U.K., PE firms are captured under the **CRC Energy Efficiency Scheme**, which is a mandatory cap-and-trade system.

DRIVER 4 | ESG FACTORS ARE INCREASINGLY SEEN AS A DRIVER THAT CREATES VALUE

The PE industry is uniquely situated to create and measure value. The PE model is based on the fund manager's ability to find and grow investment opportunities, by driving additional value from performance improvements and operational efficiencies in portfolio companies. The industry increasingly sees ESG factors for example eco-efficiencies as fund value drivers.[14]

The PE's buy-to-sell model (with an average holding for a portfolio company three to seven years) presents a unique opportunity to measure value created by ESG improvements. Some PE firms, such as KKR and Doughty Hanson, provide the sector with examples of measuring the dollar value created by their ESG efforts. For example, Doughty Hanson claims that its environmental improvement programs in portfolio companies have led to savings and additional income of €18 million with a further planned €21 million.[15]

A report published by WWF and Doughty Hanson[16] presents different methodologies to measure value created by ESG improvements. One model, developed by PricewaterhouseCoopers Sustainability and Climate Change practice, used to value risk and opportunities in a portfolio company, identifies ESG value drivers and measures their contribution to the bottom line.

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[14] "Responsible Investment: Creating Value from Environmental, Social, and Governance Issues," PricewaterhouseCoopers, March 2012, accessed August 21, 2012, www.pwc.com/en_GX/gx/sustainability/research-insights/assets/private-equity-survey-sustainability.pdf

[15] "Private Equity and Responsible Investment: An Opportunity for Value Creation," Doughty Hanson & Co and WWF, accessed August 21, 2012, http://assets.wwf.org.uk/downloads/private_equity_aw_lores_2.pdf

[16] Ibid.

Stakeholder Expectations

To define their approach to ESG reporting, fund managers should identify their stakeholders' expectations. Our research found that stakeholders, including investors and civil society, expect GPs to report on (1) the process by which they actively integrate ESG considerations at all stages of the investment life cycle and (2) their fund's ESG performance, including how their responsible investment approach leads to real sustainability improvements and value creation in their portfolio companies.

"You can't manage what you don't measure. EDF believes that active measurement and management of ESG factors creates economic value for investors. The gold standard today is clear, credible metrics and concrete, measurable results."
—Environmental Defense Fund

FUND MANAGERS ARE EXPECTED TO REPORT ON THEIR PROCESS

Among the range of ESG issues facing PE firms, implementing adequate processes to manage ESG risks and opportunities is a material issue for the sector. GPs are expected to report on how they actively integrate ESG considerations into fund management and investment decisions.

The LPs' leverage lies in influencing the investment process rather than in specific investment decisions. LP investment involves a "blind pool commitment, meaning that when an LP decides to invest in a fund, they can define the investment strategy, but the underlying assets are not known."[17] Therefore an LP's investment decisions are largely based on its confidence in the GP's governance systems and track record. LPs cannot materially influence specific investment decisions, but they can significantly influence the decision-making process.

Stakeholders, especially LPs, need assurance that the GP has:

» implemented adequate tools and processes to identify and manage risk in the portfolio as well as capture opportunities for value creation throughout the investment cycle (acquisition, hold, and exit);

» dedicated knowledgeable staff to implementing the processes; and

» established a process to engage with external stakeholders when appropriate.

During our interviews, GPs stated that defining relevant process-oriented KPIs that illustrate their approach to integrating ESG considerations in investments can be a challenge. For example, one proposed KPI may be the number of deals a PE firm did not make following ESG considerations. However, this KPI could be influenced by the sectors' the PE firm is investing in rather than by the PE firm's policies.

FUND MANAGERS ARE EXPECTED TO REPORT ON THEIR PERFORMANCE

PE firms are expected to connect their policies with performance results and report on how their responsible investment approach leads to real sustainability improvements, and if possible, growth in the value of their portfolio companies. GPs should focus on identifying, measuring and reporting KPIs that inform stakeholders about the environmental and social impacts of their portfolio companies and illustrate how their investment decisions contributes to economic growth and well-being.

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[17] "Responsible Investment in Private Equity: A Guide for Limited Partners," UN Principles for Responsible Investment, 2nd edition, June 2011, accessed August 21, 2012, www.unpri.org/files/lp_guide_2.pdf

Many PE firms report on their portfolio's ESG performance through case studies, resulting in a risk that this reporting translate into anectodal information. Aggregate indicators, demonstrating performance across a portfolio, can be a powerful tool, although there are evident challenges to defining and tabulating relevant aggregate KPIs.

During our interviews, fund managers stated that defining the right KPIs and collecting relevant and comparable ESG performance data at the portfolio company level can be tricky, considering the diversity of portfolio companies across different sectors and geographies. The challenge is to strike the right balance between standardization and comparability of data with applicability across a diverse portfolio of companies.

In thinking about reporting on aggregate KPIs, fund managers should keep the following in mind:

» Fund managers should not act as a repository of data for their portfolio companies. However, GPs should promote reporting from their portfolio companies, by requesting targeted and relevant ESG-related data.

» To define relevant KPIs, fund managers should identify material issues for each industry present in their portfolio. While some performance indicators may be relevant across the portfolio (e.g., organic growth of employment), other indicators may be applicable only for a defined set of industries (e.g., water use). Lack of comparable data should not prevent PE firms from providing key performance results.

Table 1: Examples of broadly applicable KPIs

Environmental	Social	Governance
» Tons of GHG emissions » Tons of hazardous and nonhazardous waste sent to landfills » Metric cubes of water consumed » Tons of forest products consumed (as a proxy for resource use)	» Organic growth of employment » Investment in R&D » Capital investment » Gender balance and percentage of minorities in leadership positions	» Contribution to taxes » Presence in tax havens

Recommendations to GPs

"We'd like to see the private equity industry develop a voluntarily baseline ESG reporting best practice framework. The framework could inform how general partners report to limited partners and external stakeholders. This would create a win-win-win situation for all."

—APG

BSR recommends that fund managers improve their ESG reporting practices by defining a robust and proactive approach to reporting on the process and the results of their ESG management efforts. In particular, BSR recommends that GPs:

- **Use a materiality assessment** to identify the issues that are most material to your company and should be the focus of your ESG report. Engage with your stakeholders to identify their expectations and inform your materiality process.
- Provide investors and other stakeholders with insight into your ESG management **objectives and performance results.** Define annual objectives and targets, and report your results against these targets annually. Objectives and KPIs can be quantitative or qualitative.
- At the portfolio-company level, **define a core set of KPIs** to track and collect data that is applicable across the portfolio (e.g., net employment, investment in R&D, and contribution to taxes), as well as sector-based KPIs for high-risk sectors (e.g., environmental data).
- **Develop a tailored approach** to reporting to LPs and other stakeholders, considering the needs of each audience. For reporting to LPs, integrate ESG information into **existing channels for investor communication** such as annual and quarterly reports or LP advisory committees.
- **Build a long-term strategy** for ESG reporting. You may not be able to achieve everything the first year, but you should aim to implement your strategy step by step.
- **Collaborate with the industry** to define a reporting framework for the PE sector. This framework should apply reporting best practices as defined by standard-setting organizations, including the Global Reporting Initiative, the PRI, and the International Integrated Reporting Council (IIRC), as well as leading companies in other sectors.