KEYNOTE INTERVIEW

Questioning the commitment to ESG

Pantheon partners Helen Steers and Alex Scott outline the firm's evolving approach to environmental, social and governance best practice

In the years since Pantheon signed up in 2007 to the UN-backed Principles for Responsible Investment, the private equity industry has undergone a transformation in the way it thinks about environmental, social and governance. We caught up with Helen Steers, head of European investment, and Alex Scott, ESG committee co-head, for an update on where the firm, its clients and managers are today.

Q How do you ensure your ESG priorities are implemented?

Alex Scott: It's a big question and not something that is ever in a steady state. We invest in primary funds and secondaries where we have more visibility on underlying companies but not complete

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control over choice of manager, as well as co-investment.

That's a complex mix and there's always a tension between ESG and investment objectives. We've addressed that through a two-pronged framework. We assess the manager when assessing primary fund investments and in conjunction conduct a company assessment when buying secondaries and co-investing. This focuses on the risks in the business itself and the sectors in which it is operating. In co-investment, by deciding to pledge additional capital to a single company you are making a statement and we have more responsibility.

Q What does the manager assessment entail?

AS: It is done in conjunction with our risk team, which assesses all operational risk factors that exist when we commit to a manager – such as cybersecurity, the valuation process, GP governance and business continuity. ESG is a special item within that and it makes practical sense to have it alongside for information gathering purposes and consistency of implementation.

The ESG assessment is semi-independent and rigorous. We ask the manager to complete a detailed questionnaire, which, through carefully targeted questions, seeks to get as much information as possible about how a GP operates. It's a template with open-ended questions that provides the manager with the opportunity to submit supporting documentation that we can test.

As a global firm, the challenge is that we could be dealing with a high profile, multi-country, sophisticated institutionalised manager that may have a dedicated ESG professional, or we could be investing in a smaller, regional VC firm with a team of only seven or eight people. You can't expect them to have the same level of focus or policy and process.

Helen Steers: The questionnaire provides for a uniform assessment across the globe and that's really important. A decade ago, most managers wouldn't be well prepared to answer those questions. Nowadays, the bigger managers are very well prepared, but even smaller managers have got much more up to speed and it's easier to get the information. We rarely encounter any resistance to this at all.

Q What do you do with the information from GPs?

AS: We have a template that sits against the questionnaire responses with three bands of ESG risk rating, ABC, or green, amber, red. We compare answers and build up a picture of where a manager rates on individual areas of ESG, for instance, its internal governance or approach to climate change. That builds into an overall ESG score that sits alongside other areas of operational due diligence that have been compiled in a similar way. It provides for an at-a-glance guide to the sophistication of a manager's operational process, including ESG, that the risk committee inserts into the investment team's investment recommendation. This immediately draws the committee's attention to areas that they might want to probe further.

Q For those GPs that land in the red space, what happens?

AS: For us to be conducting operational due diligence or delivering documentation to the investment committee, GPs will have already met certain quality thresholds. There is correlation between ESG and organisational factors. Managers that are weak on ESG as well as other factors would have fallen by the wayside before they have even entered formal due diligence. Those marked red tend to be a subset of managers that offer something powerful in terms of investment thesis but come up short on ESG. That's not usually going to be a deal-killer. An example might be a best-in-class fund in the venture space where substitution is hard.

HS: GPs could score red because they don't have a formal ESG policy. That never happens with a big GP, but with some smaller ones it can. It then gives us an opportunity to engage, talk and share best practice, and to bring them along on the journey. We sit in the middle between LPs and GPs and have a part to play in promoting ESG. A decade ago we ran workshops on ESG for managers and investors in Europe. We try to lead by example and share our knowledge. This work goes on today but mainly in Asia where there is a generally lower knowledge of ESG affairs but a real willingness to learn. Our colleague Jie Gong has worked actively with PRI and the Hong Kong Venture

Q Overall have standards of ESG improved across the industry?

AS: Yes, more managers are meeting our green rating on ESG. One of the things we want to do over the next 12 months is get more granular and recalibrate. As more PRI members are obtaining high ratings, PRI is itself looking at this over the next two years. We also need to be able to further differentiate through refining our scoring on ESG metrics.

The key themes that have risen in importance to clients are climate change and diversity and inclusion. We introduced climate change questions into our manager assessment 18-months ago. We have subsequently seen a significant ramping up in client queries on this topic in the past six-to-nine months. Internally, we've also done a lot of work on this, from the ink we use in our printers and paper recycling, to hosting a sustainability-oriented investor annual meeting last year. We've always been ahead of the private equity industry in workforce diversity, but it's become increasingly important to incorporate gender and diversity disclosures and initiatives in a way that works globally. That's not as simple as it sounds.

Capital Association to promote ESG in the region.

Q How do you assess ESG risk at portfolio companies?

HS: We use a business intelligence service, RepRisk, to monitor our 7,000 portfolio companies. It scours global news media in every language for mentions for all companies that are on our watch list, right through to their subsidiaries and brings any issues to our attention. For instance, it flagged a governance issue at one of our portfolio company's African subsidiaries. The US or UK press would never have picked this up. We learnt about it very early on. I called the GP. Happily, they were aware of the issue, were on top of it and taking action.

Q How do GPs receive that kind of a call?

HS: We have longstanding relationships with most of our GPs and we engage with them on lots of issues, not just ESG. About 30-35 of these ESG situations arise each year and then we have a conversation. We never tell them what to do. It's the same as if we had discovered a financial issue with a company; we'd want to talk about that, too. In some ways it's helpful as the more dialogue you have with your GPs the better. It all helps to strengthen that relationship. It is also an opportunity to exercise some soft influence and raise awareness of ESG.

AS: GPs are often impressed we've found out about an issue and welcome our engagement. Indirectly it really supports ESG standards in the industry because our query will often result in a deal team being asked to respond. It is a helpful reminder that ESG is important to stakeholders and remains at the forefront of minds.

Q As investors, how are you responding to climate change?

AS: We are working with a third-party consultant on our infrastructure programme to improve how we incorporate climate risk, which is multi-variable and complex. Assets in vulnerable locations are exposed to physical risk, while investments subject to changes in regulations and carbon pricing face transitional risk. There are increasing regulatory reporting requirements and we definitely want to be ahead of those.

We have focused on prioritising three objectives. The first is to identify tools to help us evaluate climate change risk in assets we're buying.

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>
> **ALEX SCOTT**
> **Pantheon**

Second, to collate information on climate change risk in specific sectors and the opportunity set over different time horizons. We can then subsequently develop a climate change heat map overlay on our programmes that we can report to clients. This will allow us to, for example, say by 2025, 10 percent of our portfolio will be at high regulatory threat, but 40 percent might benefit from changes to regulations. Building up this picture shows our clients that we know what's going on and that their portfolios are hopefully in a decent position.

The third objective is the measurement of greenhouse gas emissions across the portfolio. This is a backward-looking static metric but can complement a more sophisticated risk based approach to evaluating portfolios

At a high level all this sounds straight-forward, but integrating these into processes and reporting systems is a challenge. We're expecting to learn a lot by applying this to infrastructure, which is the sensible place to start from a risk perspective. Then we can think about private equity thereafter which is an even bigger challenge.

Q And to promote diversity and inclusion?

HS: Pantheon itself is incredibly diverse in terms of gender, ethnicity, religion, race, social background, and that's not a recent thing. It's grown up organically from our formation. It works for us as a business and we need to translate it to our GPs and their portfolio companies by incorporating questions into our risk questionnaire. We believe more diverse groups make better decisions and better investments. As part of our charitable outreach, we also partner with Sponsors for Educational Opportunity and Best Buddies, which are both US-based organisations that promote social mobility.

Q What are you asking GPs in your risk questionnaire?

HS: How diverse they are in terms of gender and ethnicity. If you don't measure it, things won't change. Many larger GPs are self-reporting and it makes quite painful reading for them. Most are not very diverse at all. GPs are making a lot of effort in recruitment, not just around gender but hiring from a wider spectrum of backgrounds. In some senses that is the easy thing to do.

The harder thing is the retention and promotion of women, ethnic minorities and individuals from a variety of social backgrounds. GPs understand that to recruit the best talent they have to change. The best people in the millennial generation will not want to work for a monotone organisation. GPs also see that in a very competitive transactional environment. They need to sell themselves to top performing companies that have a choice about where they get capital. Management teams tend to preference interacting with a GP that mirrors their own diversity.

Q At the more senior levels, what will push greater diversity?

HS: There are organisations like Level 20, which I and 11 other senior women in private equity co-founded in 2015, promoting greater gender parity. Early traction has been heartening with 2,500 members and 56 GP sponsors signed up to Level 20. Within a firm, it is essential that whoever champions diversity and inclusion must have a seat at the top table otherwise it won't work. You need senior buy-in. Ideally the managing partner or very senior partners need to fundamentally believe in it and have their remuneration linked to the promotion of these values. ■

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