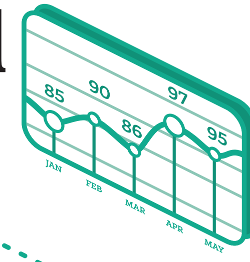
Private equity and venture capital firms embracing new norms



Environmental, social and governance issues have gained the attention of private equity and venture capital firms when investing in prospective companies

BY *Sreerema Banoo*

INCREASINGLY, venture capital and private equity firms are integrating environmental, social and governance (ESG) factors into their decision-making, from evaluating prospective investments to creating value. No longer viewed as "nice to have" in the private equity space, ESG considerations are now viewed as a significant criteria for doing business, with the limited partners driving much of this shift.

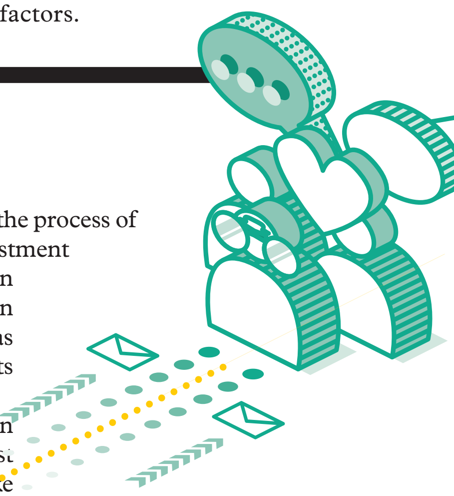
According to the 2020 Edelman Trust Barometer Special Report: Institutional Investors, 88% of limited partners globally use ESG performance indicators in making investment decisions, and 87% said they invest in companies that have reduced their near-term return on capital so they can reallocate that money to ESG initiatives.

The findings of the annual Investec GP Trends survey published in July 2021 also show that ESG issues are now influencing investment decisions. Its survey of 220 private equity professionals globally revealed that 62% of respondents said ESG or ethical factors had been significant contributors to the decision not to invest in one or more companies. This is up from 58% a year ago and 55% in 2019.

PwC, in its findings from its Global Private Equity Responsible Investment Survey 2021, says over the last seven years, private equity firms have radically reassessed the importance and value of ESG to their business. "It has gone from being considered a tangential area of compliance, or a specialist product for a small minority of investors, to becoming an overarching framework that is informing the strategic thinking of the entire firm."

There has also been a rising momentum among venture capital firms to integrate ESG in their investment consideration. The same PwC study found that three-quarters of venture capital investors are embracing ESG.

For both private equity and venture capital firms, the alignment of ESG considerations with their decision-making is driven by several factors, from investors who are adopting an ethical lens when investing, reputational impact of diversity and inclusion policies to regulatory requirements. For example, the EU's Sustainable Financial Disclosure Regulation (SFDR) requires all funds to disclose how ESG considerations form part of their investment decision-making process and how their investment decisions impact sustainability factors.



MAKING ESG SEXY

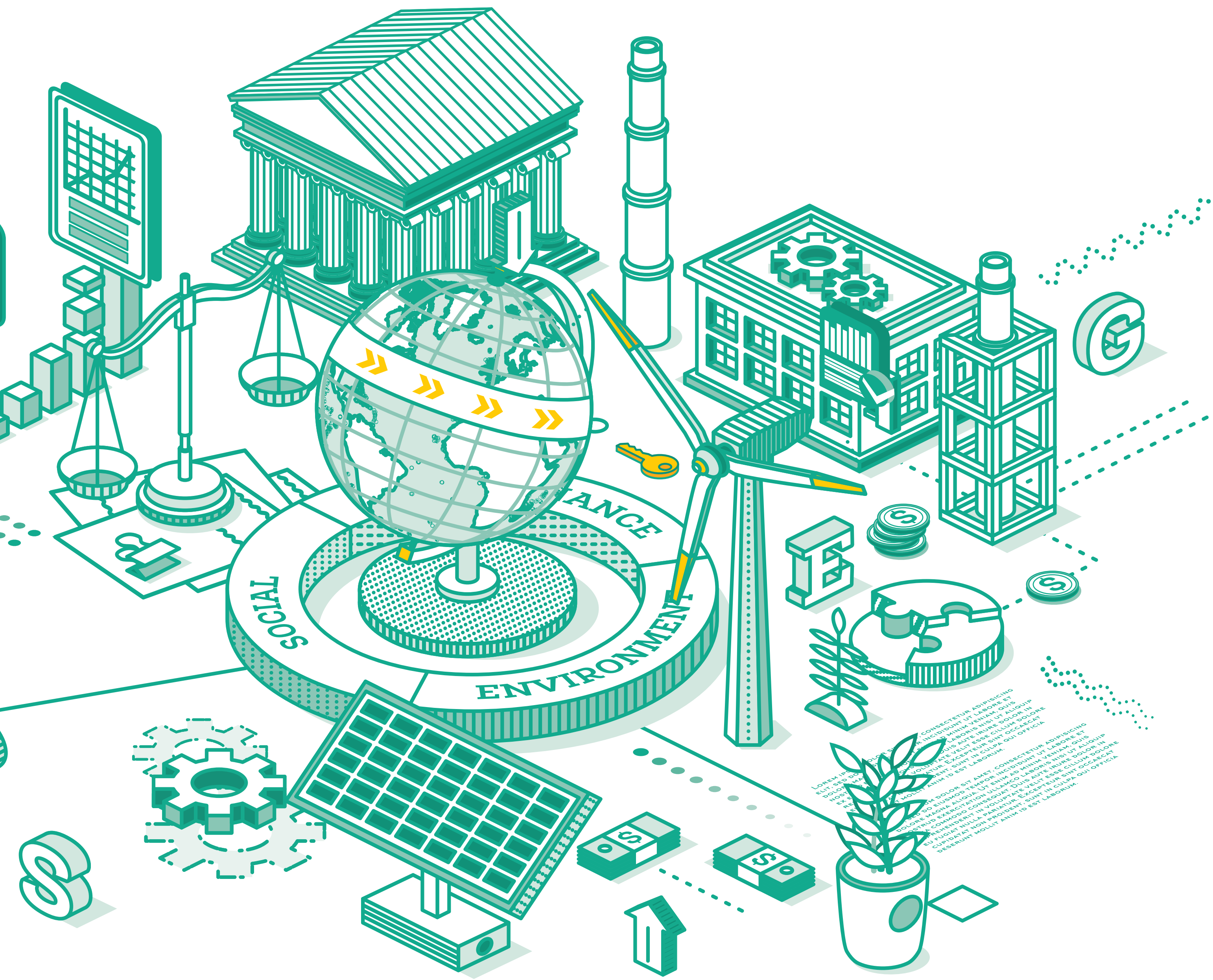
For private equity firm Creador, the process of incorporating ESG into its investment decisions began in 2014, driven by its investors such as the Asian Development Bank, which has ESG considerations as part of its investment criteria.

"This is something we've been doing for some time. But in the last few months, we've decided to make a bigger push to become best in class in ESG," says Creador founder and CEO Brahmal Vasudevan.

"We're trying to make ESG sexy and shift the mindset because for many companies, ESG is not something that you look forward to doing every day. So what we're doing is educating people, telling them that it's a process and why it has to be done."

With a fund size of US$2.2 billion and a presence in Malaysia, India, Indonesia, Vietnam and the Philippines, it is up to firms like Creador to drive the ESG agenda, he adds. "We have to show leadership in this area, and as a leader, we want to make sure that we are not harming the environment, that there's a positive impact on the communities we operate in and foreign workers are treated well."

The firm is keeping abreast of developments in the US where, for instance, pension funds are demanding private equity firms to take a more proactive approach in the area of ESG. Just recently, for example, a group of global pri-



vate equity firms and pension funds led by Carlyle Group and the California Public Employees' Retirement System (CalPERS), which manage more than US$4 trillion in assets, announced that they would standardise reporting on the ESG performance of portfolio companies.

"We're not seeing that much pressure in this area, but we think it's coming," says Brahmal.

Creador, which recently took two of the companies in its portfolio public, MR DIY Group (M) Bhd and CTOS Digital Bhd, is also cognisant that investors, guided by indices such as Bursa Malaysia's FTSE4Good Index, are increasingly seeking to put their money in ESG-compliant stocks.

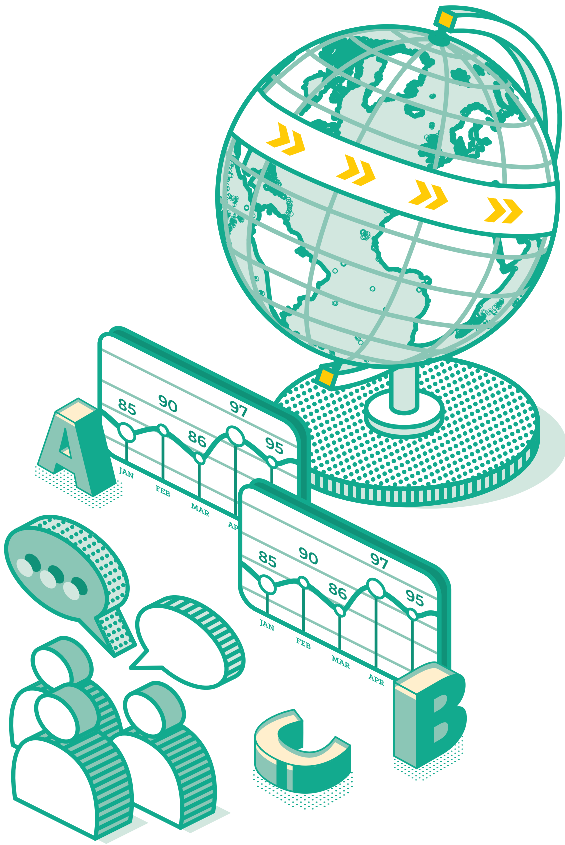
"Capital is going to shift to companies that are ESG-compliant. Of course, you would still need to be a good business and turn a good profit, but this additional measure is going to become important," he says.

CHOOSING THE COMPANIES TO INVEST IN

Venture capital firms, which may be taking nascent steps in ESG investing, are framing ESG considerations within their investment ethos. Victor Chua, founder and managing partner of Vynn Capital, says the firm's investment focus has always been on empowering and enabling the underserved communities.

"We've always considered ESG factors. It's just a case of it not being spelt out before. But if you look at our portfolio of companies, their main value proposition is really providing micro businesses and small and medium enterprises (SMEs) with access to opportunities. Dropee, for example, partnered with the Ministry of Agriculture to support farmers and fishermen who had lost their income during the first lockdown. Epost from Sabah did the same thing by handling the logistics and supply chain issues of small traders," he says.

In addition to empowering entrepreneurs, Vynn Capital



prioritises supporting women entrepreneurs and businesses that empower women. “ESG to us means providing a platform for the underdogs to get a chance to do the right thing and make an impact, which is really about bringing positive change to the industry. This may sound fluffy, but we want our entrepreneurs to provide more opportunities and for their activities not to have a detrimental impact on the environment,” says Chua.

For Inovasi Venture, a relative newcomer to the venture capital scene, its investee companies are selected against the backdrop of ESG, even though it is not explicitly spelt out. “We look at companies that have the right intention, even if the business model or market validation may not be as well developed. For us, the ESG proposition is more towards how we can provide value to the community and the tech ecosystem, and this means funding start-ups that are helping the underserved community. So, we may only invest in one company out of 100 that we meet,” says Angel Low, co-founder and principal of the firm, which was set up early this year.

This investing philosophy, she says, stems from the founders’ shared beliefs, some of whom have founded start-ups and have experienced the fundraising process within the venture capital scene. “The goal now is to give back to the tech ecosystem and support more early-stage investments. So, what we look for is passion to build the company and belief in the business model.”

Companies that are paying attention to the environmental impact of their operations show that the founders have the right intention, she adds.

AVOIDING GREENWASHING

For Creador, an essential feature of the firm’s ESG strategy is that it excludes sectors that are not ESG-compliant. “Anything that would destroy the environment and sectors such as firearms, tobacco, gambling or palm oil, to name a few, are no-go sectors for us,” says Brahmal.

He adds that once a prospective investee company has been selected, a due diligence audit on the company’s ESG areas is conducted. “From there, usually comes a checklist. For example, whether the company is compliant in 80% of areas. We then develop an improvement plan with the company to work on the 20% and address these gaps over the next few years,” he says, disclosing that the firm engages external consultants to conduct the ESG audit.

One of the challenges that institutional investors face when it comes to ESG investing is greenwashing, where the company presents itself as being more environment friendly than it is, and this happens because of the flaws of ESG analysis and ratings. The quality of information that is published or the reliance on those provided directly by the company being assessed often makes it easier for it to misrepresent its ESG targets and achievements.

Such pitfalls are avoided at Creador, says Brahmal. “The difference between what we do and what some of the public firms do is we are real owners, co-owners with board representation. We know what’s happening in the company, so we are able to access and understand its inner depths. Whereas with a public fund manager, you would not have access to the inner workings of the company and you’re relying on published data.”

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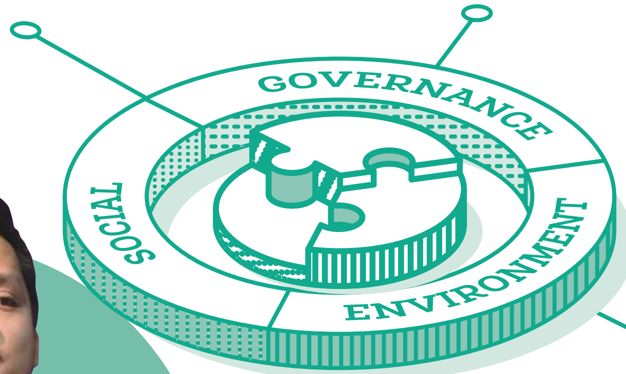

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SUHAIMI YUSUF/THE EDGE

In the case of venture capital firms, the time spent evaluating prospective companies goes towards providing a measure of comfort that these companies are serious about ESG. "We carry out extensive research into the background of the company and the founders, including discreet due diligence with previous employers, colleagues and clients. We look at how they communicate with minority shareholders, and from there we get to understand their character. We pay a significant amount of attention to the way they build their network and how they treat their people, whether it is the suppliers, customers and even customers' customers," says Low.

GETTING ESG RIGHT

Acknowledging the role venture capital firms can play in helping investee companies get their ESG proposition right from the get-go, Low says Inovasi Venture has been working with the companies in its portfolio, ZeptoExpress and The Noor, to meet their ESG goals.

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From its experience with its investee companies, the firm is developing a template for the third company that it is investing in.

For Vynn Capital, although it has not put in place a strict ESG policy, Chua points out that it has begun building knowledge and capacity in this area and structuring investment strategies based on sustainability and empowerment. "Not every start-up is ready for ESG, but the bottom line for us is spending time with the founders to understand their management style and their vision for the business. The next step is to understand how they plan to grow the business.

Although the firm is still very much in the early days of looking at ESG elements, the focus at the moment is on the social aspect, specifically empowering and enabling people to do the right things. "As we move forward, we definitely want to expand and cover the environmental and governance aspects," says Chua.

At Creador, the setting up of a dedicated team called Creador For Good, or C4G, signals its ESG commitment. "As opposed to just telling the companies what they must do, with C4G we're providing the support and resources to get it done," says Brahmal.

He adds that although Creador has an "excellent reputation in governance", he feels that more can be done in the areas related to environmental and social propositions in the firm's bid to become best in class in ESG.

Some of the ESG initiatives currently being undertaken by the Creador portfolio of companies include fair labour practices, equal representation of genders at board and management level, use of sustainable energy sources, energy and water conservation programmes, safeguarding data privacy and community engagement.

"We want to push the boundaries to get better standards, so we're coming up with a framework — separating the quick wins from the high impact areas, and then the nice-to-haves. We want to focus on the things that really matter," says Brahmal. E