ESG BECOMES A PRIVATE EQUITY PRIORITY

The adoption of environmental, social and governance (ESG) factors in private equity is on the rise. At the beginning of this year, Preqin, a company that sources data and intelligence for the alternative assets industry, surveyed more than 300 fund managers globally and its findings showed that 53% of respondents have established an ESG policy or have one pending.

Credit: Mario Caruso

WRITTEN BY PAUL BOYNTON,
MANAGING DIRECTOR OF OLD MUTUAL ALTERNATIVE INVESTMENTS

As well as a tool to mitigate risk and provide downside protection, managers are increasingly embracing the upside potential of investing in sustainable businesses. This trend is driven by a multitude of ethical, financial and demographic forces resulting in ESG (particularly environmental and climate issues) having a growing presence on the global political agenda.

01/ WHY IS AFRICA LEADING THE PACK?

While the debate continues to rage on about whether impact and other forms of responsible investing compromise or propel financial returns, what seems to be missing from the narrative is how different markets compare to each other in terms of ESG integration. When it comes to this, it's clear to me that African private equity has been ahead of the curve for over 20 years.

The industry is rooted in funding from the world's Development Finance Institutions (DFIs), which have a major, longstanding focus on ESG principles as the key to sustainable development in African countries, and although the industry continues to grow and mature, DFIs still account for a significant majority of the capital in many of the funds that have been raised. Due to these origins, African private equity managers typically invest for developmental outcomes in addition to financial returns.

According to a report from the African Private Equity and Venture Capital Association (AVCA), fund managers on the continent allocate more time and effort to ESG issues than in more developed markets, even for funds that are not explicitly impact focused. Since the 1990s, the number of funds on the continent has grown from around a dozen Africa-focused private equity firms managing about US$1 billion to more than 200 firms with some level of focus on Africa, managing more than US$30 billion. However, for many of these funds DFIs are still the first source of capital, and the first barrier to it. African managers understand that if they are not serious about ESG, they are not going to raise capital.

Furthermore, DFIs – which exist to promote sustainable development – are themselves becoming more sophisticated in their ESG requirements. Rather than narrowly monitoring a manager's ESG systems and capabilities, their emphasis is increasingly on identifying broader ESG risks and opportunities in the context of Africa's urbanising and industrialising economies.

As well as undertaking more direct investments themselves, DFIs are becoming more heavily engaged with a fund's investment process. In the case of first-time managers, DFIs are requesting to review ESG due diligence and give feedback to the investment committee – this is most certainly a new development. Their increasingly hands-on approach also includes providing grants, information sharing or training to investment companies where required. As DFIs' focus broadens from purely risk mitigation towards value creation, demonstrating a track record of positive ESG outcomes is becoming more valuable for future fundraising.

Number of African-focused private equity funds:

a dozen
funds around the 1990s managing US$1 billion

over 200
firms with some level of focus on Africa, managing more than US$30 billion today

Simply put, the more sophisticated LPs (investors in a private equity fund) become regarding ESG, the more sophisticated managers become. And in Africa, where the scope for impact is enormous, the outcome of these developments can have significant consequences that extend beyond investee companies to the communities and countries they operate in.

02/ DRIVING STEWARDSHIP

Corruption is often cited as one of the major risks associated with investing in Africa. And while the perceived risk may be greater than the actual risk, there is no denying that good governance is a major problem for some of Africa's 54 countries, particularly when compared to more developed markets. Here is where private equity managers can and do make a tangible difference. As these are mostly closed-ended funds with a limited number of investments, the fund manager has real scope for influence – often sitting on the company board and present in forums like the remuneration and audit committee, where governance takes place.

Moreover, African companies are not subject to the same level of scrutiny from consumers and public-interest organisations holding them to account on ESG issues as in more developed markets. This makes the fund manager's role in the implementation and monitoring of ESG even more imperative.

Credit: Rawpixel

Credit: Antonio Garcia

Another area where the ESG focus of African private equity is delivering significant outcomes is in the renewable energy sector. The capital for the majority of deals in this space has come from private equity managers because banks and other sponsors are unwilling, or unable, to put the 20%-25% equity cheque that is required onto their balance sheets.

03/ A POWERHOUSE IN RESPONSIBLE INVESTING

At Old Mutual Alternative Investments, we've gained a wealth of experience investing responsibly across Africa over the last 48 years. We are proud that the investments we manage across infrastructure, private businesses, affordable schools and housing have a significantly positive impact on countries and communities. Our infrastructure investment arm is the largest equity investor in South African renewable energy, with its assets generating 25% of the total clean energy on the South African grid in 2017.

On the impact side, our Schools and Education Impact Fund of South Africa has invested R1.4 billion since its creation in 2012, which has directly resulted in the creation of 33 schools across the country with approximately 18 700 learners enrolled and 1 300 teachers employed this year. Our Housing Impact Fund South Africa (HIFSA), which was launched in 2010, has developed about 11 000 housing units and created more than 57 000 jobs and is now targeting up to 80 000 housing units. HIFSA's Fourleaf Estate development in Port Elizabeth is on the cutting edge in terms of environmental performance and received the first African EDGE certification status – a global green standard.

> SIMPLY PUT, THE MORE SOPHISTICATED LPS (INVESTORS IN A VENTURE CAPITAL FUND) BECOME REGARDING ESG, THE MORE SOPHISTICATED MANAGERS BECOME.

Before we invest in any venture, our due diligence process is designed to highlight any gaps in ESG management and, if we decide to proceed, we spend considerable time with the management teams of potential investee companies to ensure that we are fully aligned and motivated on what needs to be done.

04/ THE FINAL WORD

Though the practice of responsible investing will continue to build momentum, a key barrier to its advancement is the perception that it is a trade-off for financial return. However, given its history, the African private equity industry can provide rich examples of ESG factors being the key driver of value creation.

Besides delivering attractive returns for our investors, it is just as important that we are building for the future of the continent. As one of the largest and most experienced alternative investment managers in Africa, we strive for and deliver on our investors' expectation to be a force for positive change.