



Can Private Equity Make Money While Doing Good?

LPs can help avoid an impact investing debacle, with the right tools.

Demands on **private equity** (PE) and venture capital funds have gone from “financial returns-only” to include mandates to do good. If these ambitions are achievable, then limited partners (LPs) need to keep a close eye on the promised outcomes and adjust their risk management processes to this new paradigm.

Only then can LPs confidently say that they’re earning a profit and making the world a better place.

In a recent **Fireside Chat**, *Wall Street Journal* reporter Simon Clark described the problem covered in his recent **book**: “When companies and investors sign up for this broader stakeholder capitalism mission, big problems can emerge.”

Co-authored by Will Louch, Clark’s book chronicles how Arif Naqvi, CEO of Abraaj Group – the world’s then-largest emerging markets fund – raised billions in impact investment dollars from governments and institutional investors as he **swindled away** more than US\$660 million. Naqvi was one of the most prominent voices in the impact investing world who **promised** that there’s “no trade-off between doing good and making money”.

In 2017, Abraaj oversaw approximately US\$14 billion in assets under management as Naqvi raised money for a US\$6 billion health care fund from

investors like the Bill & Melinda Gates Foundation, Bank of America, the International Finance Corporation and the CDC Group. A short time later, the Gates Foundation couldn’t account for a huge sum of its investments; Abraaj filed for **liquidation** in the Cayman Islands in 2018. A year later, Naqvi was arrested in London based on a warrant from the United States Justice Department. He now awaits **extradition** to the US where he is facing up to 291 years in prison, if convicted.

The Abraaj story, albeit extreme and rare, requires soul searching from all PE stakeholders. How can investors who trust their capital to PE funds with ESG mandates avoid disappointing outcomes?

ESG is growing in PE, as is the related risk

Impact investing is becoming mainstream in PE. In 2020, PE firms raised more than US\$370 billion in funds with ESG commitments, according to Preqin.

Research from INSEAD’s **Global Private Equity Initiative** on the changing ESG **landscape** in PE found that 89 percent of LPs consider ESG criteria in investment decisions. But interviews also revealed that LPs have trouble differentiating **greenwashing** from actual impact.

And they’re not alone. Regulators are also concerned. Last April, the US Securities and

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Exchange Commission issued a **Risk Alert** which flagged problems like weak internal controls, compliance issues and misleading marketing among funds that promote impact investing and sustainability. I expect further announcements this quarter.

Structural change

To mitigate risks and prevent fraud, LPs must drive structural change in three areas: due diligence, standardising ESG metrics and shared learning.

1. Due diligence must be ongoing

As part of risk management, LPs conduct due diligence prior to investing in a fund. They analyse a fund's finances, operations, strategy and overall ability to deliver their investment thesis. Yet the Abraj case exposes due diligence's **weaknesses**. It's shocking how long Naqvi was able to cultivate trust and hide fraud from the world's most experienced investors.

An anonymous whistle blower **emailed** the health care fund investors: "Don't believe what the partners send you." The message also gave explicit instructions to analyse the "primary source data" to "find the truth". Yet these major investors ignored it. Later, a Gates Foundation executive questioned **suspicious** requests for money and found that US\$200 million was missing.

"Investors usually think they know where their money is in private equity funds because in all of private equity there is an extraordinary amount of secrecy," Clark warned.

To reduce fraud risks, LPs must redesign due diligence to be continuous. They must monitor a fund's financials and KPIs *throughout* the fund life cycle, until they exit. We need fintech solutions that provide LPs access to online, real-time bank statements. Otherwise, quarterly reports and intermittent balance sheets can conceal fraud.

2. Standardise impact measurement metrics and build in-house ESG expertise for accountability

In 2020, the Global Impact Investing Network's annual **survey** reported that although the sophistication in impact measurement and management has been the industry's greatest progress over the past decade, it also remains its greatest challenge.

Currently, investors choose among multiple frameworks with varying metrics, resulting in what Greenbiz referred to as an "**alphabet soup** of reporting standards".

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Divergence in usage among LPs is broad. Our survey of LPs found the top three ESG frameworks are:

- **United Nations Principles for Responsible Investment** (47 percent)
- **Sustainable Development Goals** (32 percent)
- **Sustainability Accounting Standards Board** (16 percent).

Yet LPs only use these metrics to screen investments, not to track impact throughout the fund life cycle. In our survey, 45 percent of LPs said that general partners (GPs) report only high-level metrics; 35 percent said that ESG reports only focus on positive stories; and only 11 percent agreed that data are granular enough to track a fund's ESG performance against targets.

The good news is that industry experts and investors are working to standardise metrics. Work is nascent, but significant progress was made over the past year. In the next 12 months, convergence on a single standard is expected.

For example, during COP26, the **IFRS Foundation** announced the formation of the **International Sustainability Standards Board**. It will create global sustainability disclosure standards to help investors assess "sustainability-related risks and opportunities" to make informed decisions.

Another project, led by **CalPERS and Carlyle** with resources from Institutional Limited Partners Association, is the **ESG Data Convergence Project**. This LP-GP industry-led effort aligns investors on six metrics adapted from existing frameworks to collect "a critical mass of meaningful, performance-based, comparable ESG data". To date, a group of LPs and GPs with over US\$4 trillion in combined assets under management have **committed** to the project, with more expected to join this month.

As metrics evolve, LPs must not only insist that GPs provide annual ESG scorecards on portfolio performance, but also ensure that the metrics are meaningful and do not distract from the urgent task of reducing companies' **environmental impact**.

Finally, LPs must train and hire full-time experts. Each LP needs an ESG champion with a laser-sharp focus on standards, KPIs and industry developments. Metrics will fall short without people who hold funds accountable

3. Prioritise and share learnings

ESG in PE is a work-in-progress, steeped in challenges. As Clark said: "It's great that capitalism is taking on this broader mandate, but it's

complicated. It's hard to make money. It's hard to end poverty. It's very hard to do those two things at the same time."

As LPs test and adapt ESG metrics and processes, the industry must adopt a collaborative, learning mindset to impact investing that holds us accountable to the original goal: To reduce businesses' negative environmental and social impacts.

LPs need a secure way to raise concerns, share information and compare notes as we learn. For example, a number of GPs who first built internal capabilities are now adding external perspectives, like **KKR's Sustainability Expert Advisory Council**, of which I am a member.

Expect that we will make mistakes along the way, but let's talk about them.

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