Private Equity:

Assessing ESG risks and opportunities

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Federated Hermes Limited

www.hermes-investment.com
For professional investors only

Responsible investing in private equity

Federated Hermes is a global leader in active, responsible investment. We are guided by the conviction that responsible investing is the best way to create long-term wealth for our clients. We are pioneers in global stewardship, and have been developing innovative environmental, social and governance (ESG) strategies since our inception in 1983.

Federated Hermes has been at the forefront of ESG integration in the private equity space since 2010, and in 2016 we won the British Private Equity & Venture Capital Association (BVCA) Award for Best ESG Framework.

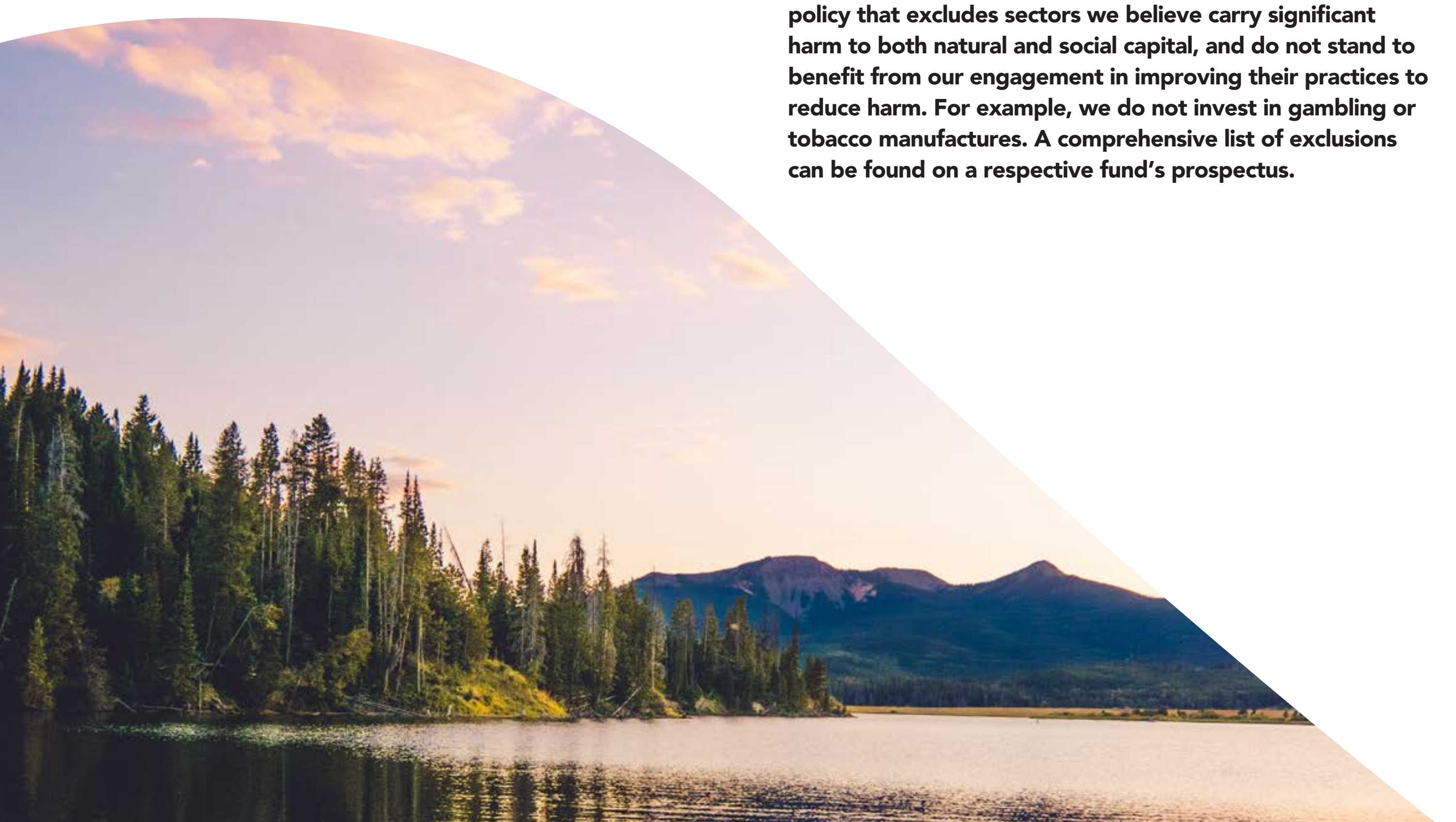
Our investment philosophy

At Federated Hermes Limited, our approach is underpinned by four mutually-reinforcing strands of responsible investing. These are:

- **ESG-integrated investments**
- **Active ownership and management**
- **Advocating in the interest of our beneficiaries**
- **Behaving as a responsible business**

Together, these pillars aim to generate sustainable wealth creation for the end-beneficiary investors, encompassing investment returns and their social and environmental impact.

We believe that to truly understand the risks and opportunities of an investment, we must consider all material factors, and this includes material ESG considerations. As ESG pioneers in the private equity space, we have seen first-hand the impact ESG factors may have on an investment over its lifetime. As a result, we believe it is important to integrate these factors as part of the fundamental analysis in any investment process.



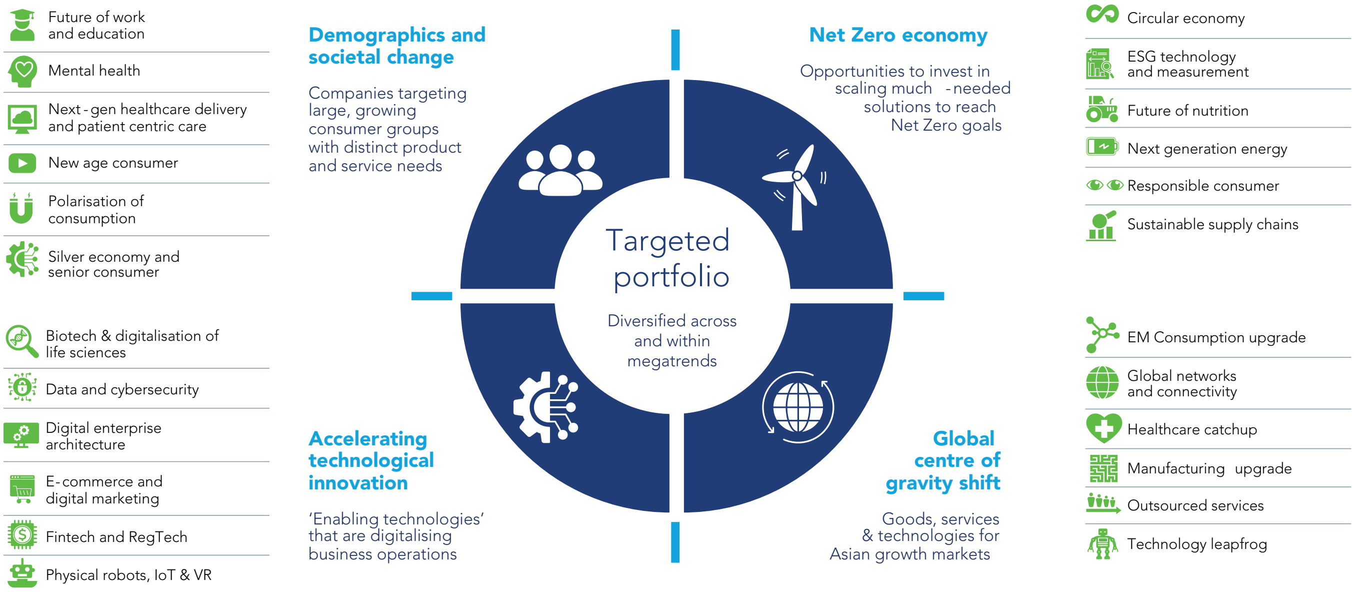
Crucially, ESG factors have different respective timespans in relation to an investment, so, in investments that have a shorter time horizon, one may argue certain ESG factors are not material. However, for private equity – a long-hold asset class with investment horizons of between five and seven years per investment – it is even more crucial to maintain a good understanding of all relevant ESG risks and opportunities, as these risks may materialise during the holding period or impact the exit prospects of a company. Good management of ESG risks, especially when better than peers, can enable a company to outperform over the long term.

Our approach to responsible investing

The assessment of ESG risks and opportunities is fully integrated into our investment process and is a core part of our fundamental analysis. We adopt a three-stage approach to our assessment:

1. Our investment process applies a rigorous exclusions policy that excludes sectors we believe carry significant harm to both natural and social capital, and do not stand to benefit from our engagement in improving their practices to reduce harm. For example, we do not invest in gambling or tobacco manufactures. A comprehensive list of exclusions can be found on a respective fund's prospectus.

2. Our thematic framework identifies opportunities to solve current environmental or social challenges with lower ESG risks. We aim to identify the following themes:



Source: Federated Hermes GPE, as at 2023.

3. We actively seek partners with a similar approach to responsible investing. Before investing in a fund, we thoroughly assess any potential partners for our investments. We assess the manager's approach to identifying and managing ESG risks and opportunities using the Institutional Limited Partners Association (ILPA) ESG due diligence questionnaire, in order to gather information needed to rate managers using our proprietary assessment matrix. Managers that we partner with may sit across different levels of sophistication in their approach to ESG integration. However, at a minimum we expect them to assess material ESG risks and opportunities during their investment process. On an ad-hoc basis, we also identify areas of improvements for managers with a less sophisticated approach to ESG integration and work with them to improve their practices.

ESG integration in the investment process

In most cases, we partner with lead investors to co-invest, but, in some cases, we play the role of lead investor. In this case, we have greater input when identifying areas of improvement in an investments' management of ESG risks, and are likely to take a more forward-looking approach in setting clear objectives as we consider necessary.

As co-investors, we expect the lead investor to address the management of ESG issues for the investment opportunity. We will review the ESG due diligence from the lead investor to conduct our own assessment of the investment opportunity. In some cases, we may identify areas of due diligence we would like to investigate further, at which stage we will use a variety of sources to complement our assessment. This may include the use of internal tools, desktop research, and expert assessments, for example.

All investment opportunities are presented to the Investment Committee for review, where, as part of the financial assessment, ESG analysis is also discussed. The team utilises an internal assessment framework to present ESG risks and opportunities. This framework scores an investment on a scale of one to five. Where investments are rated a score of two or three, the investment team will undertake various actions to monitor and address the ESG risks. We expect the lead investor to proactively work with the investee company to address these ESG risks and monitor the risks on a regular basis. This varies depending on the severity of the risk; for example, the higher the risk, the more frequent the monitoring, and vice versa.

Federated Hermes GPE ESG risk matrix:

1	Significant risk identified	**DO NOT INVEST**
2	Relevant risk identified, remediation plan required	**POTENTIAL TO INVEST – ESG WATCHLIST**
3	Relevant risk identified, to be monitored	**POTENTIAL TO INVEST – ESG WATCHLIST**
4	No core ESG risks identified	**POTENTIAL TO INVEST**
5	ESG best practices identified across business	**POTENTIAL TO INVEST**

Source: Federated Hermes GPE, as at 2023.

Monitoring our investments

Our Portfolio Review Committee (PRC) meets on a quarterly basis and assesses all investment risks, including those relating to ESG. The investment team are required to report on any changes in the risk level of the portfolio relative to the previous quarter, as well as details on the catalysts of the change. Investments that are given an ESG score of two are also discussed to review the risks identified and its current status. In some cases, following the quarterly review, we may decide that the ESG risk is too large and will seek to divest. This would lead to a call with the lead investor to discuss liquidity.

Other ESG risks are reviewed on an annual basis where the mitigation activities undertaken that year are reported back to the PRC.

> **It can also be challenging to collect structured ESG data, which is why we became signatories to the ESG Data Convergence Initiative (EDCI).**

Overcoming challenges and limitations

In private equity, we see a number of challenges that may limit our ability to integrate ESG factors. The main limitation we have identified is the lack of readily-available ESG data. Due to the private nature of these investments, there is no database that we can 'plug and play' in order to access ESG information on a company. Therefore, we place increased importance on the due diligence we undertake as part of the initial analysis. We also find that quantitative data is often backward looking and is not a reliable indicator of future performance. As such, it is important that we overlay any quantitative data with our qualitative analysis, using information we have obtained through due diligence.

ESG integration does not stop at the pre-investment process, especially given the illiquid nature of this asset class. As such, it is important to implement a formal monitoring process to review the identified ESG risks so the investment team have a clear sight of any developing risks.

As co-investors, we have found that during the holding period, it can also be challenging to collect structured ESG data. This is why we became signatories to the ESG Data Convergence Initiative (EDCI), and we work alongside our partners to gain access to these key performance indicators (KPIs) for each investment.

No two businesses in our investment universe are the same. Therefore, it is important that we have a good set of questions that are relevant to the business that will help us understand the ESG risks and opportunities. This is where our ESG assessment framework helps us rate different businesses on their exposures in a bespoke manner. Being a co-investor also means that we are reliant on the lead investor to be proactive on the engagement with the company of the management of any ESG risks. As a result, we place great importance in finding the right partners for our investments.

We believe we have designed a system by which the investment team can identify and underwrite the ESG risks and opportunities of an investment. If an ESG risk plays out during the investment process, it may significantly impact performance as we believe that the focus on materiality and the responsibility lying with the investment lead strikes an appropriate balance for our investment model.

ESG assessment in action

Case study: ESG-driven rejection

Federated Hermes GPE was offered the opportunity to invest in a mid-market services company:

Opportunity looked attractive:

- ✔ Strong growth track record
- ✔ Attractive entry valuation given growth profile and company outlook

- (green) No red flag was identified ahead of first stage IC and support was granted by IC members for conducting further analysis ahead of final approval
- (red) Some Governance and Social risks with significant financial materiality were identified by the deal team while conducting ad hoc ESG due diligence
- (red) No comfort was built around potential mitigants and corrective actions

✘ **Decision of the deal team to <u>reject the deal</u> ahead of final IC based on the high ESG risks identified**

Case study: Cybersecurity incident

A software company in the portfolio was hit by a cybersecurity incident during the holding period.

- (amber) The company was considered as a potential for the ESG watch list. It was then added to the watchlist and monitored. Once the company had taken the appropriate action, it was then removed from the watchlist.

- ✔ Several corrective measures were adopted by the company to address the issue, including:
- ✔ Assessment of materiality of the data breach
- ✔ Communication to all relevant stakeholders affected by the data breach

- (green) Satisfactory level of comfort gained by the deal team following the prompt response of the company, as well as limited materiality of the reported data breach

✔ **Decision to <u>include the company in the ESG watchlist</u>**

Source: Federated Hermes GPE, as at 2023.

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Limited

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Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit **www.hermes-investment.com** or connect with us on social media: