Grant Thornton

ESG in Nordic Private Equity

The State of Play

1

June 2020

September 2020

Foreword

ESG within private equity was once believed to be trailing behind many other financial market participants, ostensibly due to a lack of transparency. However, many global investors are beginning to understand that ESG and private equity can have a rather beneficial relationship. This stems from the fact that private equity investments are generally based on active ownership strategies, typically with short to medium term horizons, where there is an opportunity to generate positive societal outcomes as well as increase financial returns. This win-win relationship is exactly what good ESG management is all about.

The problem for many private equity investors is that the journey is still relatively new. Expectations, methodologies, and frameworks tend to create confusion and, at times, inefficiency for those that end up playing a trial and error game. Even for those private equity investors who have been working with these questions for a longer period, may find it reassuring to understand not only what are common approaches among their peers, but also how other investors might be developing new and innovative solutions to further integrate ESG.

We also understand that advisors, like ourselves, play a critical role in advancing ideas and methodologies to support our clients. Hence, we took this study upon ourselves to better understand how some of the leading private equity firms in the Nordics are approaching ESG within their own investment cycles. Additionally, we hope to uncover new and innovative methods to accelerate ESG integration within the private equity asset class.

Lastly, we would like to thank those who have participated in this study. All have been tremendously helpful and transparent in doing their part in advancing the transition to a more sustainable economy. We hope this research provides valuable insights to all asset owners and asset managers investing within private equity markets.

Timothy Buckby
Manager Advisory
ESG & Sustainable Finance

Markus Håkansson
Manager Advisory
Sustainable Business Services

Mattias Frändå
Associate Advisory
ESG & Sustainable Finance

About the authors

Timothy Buckby

Manager Advisory
ESG & Sustainable Finance

Timothy is a specialist within Sustainable Finance and the team-lead for Responsible Investment Advisory within Private Equity. Having exposure to privately owned SMEs and private equity investors, his primary focus is within ESG due diligence, ESG strategy, and sustainability reporting. Timothy has also collaborated internationally to develop sustainable finance services and products for private equity within Grant Thornton member firms.

Markus Håkansson

Director Advisory
Sustainability Business Services

Markus joined Grant Thornton 2014 and he has been active in the business since 2002. Markus designed and built Grant Thornton Sweden's Sustainability Business Advisory and is currently engaged in integrating sustainability into Grant Thornton´s business areas. Sustainability Business Advisory Services are divided into five areas: Sustainable Finance, Strategic Services, ESG Education, Sustainability Reporting and Sustainability Audit.

Mattias Frändå

Associate Advisory
ESG & Sustainable Finance

Mattias joined Grant Thornton 2017 as a business advisor with a focus on sustainability issues. Since his start, Mattias has been heavily involved with assignments within sustainable finance. Mattias' primary tasks focus on ESG Due Diligence, Sustainability Reporting, Strategic Services, Sustainability Audit and Sustainability Assessment.

Our approach and purpose

The purpose of this paper has been to build understanding around a common approach to integrating Environmental, Social & Governance (ESG) aspects within Nordic Private Equity (PE) and to further develop best practice. In addition, this paper aims to assist General Partners (GP) to identify areas for development within their own practice. Moreover, we will provide an exploratory side-note to gain perspectives of Nordic Limited Partner's (LP) ESG expectations and commitments. Furthermore, we wish to build insights on the future outlook for ESG in both the Nordic and global PE markets.

During the period from April to June, 2020, Grant Thornton conducted qualitative interviews with 11 General Partners, as well as 2 Limited Partners. Each GP was located in the Nordics with the exception of one firm who, together with their Nordic Partner, included their Global Head (UK) of ESG, to discuss how ESG has been integrated both globally and into their Nordic division. Due to the prevailing situation with Covid-19, all interviews were conducted via video conference. One to three professionals from each LP/GP firm participated, all of whom had thorough insight on their firm's ESG practices.

Our interview questions for General Partners were designed to uncover ESG approaches within the following five areas; integration of ESG into the PE organisation, fund raising, deal sourcing, investing, active ownership and monitoring, and portfolio company exit. In addition, each interviewee was given the opportunity to speculate on the future outlook of ESG, as well as how covid-19 affects commitments to ESG.

Questions for the Limited Partners were designed to identify their expectations and perspectives on; GPs' ESG performance and reporting, important aspects related to ESG within fund selection, areas to develop, as well as future aspirations and requirements among their peers.

All data collected during the interviews were analysed and compared to identify common approaches as well as best practice. Best practice was identified when a GP demonstrated innovative methods to integrate ESG into their investing activities.

Number of General Partners interviewed:

11

Number of Limited Partners interviewed:

2

Content

Executive Summary

PE Organisation

To successfully integrate ESG into their investment organisation, top management buy-in was agreed by all of this study's participants as a critical factor. Activities and functions are often leveraged to build a basic level of understanding and knowledge among investment and portfolio teams. Although larger funds are generally more mature in their ESG efforts, smaller funds do believe they are able to integrate, build awareness and implement ESG decision fluidly. Among Nordic PE organisations, ESG linked remuneration can be best described as being in an exploratory phase. Nevertheless, a number of the GP participants provided examples of ESG incentive programs that were based on short-term objectives.

Fund Raising

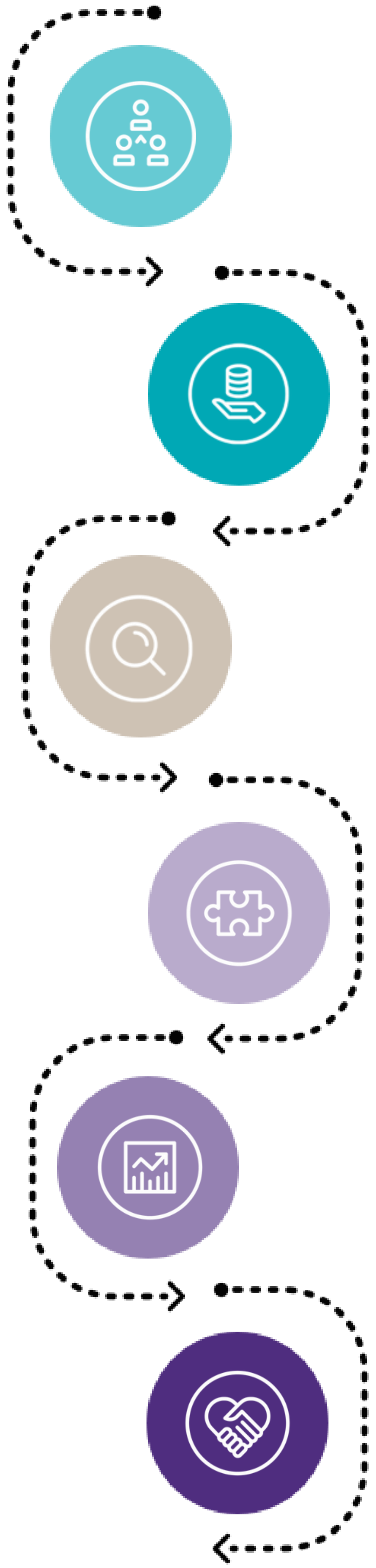
There is no doubt ESG dialogues in fundraising have increased ten-fold in recent years. A number of GPs have prosperously attracted capital from asset owners by leveraging ESG niched investment models and sustainable thematic philosophies. Nevertheless, there was a strong argument by almost all participants that LP expectations tended to be diverse and often made the task of aligning to all demands quite complex. Being proactive towards ESG during fundraising dialogues with numerous LPs, helped set the GP's own agenda. By demonstrating their ambitions, knowledge and the ability to create shared value, they are able to display the features that LPs are looking for in a GP.

Deal Sourcing

Deal sourcing ESG approaches differed among Nordic GPs. Nevertheless, the majority of the Nordic PE community agrees that the sourcing phase is becoming increasingly important considering the implementation of new regulations around green financing. GPs identify the risk that they may be left with stranded assets in the mid-to-long term as investor preferences are shifting towards investments that are suited towards a sustainable economy. Best practice demonstrated the ability to pragmatically integrate ESG into early stages of deal sourcing. Using an internationally recognised framework – such as the SDGs – to apply a thematic lens, appeared to be a helpful method to identify future trends and align with the global market.

Investing

Considering ESG has become an integral part of fund-raising agreements and GP investment strategies, ESG Due Diligence (DD) has also become a standardised section within transaction work streams. Historically, ESG DD has been heavily focused on compliance and possible risk aspects. However, in recent years GPs are increasingly including value creation opportunity within the assessments. Moreover, ESG has become a staple part of Investment Committees' (IC) discussions. It is uncommon that the IC includes a specific ESG position, yet in many cases, IC members are all expected to have a satisfactory understanding on ESG investing aspects. Lastly, ESG aspects impact investments decisions. There are numerous examples when an identified ESG risk was too high, leading to a non-invest.



Active Ownership

Integrating ESG into portfolio companies, vary between Nordic GPs. Approaches range from systematic requirements appearing compliance-like in nature, to more democratic approaches where GPs facilitated discussions with company management to determine their own sustainability pathway. An innovative approach to supporting investment, and portfolio, teams was by implementing an ESG manual/playbook to provide relevant information sources and support autonomous decision making.

ESG reporting and monitoring is an important aspect to not only gain understanding of portfolio company performance, but also a vital link to building trust and transparency between vital stakeholders. The utilisation of software to collect the necessary sustainability data has increased. The PE houses that use automatic ESG KPI monitoring are then able to follow the companies' ESG progress in a simpler and more reliable manner.

Exit

Many GPs are looking at how to systematically prepare ESG into the exit process. For many, the challenge lies in transforming the equity story for portfolio companies that were purchased in older funds. Due to the rapid development of ESG, older funds did not have the same exposure to ESG expectations during fund raising negotiations compared to today's standards.
Although many wish to see the evidence, Nordic GPs have not yet found a method to illustrate the tangible financial value that is created through ESG efforts. Albeit, all respondents argue that ESG supports value creation implicitly. All in all, Nordic investors appear to have moved on from the discussion and instead, focus on how they can leverage ESG to improve operational performance, access new revenue streams and build trusting relationships with both LPs and portfolio company management.

The state of play

In this section

Responsible investment - What is ESG?

"I think that the GPs that don't take it [ESG] seriously - or don't try to contribute to the best of their abilities - will have a harder time going forward. If you look at the new players that have popped up in the Nordic and European markets, a lot of them have specific ESG niches. What's interesting, is that many have raised funds extremely quickly – LP's seem eager to put their money into Sustainable Finance."
- Accent Equity, Tommy Torwald

The rise of Responsible Investment (RI) has not gone unnoticed among private equity investors. Specifically, Environmental, Social and Governance aspects of organisational performance is becoming a focal point for investors. ESG management is being used to not only manage assets in a responsible manner but also help improve equity valuations[1]. However, the emergence of ESG investing has also brought with it, a multitude of definitions, frameworks and investment strategies – so what do we mean by ESG investing? Simply put – **ESG has become an umbrella term for investors, and corporates, to identify non-financial aspects that may pose both financial risk and opportunity.** ESG provides the lens to analyse aspects that traditional financial analysis may have overlooked.

Furthermore, ESG has provided investors with a structured means to identify future trends and risks on potential target investments. Yet, also offers an inward spotlight on current portfolio hygiene factors. For example, portfolio companies which may be prone to high carbon emissions may be exposed to not only higher carbon taxes in coming years, but may also lower the commercial attractiveness towards potential buyers on exit. However, those same companies which are able to identify the risk early and begin to mitigate the risk through innovative measures and strategies, can take on the advantage of being a high performer in relation to their sector peers. Thus, providing investors with a better alternative compared to other potential investments with poor ESG performance. Yet more importantly, good ESG performance demonstrates a company's ability to innovate and adapt to future trends and stakeholder demands.

ESG aspects, by definition, are broad[2] (see diagram 1). What is important to understand, is the connection each aspect has to financial materiality. In essence, the multitude of ESG risks and opportunities which exist, need to be narrowed-down to which aspects have the ability to create or destroy value over the short, medium and long-term.

Keep in mind, definitions vary for what constitutes materiality. The Global Reporting Initiative (GRI) states that materiality has two dimensions[3]:

1) reflects the organisations most significant environmental and social impacts, and
2) has a substantial influence on the assessments and decisions of stakeholders.

On the other hand, the Sustainability Accounting Standards Board (SASB) addresses sustainability topics that are reasonably likely to have material impacts on the financial condition or operating performance of companies in an industry[4]. Regardless of definition, we see a common understanding which ESG has for Investors. They are non-financial aspects which have:

1) the ability to create and/or destroy value over time, and

2) has an impact on important stakeholder's perceptions and decisions.

Diagram 1
Source [2020] https://www.sasb.org/standards-overview/materiality-map/

1. MSCI, Foundations of ESG investing: How ESG affects Equity Valuation, Risk, and performance (2019)
2. The SASB Materiality Map
3. GRI Standards, https://www.globalreporting.org/standards/questions-and-feedback/materiality-and-topic-boundary/
4. SASB: https://www.sasb.org/standard-setting-process/conceptual-framework/

ESG vs impact

> *"In the transition to a more sustainable economy, we need both ESG and impact. ESG as a basis to ensure that all of our businesses have their house in order and run their companies in a sustainable, responsible and social manner. Impact is to identify, support and scale the solutions for today's biggest societal challenges."*
> *– Emma Verheijke, Partner, Grant Thornton, Netherlands*

In recent years the emergence of impact funds have increased. The Global Impact Investing Network (GIIN) estimates the size of the current market at USD 715 billion in AUM[1]. Like the multitude of definitions and meanings that come within the field of sustainability, the line between ESG and impact can at times be fuzzy. According to the GRI Standards, 'impact' refers to the effect an organization has on the economy, the environment, and/or society, which in turn can indicate its contribution (positive or negative) to sustainable development. It does not refer to an effect upon an organization, such as a change to its reputation[2]. On the other hand, the Impact Management Project (IMP) defines impact; "is a change in an outcome caused by an organisation. An impact can be positive or negative, intended or unintended[3]".

ESG refers predominantly to a company's operations, e.g. how they do business whereas impact usually refers to the outcomes realised by a company's products or services, e.g. what they do as a business.

For example: ESG refers to labour conditions in the value chain, CO2 reduction policy, code of conduct etc., and impact refers to a company developing and producing a solution for hydroponic farming thus addressing the global food challenge and preventing soil erosion.

In short, traditional impact investment funds have been known to provide flexible capital in areas where sustainable development is needed most, for example underdeveloped markets. In other words, true sustainable impacts can be understood as the ability to provide sustainable solutions that demonstrate positive impact, or reduce negative impact, in markets that were previously underserved.

GIIN defines impact using "the three I's": Impact investing is about **Investing** money (hence distinguishes itself from philanthropy), with the **Intention** to create positive, measurable **Impact**.

Traditionally, impact investing would usually entail a trade-off for below market financial returns. Nowadays, that is no longer the case. As the market matures, an increasing amount of impactful companies and solutions have great business cases and solid financial returns.
However, in recent times, investors are beginning to connect impact with positive results on ESG performance. Regardless of the fine lines between definition, it is important to understand that the term "impact", within investing, does have an explicit benefit towards stakeholders and/or contributes to solutions for sustainable development. Better yet, the IMP classifies impact investment into three main categories:

A	Act to avoid harm
B.	Benefit to stakeholder
C.	Contributes to solutions

Furthermore, the IMP provides investors and enterprises with tools to identify and measure their positive and negative effects on people and planet. In particular, the IMP reached a global consensus that impact can be reached across five dimensions (see diagram 2.)

Impact dimensions and questions each dimension sees to answer:

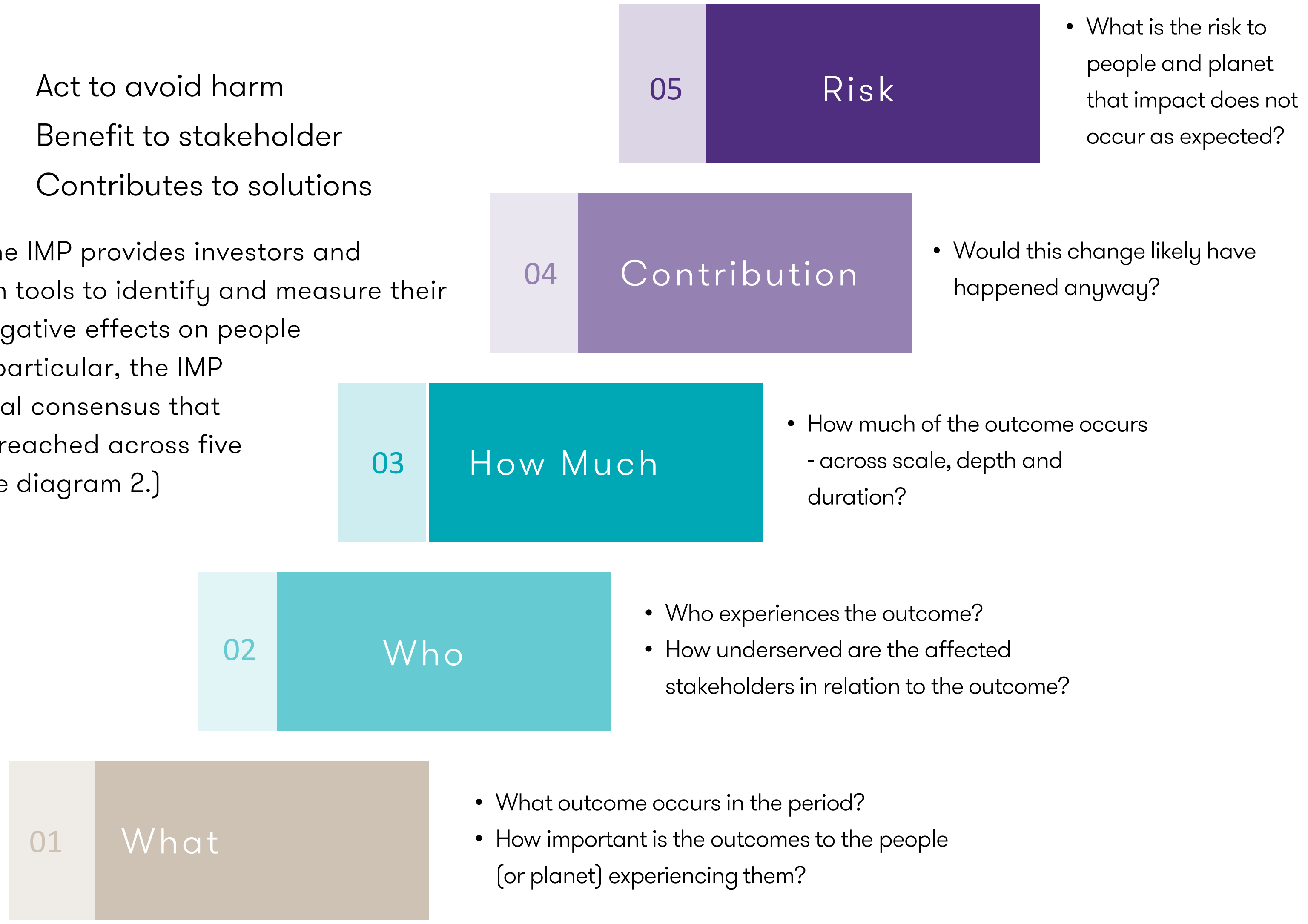


Diagram 2
Source [2020] https://impactmanagementproject.com/impact-management/impact-management-norms/

1. Global Impact Investing Network, 2020 Annual Impact Investor Survey
2. GRI Standards, Materiality and topic Boundary
3. Impact Management Project, Impact Management Norms

PE – ESG investing approaches

The development within ESG investing is constantly gaining more traction. A recent study by Bain and Company has revealed that 80% of global investors have more focus on sustainability than they did five years prior[1]. Furthermore, the UN PRI's signatory list continues to grow. As of early 2020, PRI signatories with approximately 90 trillion AUM are collectively committing to further mainstream responsible investment[2]. This increase in awareness has also brought with it; competition, innovation and segregated investment strategies.

Many PE firms in the Nordics, and internationally, are rethinking their investment strategies to incorporate ESG to stay competitive and even differentiate themselves from their peers. Interestingly, there has been a number of newly established PE firms that have ESG and impact as a central part of their investing philosophy. Having a sustainable thematic fund has been said to attract capital prosperously. However, many are curiously awaiting to observe how ESG can provide tangible financial value on exit.

Nevertheless, PE investors are to define their own ambitions in how far they wish to integrate an ESG mindset into their investment process. It goes without saying, the multitude of ESG frameworks and strategies hasn't made things easy for the 'traditional' PE investor. Nonetheless, if we exclude philanthropic investing, sustainable investing approaches within PE can be narrowed down into just a few categories. Howbeit, it is not uncommon to see a combination of the listed approaches (see table 1).

Active ownership – a natural approach

For most public equity investors, Active Ownership is a responsible investment strategy of its own. However, an important element of the PE asset class is built on a foundation that buyers take an active role in supporting management to improve the company's current strategic focus and financial management. Once a PE investor has committed to actively engage with their portfolio companies on ESG matters, naturally, an active ownership strategy has been incorporated. However, the level of ambition is what varies between investors.

Common sustainable investment approaches in PE

	ACTIVE OWNERSHIP				
TYPE	ESG RISK-BASED	ESG OPPORTUNITY	ESG TRANSFORMATION	ESG THEMATIC	IMPACT INVESTING
FOCUS	Compliance focus	Performance and efficiency approach	Leveraging active ownership to transform traditional business models into future fit businesses to achieve positive impact	Investing in products and solutions that contribute to sustainable development	Investing in services and products that provide sustainable development in underserved markets
DESCRIPTION	Investors apply an ESG lens to identify current and/or future risk that may have a negative effect on cash flows and exit valuations. Due diligence findings and a 100-day action plan is important aspect to this approach. Furthermore, regular ESG reporting plays an essential role to mitigate, or identify early warning signs on any negative impacts.	Investors have identified the portfolio company's ESG aspects which have the largest exposure to leverage new revenue streams, increase operational efficiency and reduce costs/expenditures. For the investor, increasing operational efficiency whilst reducing the portfolio company's negative ESG footprint, is a win-win.	Investors seek out traditional "business as usual" investment opportunities. However, they provide management with support to integrate structured ESG processes and transform the business model to be more sustainable. Consequently, creating a positive impact. This approach supports the transition towards a sustainable economy.	Thematic investing by definition is an approach that aims to take advantage of macro-level trends. In this case, investors seek out potential targets that offer thematic exposure to environmental and social themed products and services.	Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return[3].

Table 1.

1. Bain & Company (2019): https://www.bain.com/insights/private-equity-investors-embrace-impact-investing/
2. UNPRI (2020): https://www.unpri.org/pri/about-the-pri
3. GIIN: https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing

Future outlook

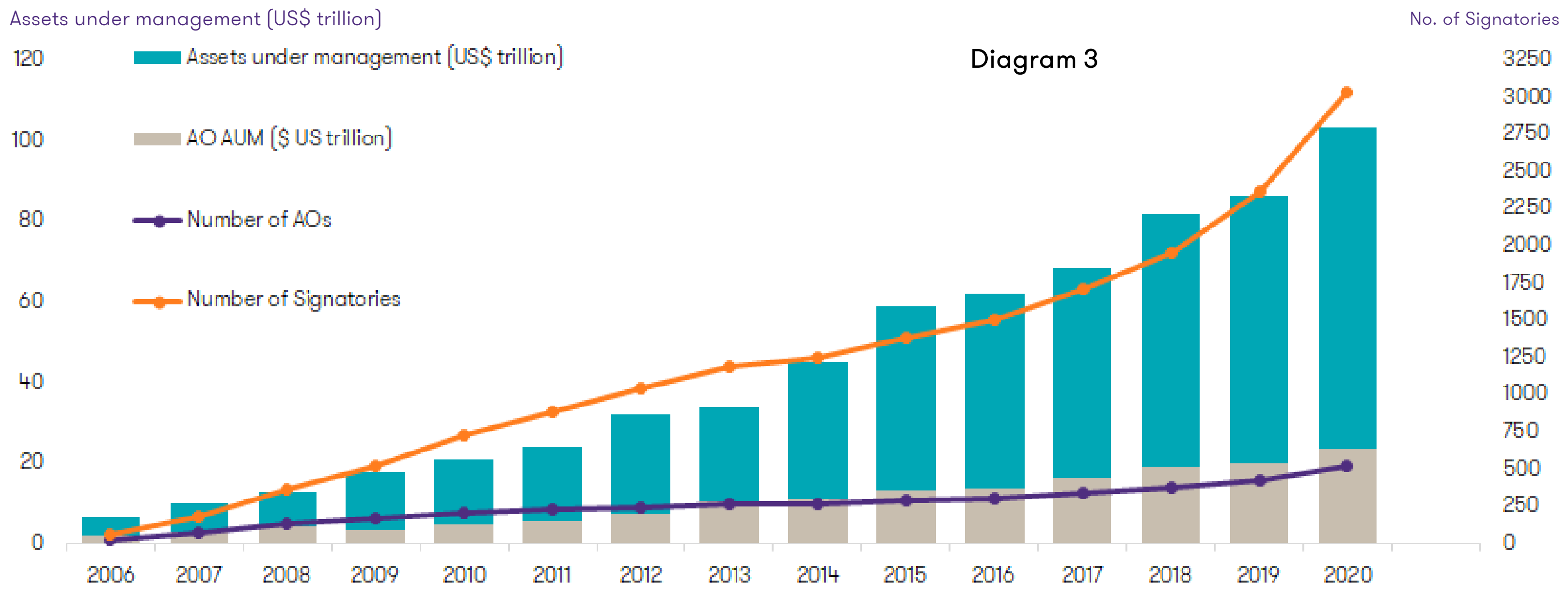
The current momentum of sustainable investing continues to move at a rapid pace. UN PRI signatories have grown year-on-year since inception – now totaling 90 trillion USD AUM[1] (see diagram 3). Nevertheless, the current Covid 19 pandemic has brought on discussions of whether, or not, ESG may be put on hold. This was not the case for AP6, a Swedish pension fund:

"We will continue with our plans to integrate ESG. As investors we want to see resilient companies that can continue to perform in various environments. ESG integration is key in this respect and more important than ever before. During the acute phase of the pandemic there may be need for a short-term change of ESG priorities, but we see no decrease in medium- and long-term priorities."
– AP6, Anna Follér

Current studies are revealing that companies which are performing well with ESG tend to be more resilient than those which are not. Amundi Asset Management reports: Companies integrating an ESG approach recognised by investors and ESG funds have been more resilient in the recent crisis period[2]. This was also reiterated upon during discussions with Nordic PE investors:

"Thematic investment pays off, which has become even more apparent during the COVID-19 pandemic. Companies that contribute to resilient and essential services for society, are coming out stronger." – EQT, Therése Lennehag

Diagram 3



1. UNPRI (2020): https://www.unpri.org/pri/about-the-pri
2. Amundi Asset management (2020) The day after #3 – ESG resilience during the covid crisis: is green the new gold?

ESG value creation

Regardless of the ESG strategy employed, let us not forget a central theme to sustainable development – value creation. Value creation has traditionally been embedded in private equity norms and mantras. However, ESG investing has provided an extra lens for investors to have an ever more holistic value creation approach. ESG value creation is about creating sustainable value that has a positive effect on both economic aspects for the investor as well as ESG, or non-financial, aspects that contribute to positive outcomes in society. Inversely, ESG value creation minimises negative impacts of the current economy's status quo, consequently, supporting the transition to a sustainable economy.

An LP perspective

There is no "one size fits all" ESG approach. LPs look for top management buy-in, a plan going forwards and most of all, trust and transparency.

The Nordic market has been renowned for being a front-runner in sustainable development and innovation. In contrast, Private Equity has often been labelled as being behind the curve when it comes to sustainability, primarily due to a lack of transparency. Howbeit, we have seen an incredible surge in recent years within sustainable innovation and practices among Nordic PE houses. Without referencing any particular evidence, it can be assumed that ESG practices within Nordic PE has been pushed onto the agenda via LP demands and expectations. Now we are seeing a successful alignment between LPs and GPs. In fact, certain Nordic GPs are pushing the agenda proactively, and exceeding expectations:

"Our feeling is that it has now gone from the LPs driving ESG, to the GPs being the driving force, unlike 4-5 years ago. There has clearly been an increased interest in ESG among GPs. For example, ESG expertise is being added to teams in all geographies and ESG specialist roles are likely to take an active part of the core investment – or operations processes."
- AP6, Anna Follér

For many Nordic LPs, ESG is playing a prominent role in fund selection. Considering their investment mandates are long-term, an ESG lens can help minimise, or avoid, long-term risk that may result in stranded assets. On the other hand, ESG can help identify trends and help to identify business models that will create long-term value and resilience.

"ESG is one of six perspectives when we invest in PE funds. If we are not comfortable in terms of commitment, approach etc. then it can be a deal breaker. In one occasion a few years ago, there was an ESG policy in place, but there was a lack of mindset related to ESG, there was no ambition to raise the bar and strengthen ESG integration. We concluded the risk for us was too high and walked away." - AP6, Anna Follér

Although this paper is focused on the Nordic PE market, ESG development is not only limited to the Nordics. Due to incoming EU regulation – the EUs Sustainable Financial Action plan[1] – discussions have increased ten-fold amongst asset owners and asset managers.

"We see many European LPs that are driving the ESG agenda, in the Netherlands, UK, France in addition to Nordic LPs. We have also noticed an increase in ESG-ambitions and requirements among US LPs since a couple of years back." - AP6, Anna Follér

Lastly, for a GP that is beginning their ESG journey, LPs are not necessarily looking for the most complex and futuristic ESG strategy, but more importantly an ESG mindset. There is no one size fits all ESG approach, therefore LPs look for top management buy-in, a plan going forwards and most of all, trust and transparency.

"What we want to see and figure out when we do the due diligence is if ESG is something that they are committed to for real or is it just something they have as a policy in the drawer. We want to see if they care about it and really work with it. But we are not, at the moment at least, pushing a specific reporting framework. But I think in the future for us to be able to follow and document the progress, we will need to have a more formalized reporting standard"
- Sampension, Andrea Zerath & Steen Hauskou Bertelsen

1. European Commission: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

An LP perspective

Although ESG momentum appears to have a strong foothold for financial market participants, there are a number of areas for Private Equity investors to consider going forward:

1. ESG reporting
2. ESG integration
3. Quantification of climate impacts
4. Quantifying the effects of ESG to tangible financial value on valuations

"There will still be focus on increasing disclosure and the reliability of non-financial data. We may also see a focus on valuation and exit regarding the connection of ESG on financial returns. Lastly, we to see more of the GPs looking to quantify the fund's impact on climate change" - AP6, Anna Follér

ESG reporting is the most common challenge among LPs and GPs. From the LPs perspective, they are calling for more reliable and comparable data. Meaningful data that can identify risks and trends whilst at the same time, providing transparency.

"Going forward, we would like to see quantitative, comparable ESG-data in order to facilitate data aggregation on portfolio level. ESG-reporting has developed greatly in the last five years in PE and we see some advanced practices in several of the Nordic PE firms. However, today we see a mix of different KPIs as well as a variety of qualitative information. Hopefully, new data collection technologies and continued dialogue in the market will lead to greater standardisation of ESG-data in PE over time. It shouldn't be impossible to compare ESG performance in a similar manner as we already compare financial data" - AP6, Anna Follér

On the other hand, GPs are calling for a more standardised approach from the LP community. A myriad of standards and expectations are troubling GPs, specifically small funds that rely on slim organisations with limited resources to fulfil multiple expectations.

Nevertheless, the pros and cons that come with standardisation need to be addressed appropriately so we don't lose sight on what is most important – forging sustainable development and value creation.

"I hope that there are more LPs and GPs that would like a better reporting standard. I also hope and think that the 'E' and 'S' will be a more integrated part for LPs, not only on the mitigating risk side but also more as an investment opportunity." - Sampension, Andrea Zerath & Steen Hauskou Bertelsen

The GP firm

Achieving ESG integration

In this section

Top management buy-in

Overall ESG objectives and strategies

ESG teams and resources

External support and training

ESG remuneration

Top management buy-in

"We see top management buy-in in the Nordics. This is probably one of the success factors when it comes to how ESG-practices have developed in Nordic PE." – AP6, Anna Follér

Management buy-in has been agreed by all participants as a critical factor to successfully integrate ESG into their investment organisation. Although, the participants often appeared to be at different levels of maturity in their ESG journey, it became apparent that without top-management buy-in, it would create difficulty in moving from a compliance based approach to an integrated approach that is designed to create value. The difference between the larger and smaller GPs, is that the latter had the advantage of building awareness and understanding much quicker and fluidly within the organisation than larger PE firms. However, this has moved the larger funds to drive innovation on how to integrate ESG knowledge throughout the organisations, for example, raising ESG discussion high on the agender of board meetings and in some cases going public with a "statement of purpose".

"Internally, we have moved from being compliance focused to really being aware of the positive effect of ESG. We are a smaller firm that can take the discussions very open and easy, which has resulted in a high level of ESG buy-in" – Polaris, Henrik Bonnerup

"It starts with commitment from the top. The partners, and those who lead the investments - unless they feel committed and that they feel that this is important, it will be difficult. Then you need a basic level of understanding and knowledge in the investment team. Lastly, I would say to look at your core processes and identify where and how do you integrate it so that it becomes a part of the work that the investment teams do, the same way that they do a commercial Due Diligence - do you have a requirement to do an ESG Due Diligence? See how you can formalize it and build it into the core. That's the only way you make it stick."
- Summa Equity,
Helena Fagraeus Lundström,
Alexander Bjørklund

Best practice

Best practice begins with an ESG foundation within the partner group as well as the executive management. Whether a GP is mature or immature in their ESG journey, awareness and understanding is vital. Activities and functions must be leveraged to build a basic level of understanding and knowledge among investment and portfolio teams. Those demonstrating best practice, often have ESG and sustainability high on the agenda in annual meeting and other important stakeholder dialogues.

"A major milestone was getting the EQT Statement of Purpose signed by the Board and later having it integrated into the articles of association of EQT AB. It sends a strong signal to the market and all stakeholders - not least shareholders, clients and talent. If we don't create awareness and a movement, ESG will end up being a sunk cost, not the return on investment we are all seeking."
– EQT, Therése Lennehag

Lastly, firms that have clear high-level objectives and exert resources to align those targets with investment and portfolio teams, appear to achieve internal integration successfully.

"Top management endorsement is key to integrating ESG. And you have to walk the talk. It's easier because we are small, everyone is in the room when we talk about it and if somebody doesn't agree, it's in plain sight and we can discuss it directly."
– Impilo, Veronica Byfield Sköld

Best practice demonstrates:

1 Strong ESG knowledge and awareness in top management and the Board

2 Sustainability is prioritised on the agenda of strategic discussions

3 ESG objectives are implemented and relevant resources are provided to support alignment between executive management and investment teams.

ESG strategies and objectives

ESG and responsible investing does not have a one-size fits all approach. Typically, simplistic objectives with incremental steps are generally preferred rather than complex strategies and processes. Our interviews revealed that the majority of participants have implemented some form of implicit ESG objectives which acts as an ongoing process to further develop their sustainability efforts. In other words, incremental activities that can support investment teams and portfolio companies to transition into a sustainable economy. For example, establishing a sustainable culture within their portfolio companies through training and building case studies. However, many of the participants were in early stages of rolling out more explicit objectives that could be measured. For example, CO2 reduction targets indicated as a percentage of the portfolio's total CO2 output.

"The challenge remains to show that ESG objectives are integrated, because there is a risk that ESG becomes a siloed activity...you need to have sharper targets, not just the classical ones, you also have to have ambitious targets that you talk about on a higher level" – Impilo, Veronica Byfield Sköld

In general, ESG objectives should be aligned to the GPs knowledge and maturity on ESG topics. Through the implementation of simple objectives, such as implementing ESG as a standard agenda in board meetings, the GP is able to build awareness and begin exploring which explicit objectives can be aligned to the firm's overarching investment strategies.

Best practice

Those participants whom were seen to be exercising best practice, were often explicit in which ESG strategies and objectives they were pursuing.

"We aren't an impact investment fund, but we invest where we can have an impact...Its about how we team up with management to create a more sustainable business" – CapMan, Pia Kåll

Of course, those pursuing explicit objectives on the fund level often have a standard set of KPIs in place which were often related to; climate action, diversity and inclusion, transparency and business ethics. However, A number of GPs would also suggest the portfolio companies choose 3-5 company specific KPIs that could be used by the portfolio teams to monitor company specific risks and exploit opportunities.

"Diversity, climate action and transparency are a priority. We have a clear objective that all companies should progress in the sustainability agenda and we measure that through a sustainability scorecard. For example, we have a target that says: in two years of ownership, they should have identified their material ESG priorities and have attained minimum requirements in our scorecard." – Nordic Cap, Elin Ljung

"The SDGs are integrated into our investment strategy in the sense that our three investment themes that we have are linked to different SDGs or opportunities for businesses to contribute to the SDGs" – Summa Equity, Helena Fagraeus Lundström

Best practice demonstrates:

1. Material ESG impacts and opportunities have been identified within the GP's investment strategy and current holdings.
2. Targets have been set to reduce the portfolios negative impacts and increase positive outcomes
3. Relevant portfolio-level, as well as portfolio company specific, KPIs are routinely measured, monitored, and reported.

ESG teams and resources

The most obvious conclusion in our discussions regarding ESG teams is plain and simple - the larger the firm, the more resources devoted towards ESG efforts. That being said, smaller funds appear to have an advantage to integrate, build awareness and implement at a fast pace. Admittedly, larger funds have had the exposure to external pressure for an extended amount of time which can explain their further developed ESG processes and awareness.

> *“We see in our score on ESG assessment that also some smaller PE funds have high scores, despite less resources."*
> *– AP6, Anna Follér*

> *“We believe that ESG criteria are financially substantial in an investment process. So, you need to integrate it into the tasks. We believe, it’s not a good solution to only have an ESG team on the side.”*
> *- Sampension , Andrea Zerath, Steen Hauskou Bertelsen*

PE FIRM SIZE	STRUCTURE	UPSIDE	CHALLENGE
Large	Typically 1-3 fulltime ESG professionals employed.	• Builds awareness across the investment teams and provide the teams with sufficient knowledge and resources to integrate ESG activities into the investment process.	• Silos: difficult to achieve full integration. • Investment teams may feel that ESG is not their responsibility, consequently increasing the workload of the ESG professionals.
Small-Medium	Typically assigned as an add-on responsibility to an investment manager’s existing role.	• ESG tasks are integrated across the investment team which builds awareness and knowledge resourcefully. • Decisions can be executed efficiently.	• Lack expert knowledge resulting in trial and error inefficiency. • Increased external advisory costs due to outsourcing. • Low internal knowledge may adversely affect dialogues with LPs and other important stakeholders.

ESG teams and resources

Best practice

Best practice simply demonstrated the fund's ability to delegate roles and responsibilities across all functions. To accelerate integration, one of the larger GPs was in the process of introducing "ESG champions" in each investment team to support alignment with top-level objectives. Furthermore, three of the participants had implemented investment/management guidelines – in the form of playbooks - for investment teams, as well as for portfolio company management (See Diagram 4). However, it should be noted that a clear connection should exist between the two documents. Simple and shorter playbooks appeared to be more helpful for investment teams depending on their level of ESG maturity. Lastly, targeted ESG training for investments professionals were aimed to build an increased level of knowledge among the investment teams, thus, avoiding siloing and accelerating integration (see section External ESG support and training).

"Each team has a partner and an investment manager whom are responsible for integrating ESG" – CapMan, Pia Kåll

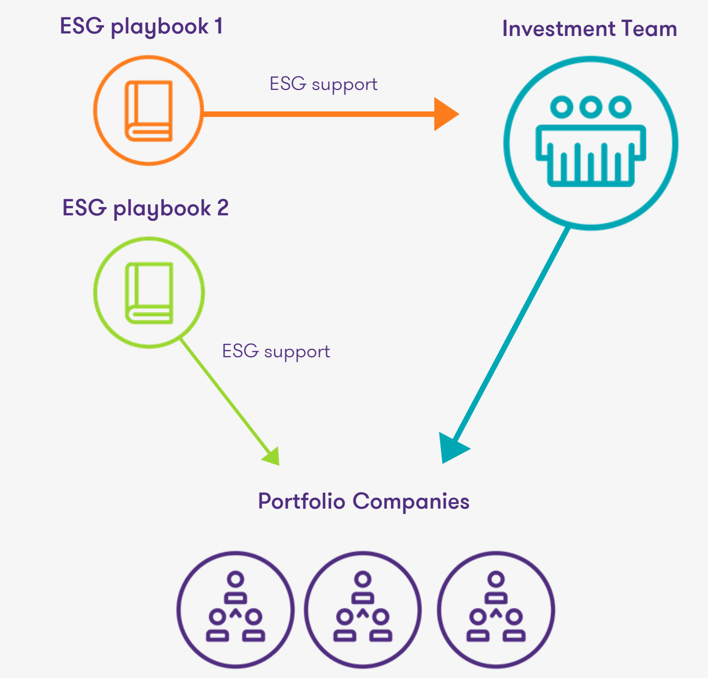
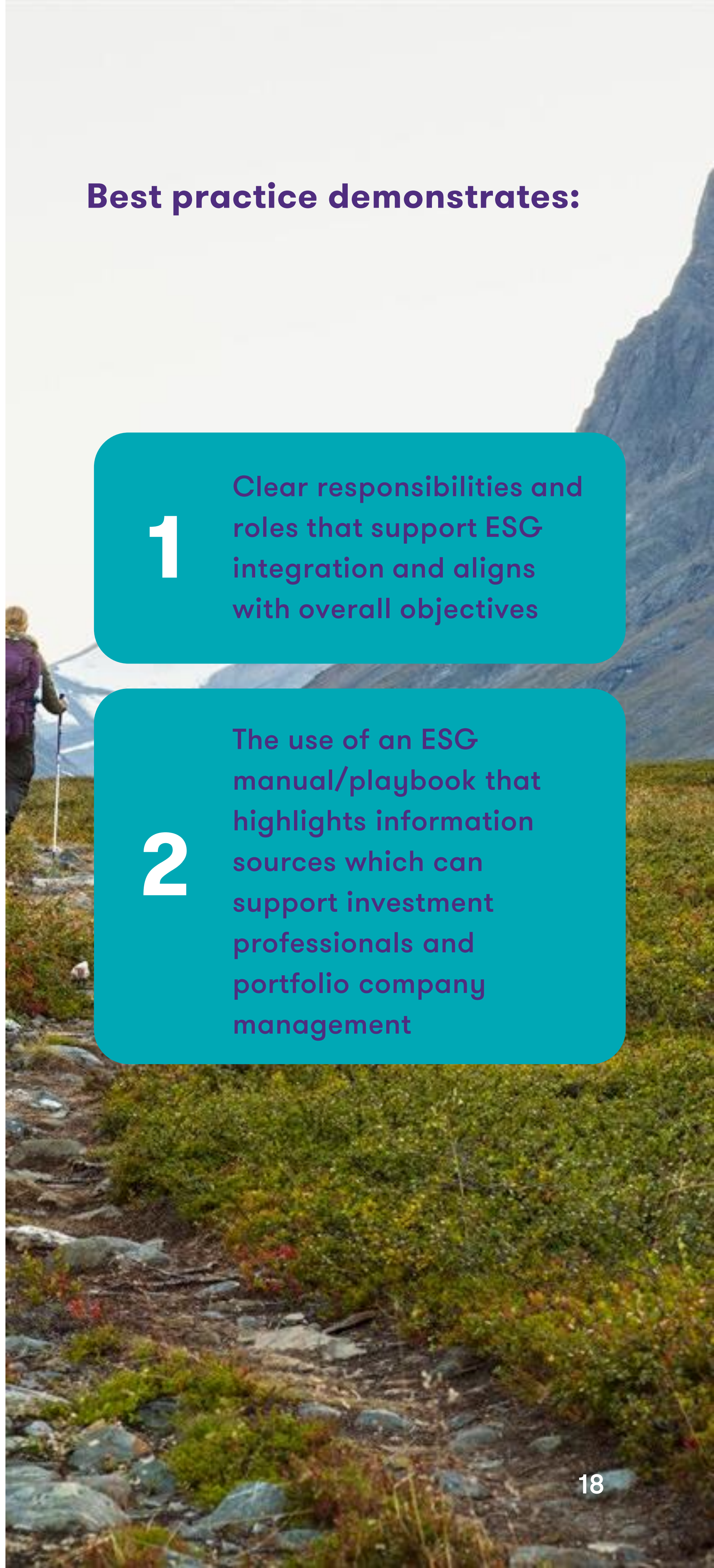


Diagram 4

"Being a small fund has its pros and cons regarding ESG – we don't have as much time or resources as the larger funds. However, we are able to communicate ESG matters clearly and effectively, come up with new ideas quickly and develop our companies accordingly"
- Intera, Otto Wirkkala

[Regarding siloing] "Because of the focus on training at an early stage in a more structured approach, it became very clear that it's the investment team that is responsible to integrate ESG in the investment phase and drive it with Board of Directors in the ownership phase. Because of that clear responsibility, we did not have the problem of a siloed ESG department"
- Nordic Cap, Elin Ljung

"We do not have a separate ESG-responsible role at the moment. This has been an ongoing discussion and learning process for us, and we are constantly testing new formulations. Currently we have a Sustainable Growth taskforce with mostly investment professionals. We also have an Investment Director taking on an internal secondment as Sustainability Lead at Verdane, to map out the next steps of sustainability integration into all parts of Verdane's investment process from sourcing to value creation to exit, and how that will look like from a resource-needs perspective."
– Verdane, Maggie Yang



Best practice demonstrates:

1. Clear responsibilities and roles that support ESG integration and aligns with overall objectives
2. The use of an ESG manual/playbook that highlights information sources which can support investment professionals and portfolio company management

External ESG support and training

In general, all the participants leveraged the use of external ESG advisors and consultants. However, the level of services rendered, tended to be broader – or basic – for GPs who were early-on in their ESG journey. For example, knowledge building, establishing ESG frameworks and compliance-based due diligence.

> *"Don't start out with ESG labels and colours if you don't have embedded things in your own organisation. If you make ESG just a part of compliance, then you are starting from the wrong starting point. It has been important for our journey to start internally and then build out. And now we are in the build out phase. So take in an expert that can educate the team, find out what is up and what is down" – Polaris, Henrik Bonnerup*

In contrast, those funds which have reached a higher level of ESG maturity – typically larger in size – engaged with more streamlined services such as CO_2 emissions counting or even collaborating with advisors to integrate ESG into commercial due diligence services. However, the common thread between all GPs for external support are; training services, reporting and ESG due diligence.

Training has played a crucial part in many of the most successful ESG strategies . Many of the participants have demonstrated some form of internal knowledge-building exercises. Specifically, training among investment teams has helped provide knowledge on how to leverage the multitude of ESG frameworks that can be integrated into the investment process.

"We have implemented a joint training along with external advisors which has been a very comprehensive program where the aim has been to get everyone up to at least a minimum standard. It's a course where our team meets on several occasions over a 8-10 month period. During the course, all participants are guided through the process of setting up a structure to work with ESG…we also use the course to build case studies to identify value creation opportunities"
– Accent Equity, Tommy Torwald

"Another success factor in ESG integration is capacity building. For investment professionals to take on board, diligence and monitor ESG, there must be a clear business case and understanding about material issues. In the Nordics, we have seen examples of advanced ESG capacity building programs for investment professionals as well as portfolio company employees and boards. Also, skilled in-house ESG expertise, working with the investment and/or operations team, will provide on-the-job capacity building and training. If ESG is less integrated and handled "alongside" or discussed as morality rather than a lens to see risks and opportunities, it is not going to be successful." – AP6

Best practice

Both large and mid-sized GPs revealed innovative ways of delivering internal training. An effective training program tended to be structured and delivered in a routine manner. Interestingly, training delivered as an onboarding requirement generally aligned to the aforementioned playbook, as well as demonstrating clear roles and responsibilities.

"We have the 'Summa academy' which is our internal training program. It's a part of the people onboarding process, where ESG and SDGs are integrated"
– Summa Equity, Helena Fagraeus Lundström

"All EQT staff receive training on sustainability when joining the firm as part of their introduction, and this is the same for everyone - investment advisory professionals, the finance department, assistants… Then we also have targeted training for investment advisory professionals where we focus on the mega factors, the societal challenges and the global goals that are shaping the markets in which the EQT funds invest. This is to create awareness that the greatest challenges can be our greatest opportunities and discuss how these are going to affect the commercial outlook, the investment case. We also go through the tools we have within EQT to navigate this landscape."
– EQT, Therése Lennehag

Best practice demonstrates:

1. The implementation of a structured training program that builds knowledge around roles, responsibilities and guidance on relevant frameworks
2. Tailored training that connects the overarching investment strategy, including industry and sector specific themes
3. The use of external experts to instruct on up-to-date ESG training and knowledge for investment professionals

ESG remuneration

Among Nordic PE organisations, ESG linked remuneration can be best described as being in an exploratory phase. Howbeit, remuneration appears to be a developing discussion among the majority of GPs whom are open to new models. Furthermore, remuneration and incentive programs were perceived as a means to accelerate ESG integration and value creation. On the other hand, one interviewee acknowledged that LPs are not interested at this stage, although that could change if we can tie ESG remuneration to increased returns and long-term risk reduction.

All in all, explicit ESG remuneration and incentives are immature, yet developing. A number of the GP participants demonstrated examples of implicit ESG incentives and were based on short-term objectives. For example, linking the Chief of Operation’s incentive program to the minimising of workplace accidents, aims to; lower sick days, promote positive employee welfare and improve operational efficiency. Consequently, creating tangible financial value.

“The challenge for ESG focused remuneration is that it is such a multi-faceted topic. But clearly something that needs to happen in order to make sure ESG is integrated throughout the organisation.”
– Altor, Stephanie Hubold

“Remuneration linked to ESG is an interesting question, and maybe it can be something that we would ask for in the future. It is well worth exploring. GPs implementing ESG related criteria in their remuneration program for portfolio companies, could be a good way to attack the challenge of getting ESG integrated.” - Sampension , Andrea Zerath, Steen Hauskou Bertelsen

Best practice

Albeit ESG remuneration discussions are developing, two participants exemplified incentive programs that were aligned to overarching ESG objectives of the PE organisation. In particular, one participant demonstrated an innovative “step-by-step” approach. All full-time employees have a percentage of their bonus tied to an ESG KPI. The first year was tied to identifying a shared value initiative which would support the maximisation of profitability and operational excellence whilst also having a positive impact on an E,S or G Factor. The following year would be to implement or roll out the initiative, followed by monitoring and reporting on the ESG KPI which was most relevant for the project.

“Verdane has incorporated ESG into firm-wide KPIs, which are linked to bonuses for everyone in the organisation. Specifically, for 2020 one of our core organisational KPIs is to have at least one sustainable growth initiative running in each core company [where we have a board seat and significant ownership] by the end of the year.” – Verdane , Maggie Yang

“Incentives need to be introduced in an environment where people feel trust and are transparent, because the last thing you want is for people to find smart ways to trick the numbers. In the end, it’s not about the exact number on paper, it’s about changing mindsets, encouraging a certain behaviour and thereby achieving the goals, the positive real world outcomes - and these goals must be simple and clear." – EQT, Therése

Best practice demonstrates:

1. Have identified ESG value creation initiatives that have the ability to create a positive outcome or reduce negative impacts whilst, at the same time, creating financial value
2. Establish incentive programs that are designed to accelerate ESG value creation initiatives
3. Routinely follow-up on selected KPIs to monitor progress on ESG initiatives

Fund raising

ESG approaches to fund raising

In this section

Fund raising and engagement with investors

Fund raising and engagement with investors

There is no doubt ESG dialogues in fundraising have increased ten-fold in recent years. A number of GPs have successfully attracted capital from asset owners by leveraging ESG niched investment models and sustainable thematic philosophies. Nevertheless, there is a strong argument by almost all participants that LP expectations tended to be diverse and often made the task of aligning to all demands quite complex. Many of the participants were calling for a standardised approach from the LPs. Nonetheless, all participants recognised that the LP's expectations and requirements are a driving factor for the development of ESG within the private equity asset class.

"What we hear from GPs is the frustration from receiving thousands of templates from different LPs and being unable to find a common standard of reporting. I think we are aligned in that we would also like to find a common standard."
- Sampension, Andrea Zerath, Steen Hauskou Bertelsen

Furthermore, many of the participants agreed they could be more proactive when it comes to ESG discussions during fund raising. Considering ESG is often being analysed as an important criterion for LPs, it makes sense for GPs to push their own ESG agenda towards potential clients and demonstrate how ESG is not only being managed on a compliance level, but also creating implicit and explicit value of their fund.

Nordic GPs and LPs agree that having ESG as a central theme creates an important foundation for building relationships with investors.

Interestingly, discussions with AP6 revealed some of the ESG factors they expect to see in a potential GP:

> *"For us, the most important thing is that GPs have the right mindset [buy-in], knowledge [capacity] and leadership to integrate ESG. How they do this, depends on their size, strategy, sectors and geography. GPs are themselves best equipped to develop their specific approach. Our role as an LP is clearly not advising on the how." – AP6, Anna Follér*

Best practice

Only a minority of the participants approached ESG proactively during fund raising. From an efficiency perspective, being proactive helped set the GP's own agenda during dialogues with numerous LPs. By demonstrating their ambitions, knowledge and the ability to create value, GP's are able to exhibit the features that LPs are looking for in a GP.

"For the past few years EQT's fundraising materials such as PPMs, portfolio data-books and DDQs have had integrated and dedicated sections on sustainability. We have also included specific sustainability content such as case studies, PRI transparency reports, EQT greenhouse gas emission reports and an extract of the EQT sustainability blueprint in the data rooms." - EQT, Therése Lennehag

> *"In our first fund (2015), you could say that one third invested because we were sustainable, one third invested because they trusted our investment team and one third invested because we were a thematically focused fund in the Nordic lower mid-market, and that was an exposure they [LPs] wanted…suddenly (in 2018-19) all LPs thought that because we were sustainable, and thematic investing became more mainstream, they were even more attracted to our strategy"*
> *- Summa Equity,*
> *Hannah Gunvor Jacobsen*

Best practice demonstrates:

1. A proactive approach to ESG during fundraising
2. Includes an ESG section in the VDR which can be used for ESG reports, transparency reports, incident cases with mitigation response etc.
3. Integrates ESG aspects into fund raising documentation, including LPAs, PPMs, investment policies and DDQ preparation
4. Case studies that validate tangible value creation

Deal Sourcing

Integrating ESG

In this section

Integrating ESG into deal sourcing

Integrating ESG into deal sourcing

Deal sourcing approaches differed among Nordic GPs. It makes sense that the integration of ESG into deal sourcing phases had to correspond with the investors ESG investment approach. For example, those participants who were focused on ESG transformation were not necessarily screening for any specific ESG themes. They were more concerned with what risks would be identified in the due diligence phase and whether or not they could make the desired transformation during the holding phase. On the other hand, those funds which had a thematic investment approach, obviously had more rigorous controls in the early stages of screening.

> *"Our mindset and purpose is investing to solve global challenges – what are the biggest problems we see around us? and from that screen, we can ask ourselves – what kind of companies will solve these?" – Summa Equity, Hannah Gunvor Jacobsen*

Nevertheless, the majority of Nordic PE participants agree that the sourcing phase is becoming increasingly important considering the implementation of new regulations around green financing. GPs identify a transition risk where they may be left with stranded assets in the mid-to-long term as investor preferences are shifting towards investments which are suited towards a sustainable economy. Moreover, many Nordic GPs were at least applying some form of exclusionary guidelines to their sourcing process early-on.

Lastly, although most sector-niched investment teams have the tacit knowledge needed to navigate the mega trends impacting their investments, many ESG managers feel the need to develop additional ESG perspectives into deal sourcing discussions. For example, applying SDG criteria and TCFD (Task Force on Climate-related Financial Disclosures) transition and physical risk perspectives. Furthermore, many GPs have begun to leverage the SASB materiality map as a guidance tool to build awareness of what sector specific ESG risks are relevant for potential investments. This also has provided investment professional with a useful tool to help establish ESG due diligence scoping.

"In say five years' time it's not going to be called ESG investing anymore. It is just going to be called investing, because ESG would be a central part of investing and not a special theme." - Sampension, Andrea Zerath, Steen Hauskou Bertelsen

Best practice

Best practice demonstrated the ability to pragmatically integrate ESG into early stages of deal sourcing. Using an internationally recognised framework – such as the SDGs – to apply a thematic lens, appeared to be a helpful method to identify future trends and align with the global market. Additionally, self-questionnaires were used by the investment teams to help identify whether an investment is aligned to the funds strategic ESG objectives or LP preferences. Traffic light status systems regarding EGS topics were also deemed useful to encourage discussion among deal team members as well as the IC.

"EQT uses the SDGs as a lens to understand how value chains have and will be reshaped; and what the company can do to either mitigate the negative impacts or amplify the positives." – EQT, Therése Lennehag

Best practice demonstrates:

1 The use of the SDG framework to identify whether a company has a positive impact (opportunity-based) or negative impact (risk-based) on any of the 17 goals

2 The use of a self-questionnaire for the investment team which include screening questions that have a clear connection to the funds strategic ESG objectives

Investing

In this section

ESG Due Diligence

Investment Committee integration

ESG impacts on investment decisions

ESG Due Diligence

Considering ESG has become an integral part of fund-raising agreements and GP investment strategies, ESG Due Diligence (DD) has also become a standardised section within transaction work streams. Historically, ESG DD has been heavily focused on compliance and identified risk aspects. However, in recent years GPs are increasingly including value creation opportunities within the assessments.

"We're in the process to establish equal focus on ESG risk and opportunity in our Due Diligence phase" – Altor, Stephanie Hubold

It goes without saying, the types of opportunities differ between sectors and industries. For example, for some industries, such as energy, sustainability themed products services are capturing new revenue streams. Whereas other sectors, sustainability strategies may only support the organisation's "social license to operate". In other words, the ESG strategy is used to protect value rather than build add-on value. Furthermore, investors want to identify opportunities to improve operational efficiency through better ESG management, thus increasing the bottom-line.

In general, all the Nordic GPs we interviewed were conducting some form of ESG DD, but with varying approaches. We separated the majority into two groups; 1) those who conduct ESG Due Diligence on all transactions (generally through external third parties), and 2) those who perform internal ESG assessments on all transactions yet outsourced the ESG DD process on selective transactions.

Additionally, the scope of ESG DD streams would often vary in the depth of scope depending on industry and geography.

A number of the GPs experience a challenge in moving away from traditional compliance based ESG DD to a more commercial attractiveness DD approach. Discussions pointed towards the need for increased collaboration with advisors to accelerate the maturity and integration of ESG into other DD streams, such as Commercial Due Diligence.

Finally, a number of discussions pointed to the need for investments teams to be better equipped to identify material ESG aspects. We identify a number of digital tools and frameworks that several GP's leverage in pre-DD stages to identify sector specific risks. The most commonly used framework was the aforementioned SASB materiality map. The participants agreed SASB is a helpful input to quickly gain an overview of sector-specific risks linked to sustainability, however, SASB is recommended to be used as a guidance since ESG aspects vary for each case, even within the same sector. Thus, involving external expertise was recommended for GPs who are beginning their ESG journey or lack the right know-how.

"We have our own materiality checklists and toolbox which is developed for a general healthcare company. Then, depending on what sub-segment there is, you may need to add other ESG aspects to it. The deal teams are then asked to do a first assessment within the team and discuss what material aspects to look at more in-depth and which ones that are less relevant." – Impilo, Veronica Byfield Sköld

Best practice

Those GPs who displayed best practice, conducted ESG due diligence on all transactions. This was usually a "must have" for the Investment Committee. The GPs who undertook this approach, believe they are able to not only gain confidence from a third-party opinion, but also satisfy LP requirements. Additionally, the due diligence process is utilised to examine the management's mind-set towards ESG. As previously mentioned, top-management buy-in is critical to exploit ESG value-creation opportunities as opposed to forcing the sustainability agenda.

Secondly, investment teams that are capable of conducting a thorough ESG materiality analysis were able to issue more streamlined DD scopes. Thus, creating a more cost-efficient DD process.

Furthermore, a tailored ESG DD that is aligned to the firms overall objectives creates efficiency. A GP's strategic objective should be integrated into the ESG DDQ. Thus, the investors are able to identify what ESG internal controls are weak, lacking, or whether, or not, corrections can be made accordingly in the initial 100-day action plan.

Best practice demonstrates:

1. Conducts ESG Due Diligence or integrates ESG aspects into due diligence workstreams on all transactions
2. Investment teams conduct a thorough ESG materiality analysis
3. ESG DDQs are aligned with the funds over-arching strategic objectives and vital stakeholder expectations
4. Leverage due diligence data to shape 100-day action-plans, as well as identify relevant KPIs to use in ESG reporting post-transaction

Investment committee integration

Investment committee integration

ESG has become a staple part of Investment Committee (IC) discussions among Nordic GPs. Although they vary in approach, the majority of participants have agreed that ESG has become a regular part of the IC's process. Similar to the ESG DD evolution, our discussions revealed ESG dialogues on the IC have developed over the years from a risk focus to now increasing the focus on opportunity.

It is rare that the IC allocates a specific ESG position, yet in many cases, IC members are all expected to have a satisfactory understanding on ESG investing aspects. Correspondingly, if an ESG aspects does create significant risk, the internal ESG responsible (manager) will be utilised in discussions.

> *"We feel it's necessary for everyone on the IC to have a strong knowledge about ESG. This is one of those cases where we feel that a specialist role on the IC is not the best way to go for Summa, we feel that this should be everyone's responsibility."*
> *– Summa Equity, Alexander Bjørklund*

ESG impacts on investment decisions

Seven out of eleven GPs have had examples where ESG aspects have impacted the investment decision. Whereas, the remaining four GPs explained ESG aspects have had a more implicit effect on investment decisions. For example, driving down the bid price, or a non-invest, due to a lack of confidence in management. However, the majority agreed that ESG aspects will increasingly become a focal point in investment decisions.

"If we, in the DD phase, find ESG risks or issues that we don't think that we can actually correct or improve, then we don't pursue that investment."
– CapMan, Pia Kåll

> *"ESG-aspects form part of the Portfolio Company's narrative and equity story, strengthening their market position and as such support a more attractive valuation multiple. You can also calculate the monetary benefits of efficient use of resources when relevant. Finally, the market is increasingly expecting a certain ESG hygiene level. Companies not reaching this level find it more difficult to attract capital. Robust policies, processes and tools when it comes to sustainability at the GP level help secure this level and provide comfort to counterparties. ESG is now a hard ask, not just a nice to have."*
> *– EQT, Therése Lennehag*

Best practice demonstrates:

1. ESG is integrated into IC discussions
2. All IC member have a satisfactory understanding on ESG matters, specifically regarding the fund's strategic ESG objectives

Active Ownership

An approach to integrate ESG into portfolio companies

In this section

Integrating ESG into portfolio companies

Motivating portfolio company management

ESG reporting and monitoring

Integrating ESG into portfolio companies

Processes for integrating ESG into portfolio companies, vary between Nordic GPs. Approaches range from systematic requirements appearing compliance-like in nature, to more democratic approaches where GPs facilitated discussions with company management to determine their own sustainability pathway. Although approaches varied, we observed two common threads among the participating GPs.

Firstly, many took a top-down perspective integrating sustainability into board discussions. However, the frequency to discuss sustainability topics varied between ad hoc to routinely – one to six times per year.

Secondly, management training was a common factor for integrating ESG into the portfolio companies. In some instances, GPs would organise knowledge-building activities in the form of sustainability themed conferences for all portfolio companies' CEOs and CFOs. On the other hand, some GPs introduced specific workshop-based sustainability training to support company management in understanding the different reporting frameworks and concepts, as well as, how to work strategically with material ESG aspects connected to their business model. Several of the study participants believed that ESG training not only provides portfolio management the knowledge to demonstrate how ESG can be leveraged to create value, but also the opportunity to meet informally with a diverse range of industry knowledge, maturity and ideas.

Best practice

A minority of the participants did appear to have an increased ambition level to integrate ESG into the portfolio companies. Best practice demonstrated a further clarification of top-down management, as well as a more systematic and structured approach with goal setting, developing value creation initiatives, actions-plans and follow-ups.

The structural approach to integrating ESG is often linked to a second version of the aforementioned ESG manual or playbook. However, this manual is developed towards portfolio company management teams rather than investments teams. The playbook/manual is a mandatory part of the onboarding program and clarifies the GP's sustainability-related expectations for the portfolio company, as well as what non-financial KPIs that the companies are expected to report annually. The playbook/manual also serves as a guide to support the companies' management on sustainability development and progress, including best-practice cases, examples of ESG initiatives and strategies, targets and visions, as well as frameworks. According to the GP, an ESG playbook helps the portfolio management to focus on realistic goals and not do "too much" at the same time; as well as focus on the key issues to allocate the right amount of resources.

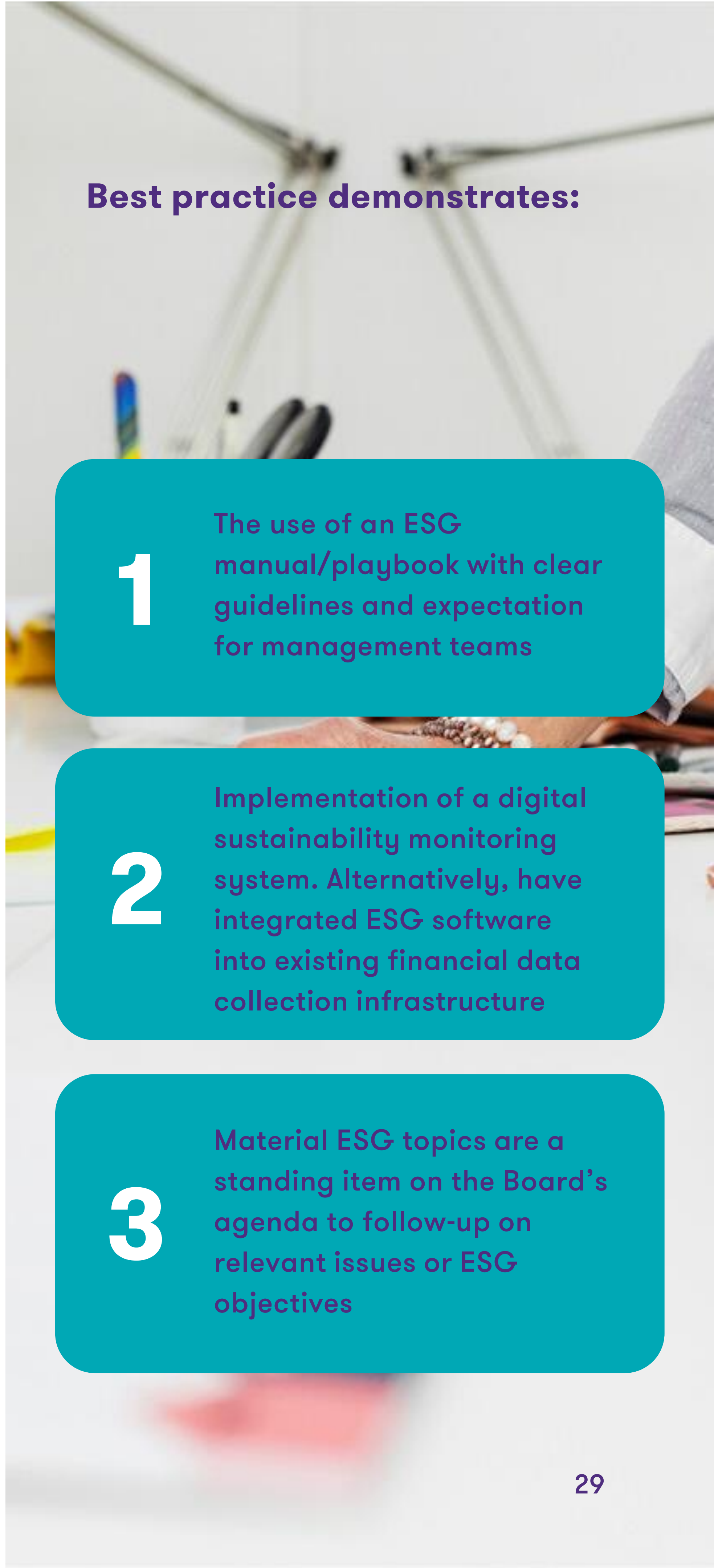
"There are too many companies saying that they support all 17 SDGs. Start with a maximum of two or three!" – Altor, Stephanie Hubold

"Our goal is to have at least one ESG ('sustainable growth' as we call it internally) initiative up and running in each company, and achieving this goal is not only an important part of our Sustainable Growth-oriented culture, but is also linked directly to compensation for Verdane team members"
– Verdane, Maggie Yang

A further success factor for integrating ESG is to utilize technical solutions to collect the necessary sustainability data. The PE houses that use big data and automatic ESG monitoring are then able to follow the companies' ESG progress in a simpler and more reliable manner. In the best-case scenario, the ESG monitoring system is integrated into their existing portfolio monitoring system which is used for the financial and valuation processes.

"The software for ESG reporting makes it a lot easier – a way to understand the portfolio's own status. It also helps in order to contribute to the SDGs"
– Nordic Cap, Elin Ljung

"It's a powerful and useful tool that provides us with a better summary of where our portfolio companies are at. We are also able to see where we need to channel our time and resources and be efficient at the same time." – Bridgepoint, James Holley



Best practice demonstrates:

1 The use of an ESG manual/playbook with clear guidelines and expectation for management teams

2 Implementation of a digital sustainability monitoring system. Alternatively, have integrated ESG software into existing financial data collection infrastructure

3 Material ESG topics are a standing item on the Board's agenda to follow-up on relevant issues or ESG objectives

Motivating portfolio company management

All participants agreed that gaining ESG buy-in from management teams is much easier today than it has been historically. It was unclear, whether this was due to younger generations joining management teams or simply, more social pressure has built awareness. However, getting management teams to commit and adhere to an ESG-strategy still provided GPs with challenges. One participant stated that the key to accelerate ESG implementation was having a CEO that can connect ESG to value creation in the bottom line. In other words, Nordic GPs understand that demonstrating the value creation aspect to ESG rather than the compliance-side is vital to implementing affective ESG strategies.

> *"The motivational part comes down to - are we managing for compliance or value creation? It's more appealing to a person when it points to value creation. In my opinion, that is the only way that you would implement successful sustainable change"*
> *– Altor, Stephanie Hubold*

"The carrot works better than the stick…it's about value creation… In my experience, to get management on board, especially if they are opposing or still don't quite understand the ESG angle, you have to showcase how this actually creates value for the business over time"
– Bridgepoint, Ann Dahlman, James Holley

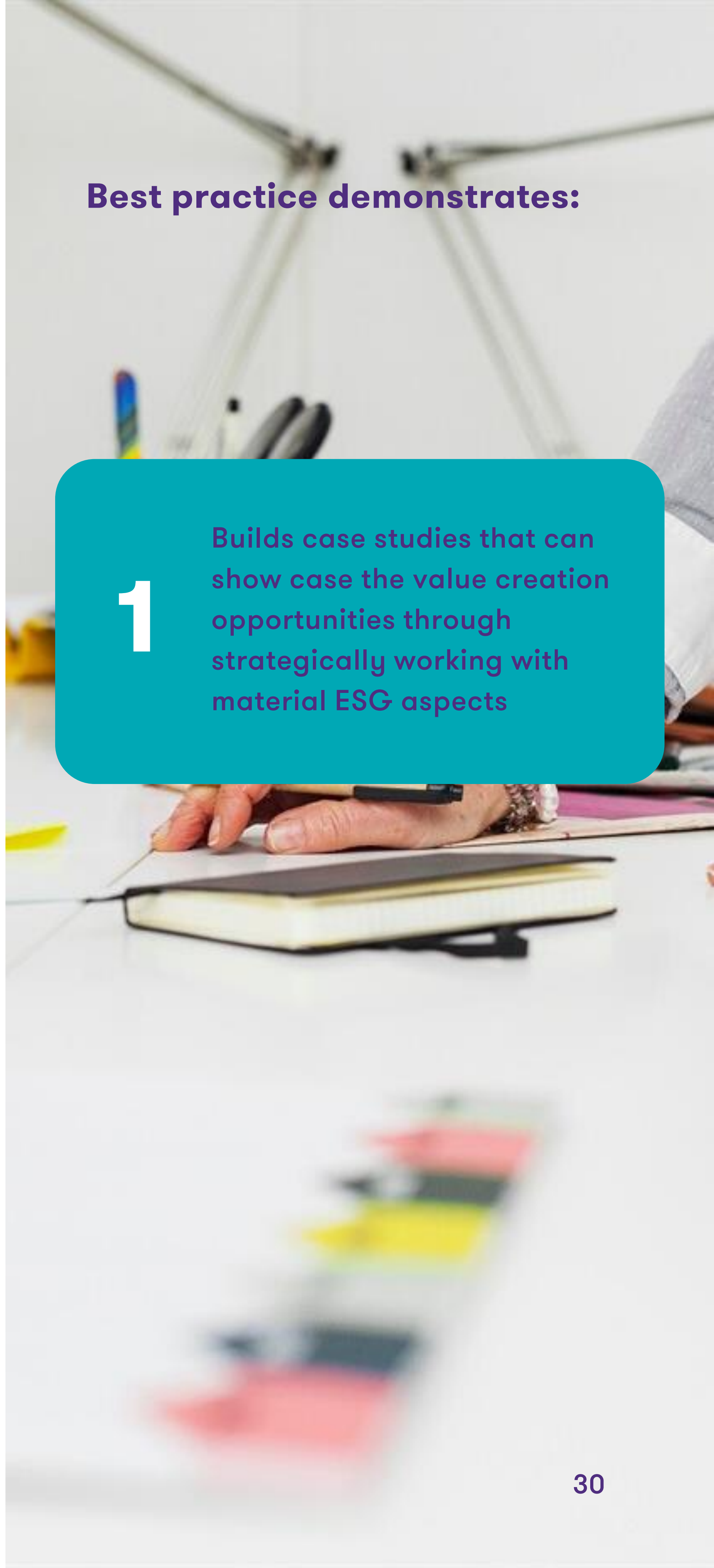
ESG must be built in, not bolted on. Similar to the aforementioned silo affect in a GP organisation, the same problem can occur within portfolio companies. ESG objectives must be integrated and aligned with business objectives. Correspondingly, ESG responsibilities must also be integrated across management teams.

"There needs to be complete alignment between ESG objectives and business objectives…if there is resistance from management, you need to find out why, you need to be open and not just push down metrics" – CapMan, Pia Kåll

Furthermore, speaking "the same language" was one approach to motivate management teams. Building sector specific case studies linked to value creation through superior operational performance or accessing new revenue streams, was often an effective way to motivate and build positive awareness.

> *"It takes a long time to make people aware, accustomed to and fundamentally understand different sets of ESG data. When we talk about EBITDA margins or sales growth it means something to people, but when you speak about carbon intensity, for some it means nothing."*
> *– EQT, Therése Lennehag*

Once again, remuneration linked to ESG initiatives and KPIs offered an alternative to further motivate management to accelerate ESG integration and performance. Although, few had implemented ESG linked incentive programs, the majority of the participants were open to exploring how to do this in the most effective way.



Best practice demonstrates:

1 Builds case studies that can show case the value creation opportunities through strategically working with material ESG aspects

ESG reporting and monitoring

"If the company has challengers [with ESG KPIs] to report and has difficulty answering our questions, then it's a sign that something is not in order – it is an indicator on how well their management are working with the topics" – Accent Equity, Tommy Torwald

ESG reporting and monitoring is an important aspect to not only gain understanding of portfolio company performance, but also a vital link to building trust and transparency between stakeholders. For Nordic GPs, ESG reporting provides several advantages; transparency, risk and value creation monitoring, guidance for decision making, indications of management teams ambitions, and data to build a strong equity story on exit.

"It's about finding the sweet spot between having good ESG performance and fulfilling compliance and external reporting expectations, you don't want to end up with ESG becoming just a box-checking activity " – Altor, Stephanie Hubold

In general, most Nordic GPs require their portfolio companies to report on a number of generic non-financial KPIs that are aligned to the overall funds reporting KPIs. Commonly used KPIs that portfolio companies were required to report were; gender equality in the Board and management teams, GHG emissions (scope 1), policy linked to the environment, and policy linked to anti-corruption and bribery.

Best practice

Those GPs who were observed to be innovative and more ambitious in reporting standards, had established a clear framework for portfolio companies to use.

A number of mandatory KPIs were selected for all portfolio companies to report on annually. The core-set of KPIs vary between respective GPs, yet generally covers environmental, social and governance aspects. The KPIs are selected based on specific criteria including relevance, measurability and the possibility of aggregation. For one GP, a common denominator is that the core-set of KPIs must relate to the UN Sustainable Development Goals.

Furthermore, portfolio companies are required to identify and report on at least three to five additional sustainability related KPIs, reflective of their industry, sector and nature of business. Examples of such KPIs include energy consumption, health and safety, service quality and staff turnover.

Due to the increased focus on climate action by many of the large financial institutions and regulators, measuring Green House Gas (GHG) emissions is becoming more mainstream for asset managers to have in place. However, not all GPs had come so far. Be that as it may, for those GPs that have begun their CO2 measuring initiatives, they believe they have been able to leverage the data to identify areas of inefficiencies and possible cost saving opportunities. In addition, disclosing fund-level CO2 emissions, may demonstrate ESG stewardship and transparency to LPs who have their own CO2 reduction objectives.

"Climate related financial risks is really important to report on, but only a part of that is Co2 emissions" - Sampension , Andrea Zerath, Steen Hauskou Bertelsen

The participants who had established measuring GHG emissions, state that there were challenges to motivate management teams, due to a substantial workload during the initial stages. They believe that the most effective method is to take a step by step approach so that the initiative doesn't feel to complex and become a burden for management.

"To get data was a challenge in the start but we have now got to a point where the portfolio companies have a workflow and people see the value of it."
– Summa Equity, Alexander Bjørklund

Best practice demonstrates:

1 Sets core non-financial KPIs for the entire portfolio to support data aggregation

2 Together with portfolio management teams, decides on company specific non-financial KPIs

3 Reports on fund-level GHG emissions in alignment with international standards (Scope 1,2 & 3)

4 Routinely follow-up, give feedback, and set new actions to achieve targets and objectives

5 Integrates ESG into financial reporting

ESG reporting and monitoring

LPs on integrated reporting:

"Private equity has significantly increased ESG disclosure in the last few years. In Nordic private equity, we see great examples of reporting. However, format, size and structure vary a lot. Those who perform best in our annual ESG assessment as relates to reporting, typically report both about policy, process and outcome, both on portfolio level and portfolio company level. We really like when we see ESG content in the financial reporting and in the reporting to the LPAC and AIM."

– AP6, Anna Follér

A simple step to improve the ESG reporting would be to integrate it better within the financial reporting so you don't have to go back and forth between different reports. Also, sometimes the ESG reports are too much storytelling and not linked to the financial performance. It's better to have a short report for every company which is included in the financial report. There should be an integrated theme into the way of how you run your business."

- Sampension, Andrea Zerath, Steen Hauskou Bertelsen

"We try to lead by example, so we had the ESG information included in our own annual report assured by an external party. It's a signal that we want to send that ESG data needs to be as decision-useful as any other financial data."
– EQT, Therése Lennehag

Best practice demonstrates:

1. Sets core non-financial KPIs for the entire portfolio to support data aggregation
2. Together with portfolio management teams, decides on company specific non-financial KPIs
3. Reports on fund-level GHG emissions in alignment with international standards (Scope 1,2 & 3)
4. Routinely follow-up, give feedback, and set new actions to achieve targets and objectives
5. Integrates ESG into financial reporting

Exit

Incorporating ESG into exit preparations

In this section

Incorporating ESG into exit preparations

Nordic GPs have spent recent years improving and integrating investment procedures to incorporate ESG. Naturally, many of them are now shifting their focus on how to systematically prepare ESG into the exit process. Although a number of participants believe the entire holding phase is, in essence, preparing for exit, the majority of participants understand the value in systematically preparing ESG into exit processes. On exit, the alignment of ESG activities that were implemented throughout the investment period becomes ever more critical to avoid sunken costs. With ESG being in, what some would call, an "infancy phase" the exit phase holds valuable learning information that can be re-used into the next investment process. Not to mention, exits are the point in time when the GP's ESG management efforts are realised into financial value.

> *"When we move towards the exit, we aim to have ESG aspects to the business, managed, in place and well communicated before we start the exit preparation."*
> *- Intera, Otto Wirkkala*

The modern exit landscape is becoming prone to increasing requests for ESG information from potential investors. ESG information regards; sustainability performance disclosure, specific ESG initiatives, corporate governance controls such as policy implementation, and incident reports.

For many PE houses, the challenge lies in transforming the equity story for portfolio companies that were purchased in older funds. Due to the rapid development of ESG, older funds did not have the same exposure to ESG expectations during fund raising negotiations compared to today's standards. Nevertheless, prior to recent exits, several of this study's participants have given portfolio companies complete upheavals on their business models to avoid transition risk and become more commercially attractive to strategic investors.

When it comes to newly invested holdings, several of the study participants admit that it is easier and more natural to include ESG in the entire investment period instead of accelerating before the exit. With that being said, there were examples of GPs incorporating vendor due diligence on ESG information, especially when going towards an IPO.

Best practice

A few of the interviewed GPs did have a systematic approach. In doing so, they demonstrated processes to review the portfolio company's ESG progress and ensure that ESG routines are in good shape prior to exiting. The mindset for incorporating a systematic ESG approach in the exit phase, is simply to proactively respond to increased demands from the market's shifting preferences to sustainable investments. Furthermore, it is assumed that ESG preferences will continue to evolve, therefor a systematic approach can identify and adapt to changes fluidly.

Best practice demonstrates:

1. Performs an ESG gap analysis in due time prior to exit
2. Evaluates the portfolio company's sustainability progress in relation to set targets, peer performance and investor preferences
3. Ensures that internal sustainability-related policies are implemented and that data collection procedures are satisfactory

Does ESG lead to tangible financial value?

Although many wish to see the evidence, Nordic GPs have not yet "cracked the code" to illustrate the tangible financial value that is created through ESG efforts. Although there are many examples of operational cost and expenditure savings, they are said to be incremental. Howbeit, all participants of this study, GPs and LPs alike, strongly believe that positive ESG performance implicitly supports financial value creation as well as demonstrates stewardship. Furthermore, good ESG practices support innovation, attract talent and help future proof their portfolio companies against incoming EU sustainability regulations, systematic shocks and transition risks.

> *"It is hard to say we can concretely connect ESG to positively impact multiples, however, we have examples where we have achieved great multiples and there was, in part, a premium connected to the brand which was centered around sustainability. But it is still tough to quantify what that meant for the deal."*
> *- Bridgepoint, James Holley, Ann Dahlman*

In the not too distant future, we expect PE investors will begin to quantify the tangible financial effects ESG has on private equity investing. However, Nordic investors appear to have moved on from the discussion and instead, focus on how they can leverage ESG to improve operational performance, access new revenue streams and build trusting relationships with both LPs and portfolio company management.

Acknowledgements

We would like to extend a big thank you to everyone who has provided invaluable input for this study:

Tommy Torwald
Director, Accent Equity

Stephanie Hubold
Head of ESG, Altor

James Holley
Head of ESG, Bridgepoint

Ann Dahlman
Partner, Head of Bridgepoint Growth in the Nordics

Pia Kåll
Managing partner, CapMan Buyout

Therése Lennehag
Head of Sustainability, EQT

Veronica Byfield Sköld
Partner, Impilo

Sonja Gerde
Investment Manager, Impilo

Otto Wirkkala
Investment professional, Intera Partners

Elin Ljung
Director of Communication and Sustainability, Nordic Capital

Hannah Gunvor Jacobsen
Investment Director, Summa Equity

Helena Fagraeus Lundström
Operational Specialist, Summa Equity

Alexander Bjørklund
Operational Specialist, Summa Equity

Henrik Bonnerup
Partner, Polaris Equity

Maggie Yang
IR & Business Development Associate, Verdane

Anna Follér
Head of Sustainability, AP6

Steen Hauskou Bertelsen
Senior ESG and Investment Analyst, Sampension

Andrea Zerath
Portfolio Manager,
Sampension

Contact us

Markus Håkansson
Director, ESG & Sustainability Business Advisory
M: +46 706 83 56 19
E: markus.hakansson@se.gt.com

Pernilla Zetterström Varverud
Partner, Head of Sustainability Business Advisory
T +46 708 21 71 25
E pernilla.varverud@se.gt.com

Mats Fagerlund
Partner, Head of Advisory
T +46 767 67 70 71
E mats.fagerlund@se.gt.com

David Ramm
Partner, Head of Transaction Advisory Services
T +46 70 329 97 43
E david.ramm@se.gt.com

Services within Nordic Advisory

Grant Thornton Advisory provides a full range service offering, including advisory in connection with divestments, acquisitions, valuation and operational and strategic advisory

Transaction Advisory Services

- Financial due diligence
- Vendor due diligence
- Vendor assistance
- Negotiation support
- Transaction advisory
- ESG due diligence
- Tax due diligence

M&A Services

- Disposal processes
- Acquisition support
- MBI/MBO
- Screenings
- Strategic advisory
- Negotiation support

Valuation

- Company valuations
- Disputes
- Internal pricing
- Incentive solutions
- Fairness opinions

Operational and Strategic Advisory

- Business consulting
- Governance, risk & compliance
- Data analytics & IT audit
- Sustainability services
- Sustainable finance & responsible investment
- Qualified accounting services

Grant Thornton Sweden

A focus on sustainability

Grant Thornton in Sweden is a leading provider of national audit, tax and advisory services. With over 24 offices and 1,300 employees, we apply strong technical guidance and breadth of experience to ensure that clients receive a truly unique experience.

Grant Thornton Sweden provides Operational & Strategic Advisory Services with 35 professionals. Full range service offering, including advisory in connection with risk management, compliance, sustainability and accounting. For us, sustainability is at the core of our operations. We work with responsible advice, sustainable working life and increasing sustainable growth in society.

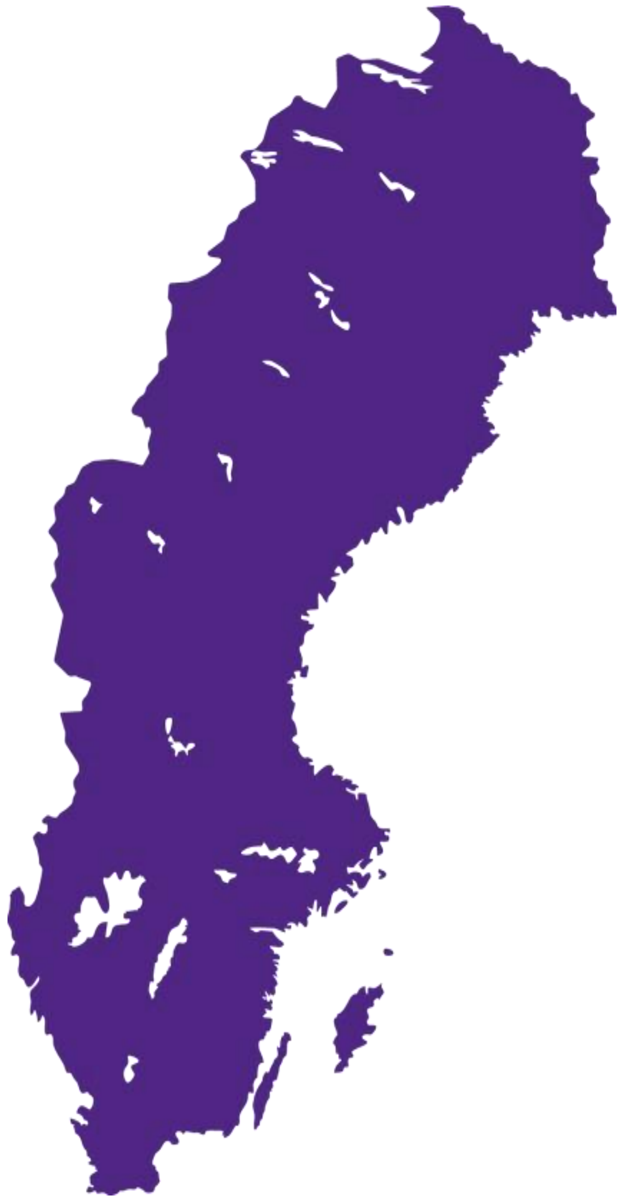
SEK1.4b
Annual revenue

24
Offices

26 000
Clients

1,300
Employees

Grant Thornton Sweden won "Firm of the year 2019" in the international GT network with over 135 member companies and 50 000 employees. The motivation was due to integrating sustainability into our business model as well as connecting the UN Sustainable Development Goals.

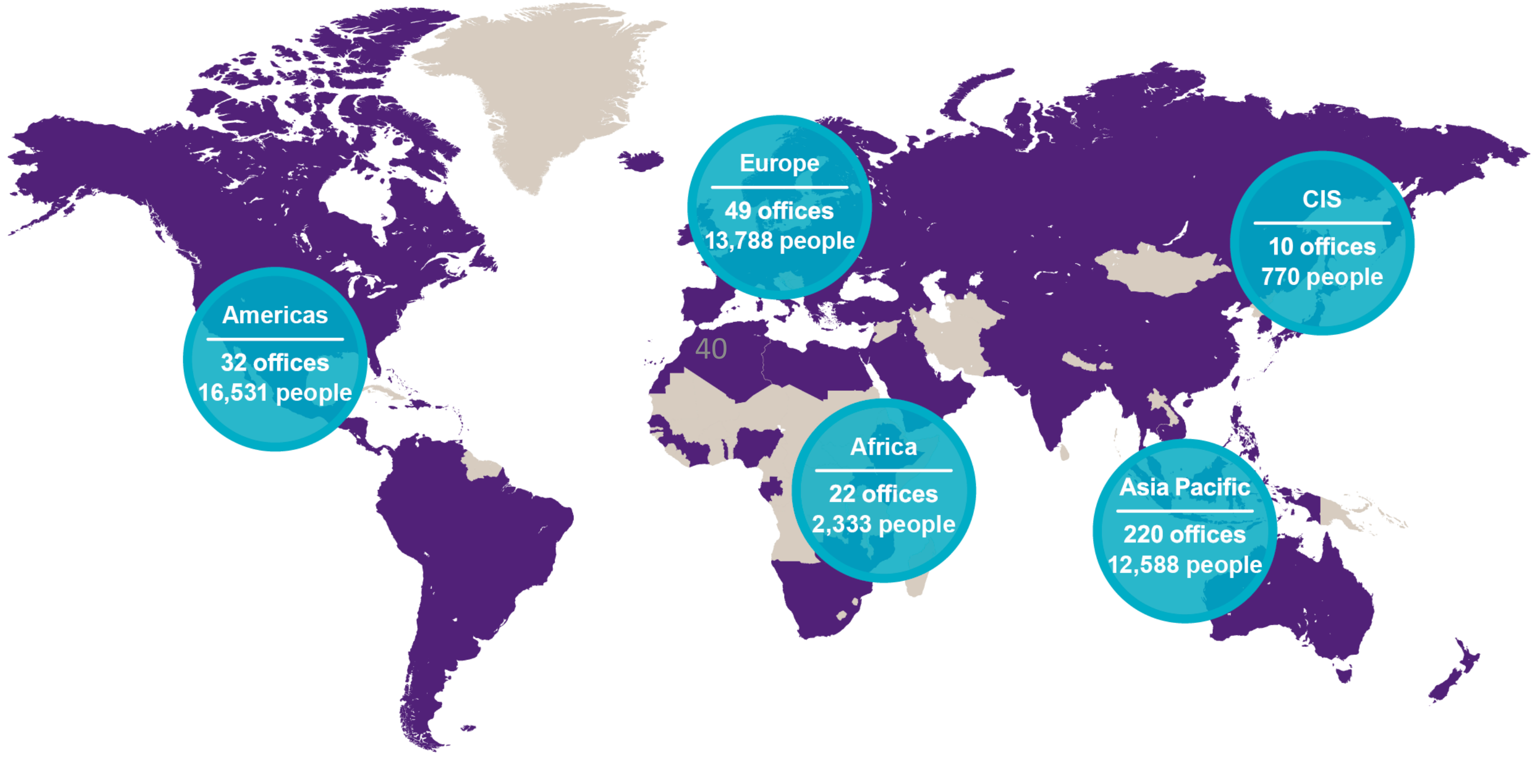


Grant Thornton International

We're a network of independent assurance, tax and advisory firms, made up of 50,000 people in 130 countries. And we're here to help dynamic organisations unlock their potential for growth.

For more than 100 years, we have helped dynamic organisations realise their strategic ambitions. Whether you're looking to finance growth, manage risk and regulation, optimise your operations or realise stakeholder value, we can help you.

We've got scale, combined with local market understanding. That means we're everywhere you are, as well as where you want to be.



Our distinctive client experience sets us apart

US $4.8bn (2016 revenue) | 47,000+ people | 700+ offices | 130+ countries

www.gti.org