

THE PRAXIS OF RESPONSIBLE INVESTMENT IN SOUTH AFRICA:
A HOLISTIC CASE STUDY OF EVOLUTION ONE FUND

A thesis submitted in partial fulfilment of the requirements for the degree of
MASTERS OF BUSINESS ADMINISTRATION (MBA)

of

Rhodes Business School

RHODES UNIVERSITY

by

IRINA ZAULOCHNAYA-BROUWER

November 2011

INTEGRATIVE SUMMARY

At the beginning of the 21st century the public interest in environmental and social sustainability, and corporate governance grew exponentially fuelled by recurring ecological and financial crises. The market demand for cleaner production and corporate transparency created opportunities for sustainability entrepreneurs in a variety of industries, including financial markets and investment management.

An increasing number of financial institutions across the world now offer ethical or socially responsible products to meet the environmental, social and governance (ESG) aspirations of their clients. In the US, according to the Social Investment Forum (SIF), responsible investment (RI) assets reached US\$ 2,29 trillion in 2007 (Mitchell, 2008). The European Sustainable Investment Forum (EuroSIF) estimated that total European SRI assets reached EUR 5 trillion in 2009 (Wheelan, 2010). In June 2011 the International Finance Corporation (IFC) reported that at the end of 2010 professional sustainable investment under management in South Africa approximately equalled US\$ 122,6 billion (IFC, 2011:44).

The statistics describing the rapid growth in the ESG-type investments are, however, complicated by the variety of names and definitions used to describe this emerging type of investment and a general market uncertainty about what constitutes the practice of RI.

The purpose of this case study is to better understand responsible investment principles and practice as seen through the eyes of a South African private equity fund, which specializes in clean technology.

Research Procedure.

With a single case study approach, the researcher explored how fund managers understood and defined responsible investment and how ESG factors were incorporated into the investment process.

The study adopted a constructivism paradigm with a relativist's ontological view of reality. It followed an inductive approach with no theoretical proposition. Various sources of evidence were used to collect research data, including internal company documents such as the Private Placement Memorandum, guidelines on categorization and assessment, investment prioritization guidelines, Social and Environmental Management System (SEMS) and a personal interview with one of the founding partners of the researched company.

The object of the study is Evolution One Fund, the first dedicated clean technology fund in South Africa.

Relevance of the literature to the case study.

The literature review served to create a context for the research and form a theoretical foundation for the case study framework. The descriptive framework further guided the development of the case study under its five themes.

Case study summary

Theme 1: What is Evolution One?

Evolution One Fund (Evolution One) is a private equity fund with a 10-year term and a secured committed capital of US\$ 100 million. The fund advisor is Inspired Evolution Investment Management (Pty) Ltd (Inspired Evolution), which is

responsible for sourcing, evaluating, structuring, closing and monitoring deals on behalf of The Fund.

Theme 2: Why clean technology investing?

The philosophy of Evolution One is that the development and use of clean technology (cleantech) products can lead to superior financial returns, reduced environmental impacts and reinforcing benefits to the society.

Theme 3: What is responsible investing?

For Evolution One, responsible investment rests in creating net positive financial, environmental and social outcomes through the investment of capital.

Theme 4: ESG issues and their materiality

Inspired Evolution performs a rigorous analysis of investments using a detailed SEMS that helps asset managers to evaluate and mitigate negative or enhance positive social and environmental outcomes of an investment. The criteria for SEMS are focused on environmental and social issues. Governance is analysed from the point of view of the sustainability risks it may pose.

Theme 5: Responsible investment strategies

Evolution One's investment strategy centres on long-term equity and equity related investing based on active management and post-investment value addition. Theme investing, namely clean technology investing, is its core strategy. The investment methodology is a dual methodology that includes negative and positive screening. Management engagement strategies are additionally used along with the investment process.

ACKNOWLEDGEMENTS

This research paper marks the completion of my MBA – an important milestone on the path of my life. Reaching this point would have been impossible without the Genius, who gave me this challenge and kindly allowed me to complete it. I therefore would like to thank the Genius for giving me trust, inspiration and insights and for working with me duly every day during this process.

I would like to thank the following people for their support and important contribution in the completion of this research:

- My husband David for his support, encouragement and patience, and to whom I dedicate this piece of work;
- My greater family for their support and understanding;
- My supervisor, Prof. Owen Skae for allowing me this learning curve and the freedom to explore this new topic; for his most valuable guidance and ideas, and for coaching me through the process;
- Chris Clarke of Evolution One Fund for allowing me to conduct this case study; for the trust he showed in me, his valuable time, sincerity and insights;
- Inspired Evolution Investment Management for being extremely responsive and helpful;
- Rhodes Business School: Prof. Noel Pearse, Ros Parker, Nicole Craig, and others for their support;
- My friends and colleagues in the 2009 MBA Class

TABLE OF CONTENTS

INTEGRATIVE SUMMARY	ii
Research Procedure.....	iii
Relevance of the literature to the case study.....	iii
Case study summary	iii
LIST OF FIGURES AND TABLES.....	viii
GLOSSARY OF TERMS	ix
SECTION ONE: CASE STUDY	1
1.1. Introduction	1
1.2. What is Evolution One Fund?.....	3
1.2.1. Inspired Evolution	5
1.3. Why clean technology investing?	7
1.3.1. Competitive advantage	9
1.4. What is responsible investing?.....	10
1.4.1. International and local principles and policies	12
1.5. ESG issues and their materiality	13
1.5.1. Social and Environmental assessment	13
1.5.2. Focus on Governance	16
1.6. Responsible investment strategies.....	17
1.6.1. Negative screening.....	18
1.6.2. Positive screening.....	19
1.6.3. Engagement.....	19
1.7. Opposition to theme investing.....	20
1.8. The future of Responsible Investment in South Africa.....	20
1.9. Opportunity in the making.....	22
References	24
Appendix A.	27
Appendix B.	29
Appendix C.....	30
SECTION TWO: LITERATURE REVIEW	32
2.1. Introduction	32
2.2. The history of Socially Responsible Investment	33
2.2.1. The issue of South Africa	33
2.2.2. Environmental and social concerns	34
2.2.3. Clean technology investment.....	35
2.2.4. The tipping point of responsible investment.....	35
2.3. The variety of funds	36
2.4. Socially responsible private equity.....	37

2.5.	The diversity of definitions.....	38
2.5.1.	Conceptual shift	40
2.6.	Regulatory framework.....	41
2.6.1.	Principles of responsible investing	41
2.6.2.	Equator principles.....	41
2.7.	Environmental, Social and Governance Issues	42
2.8.	Investment strategies.....	44
2.8.1.	Screening.....	44
2.8.2.	Engagement.....	46
2.8.3.	Integration.....	47
2.9.	Responsible investment in South Africa.....	48
2.9.1.	Enablers of growth.....	48
2.10.	Conclusion.....	49
	References	51
	 SECTION THREE: RESEARCH METHODOLOGY.....	 56
3.1.	Introduction	56
3.2.	Purpose of research	57
3.3.	Research objectives.....	57
3.4.	The object of the study.....	58
3.5.	Research paradigm.....	58
3.6.	The case study approach.....	59
3.7.	Data collection.....	60
3.7.1.	Interview.....	60
3.8.	Data analysis	63
3.9.	Quality of the study	64
3.10.	Research ethics	65
3.11.	Research limitations	66
3.12.	Conclusion.....	67
	References	68

LIST OF FIGURES AND TABLES

Figure 1.1.	The structure of Evolution One Fund	4
Figure 1.3.	Project categorization.....	14
Table 1.1.	SEDD criteria.....	15
Table 2.1.	Morningstar ESG focus areas and activities	43

GLOSSARY OF TERMS

AUM	- assets under management
BVI	- British Virgin Islands
CERES	- The Coalition for Environmentally Responsible Economies
CITES	- Convention on International Trade in Endangered Species or Wild Fauna and Flora
EDFI	- European Development Finance Institution
EIRIS	- Ethical Investment Research Services
ESG	- environmental, social, governance
EP	- Equator Principles
GP	- General Partner (in a Limited Partnership)
IEIM	- Inspired Evolution Investment Management
IFC	- International Finance Corporation
JSE	- Johannesburg Stock Exchange
LP	- Limited Partnership
ORSE	- Observatoire sur la Responsabilité Sociétale des Entreprises
PCB	- polychlorinated biphenyls
PE	- private equity
PPM	- Private Placement Memorandum
PRI	- Principles for Responsible Investment
RI	- responsible investment
SADC	- Southern African Development Community
SEDD	- social and environmental due diligence
SEMS	- Social and Environmental Management System

SIF	- Social Investment Forum
SRI	- socially responsible investment

SECTION ONE: CASE STUDY

Evolution One Fund: A new generation of profitability, where people and environment matter.

1.1. Introduction

When in the early 2000 a social entrepreneur Christopher Clarke, an experienced financier Michael Brooks, Consensus Business Croup and Pan-African Capital Holdings decided to join forces and enter the clean technology investment market in Southern Africa, they were about to open the door for new and exciting opportunities not only for the emerging class of responsible investors, but also for many environmental and social entrepreneurs in Southern Africa, who were seeking finance.

In 2007, the first South African private equity fund – *Evolution One Fund* – dedicated to clean technology investments, was officially launched. The promoters of Evolution One believed that through shaping capital deployment to the new generation of clean technology asset class, competitive returns could be achieved at the nexus of social equity, ecological integrity and responsible economic growth (Inspired Evolution Investment Management, 2010b). Led by this philosophy, Evolution One has since provided capital to clean technology companies and projects based in Sub-Saharan Africa that required growth capital or early stage/ start-up capital.

The global clean technology movement is believed to have started in the 1980s but at the beginning of the 21st century it experienced a dramatic expansion, particularly in the West, fuelled by the growing concerns of the global climate change, recurring

ecological disasters and rising energy prices. Consumers started to demand more information about how the products that they consumed affect the environment and their communities.

Prior to the latest economic crises, global cleantech investment reached a record US\$ 40,3 billion in the last quarter of 2007. The figures fell significantly in the first quarter of 2009 to US\$ 13,3 billion but showed a strong recovery in the third quarter of 2009 to US\$ 25,9 billion, indicating an upward trend (Harrison, 2009).

Some financial institutions saw potential in the growing cleantech industry to meet the financial and ESG aspirations of their investors. As a result, dedicated climate change or green funds started to emerge. These included the Climate Change Capital in Europe, with institutional investors like Robeco and HSBC, and the Climate Investment Funds, supported by the African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank and the World Bank Group.

In South Africa the expansion of the cleantech sector and the responsible investment industry in general has been much slower compared to Europe and the United States. This has been partly due to favourably high commodity prices in an economy dependent on the extraction industry, and partly due to the lack of responsible investment skills, limited history of realized returns and the general misconception of the industry as lacking financial substance (de Jongh *et al.*, 2007:39).

Nevertheless, the emerging interest from large financial institutions like the World Bank and IFC (International Finance Corporation) to invest in the cleantech in Africa, and most importantly, the belief in the potential of cleantech investment to create positive ecological and social impacts, while yielding competitive returns, encouraged

the promoters of Evolution One to pioneer the cleantech investment market in South Africa.

Today, Evolution One is one of a few clean technology funds globally that have been approved for investment by the World Bank and remains the only dedicated player in the niche market of clean technology and climate investment in Africa.

1.2. What is Evolution One Fund?

“A new generation of profitability where people and environment matter”

(Inspired Evolution Investment Management, 2008)

Evolution One, a private equity clean technology fund with a 10-year term and secured committed capital of US\$ 100 million, was launched on the 5th of June 2007, the World Environment Day, by *Inspired Evolution Investment Management (Inspired Evolution)*. The objective of The Fund was to provide financial support for the deployment and acceleration of clean technologies across the environmental goods and services markets.

Today, Evolution One comprises two independent and autonomous legal structures that co-invest on a pro-rata basis into the investment territory. These structures include a limited partnership (LP) established in the British Virgin Islands (BVI) and an en commandite (limited) partnership established in South Africa (Inspired Evolution Investment Management, 2008).

Figure 1.1. shows the structure of Evolution One Fund.

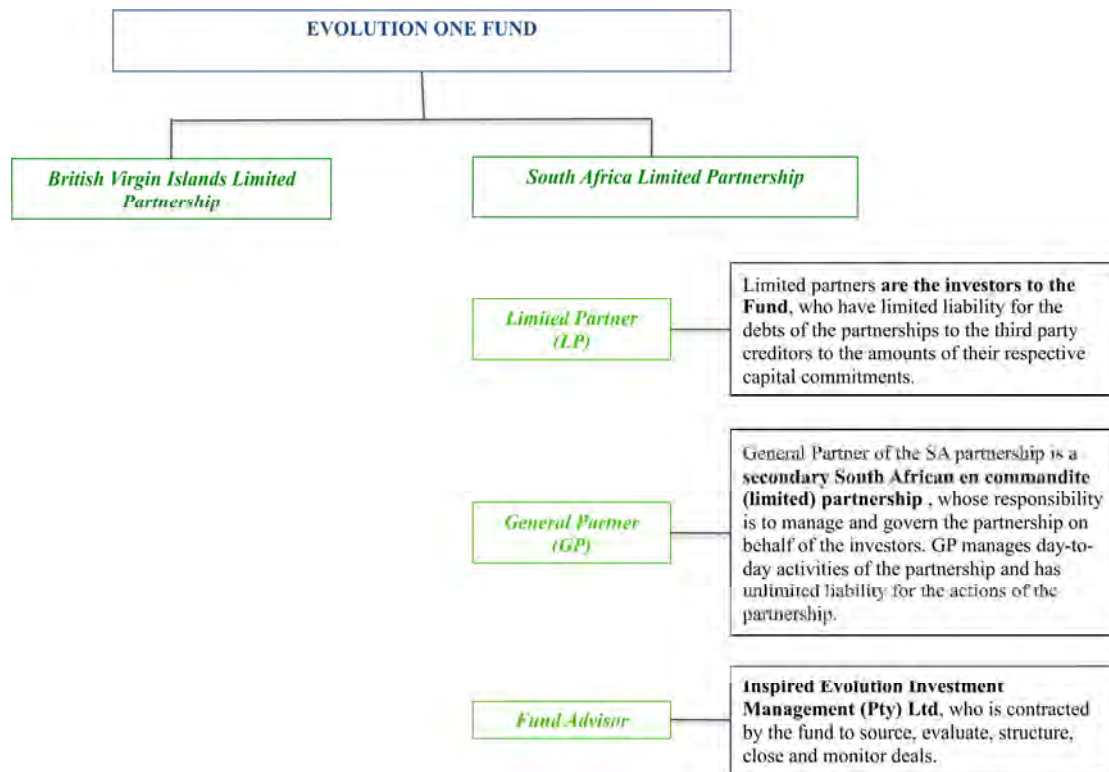


Figure 1.1. The structure of Evolution One Fund

This study focuses on the South African limited partnership, which will be further referred to as *Evolution One* or *The Fund*.

Prior to the launch of Evolution One, individual LPs have committed capital to The Fund for a 10-year period subject to two one-year extensions and were to remain passive partners with regard to the management of The Fund. Investment and risk management discretion has been delegated to the General Partner (GP) and the fund advisor. However, it would be incorrect to say that investors are totally excluded from the investment process. Some of the investors, such as IFC and the Consensus Business Group, are highly qualified in the field of clean technology investing and actively participate in the operation of Evolution One by augmenting deal flows, and guiding optimal deal structuring and access to complementary financial instruments.

The Private Placement Memorandum (PPM) of The Fund explains the details of the private equity partnership to potential investors before they purchase LP interests. The PPM also outlines the investment thesis of The Fund, its investment strategy, competitive advantage, management biographies and expertise.

The Fund is governed by LP agreements, which include appropriate alignment and the frameworks of interests. LP agreements were negotiated and signed by all parties involved at the stage of raising capital by The Fund.

Evolution One's interest is in climate change mitigation through investment in cleaner forms of energy generation and energy efficiency, as well as in selected industry areas within the environmental goods and services sectors. Today, its investment portfolio includes projects in new energy, cleaner production, air quality, waste management, green building, natural products, agribusiness and forestry, and water control and management.

1.2.1. Inspired Evolution

The advisor to Evolution One is *Inspired Evolution Investment Management (Pty) Ltd (Inspired Evolution)*, a boutique investment management and advisory company, and an authorized financial services provider in South Africa.

In November 2011 one of the founding partners of Evolution One Fund and currently an Executive Director and a Principal at Inspired Evolution, Christopher Clarke, gave an interview to the researcher of this study, in which he described Evolution One and how it came to being.

Since 1993 Clarke has been working in the business of environmental issues, offering sustainability strategy and environmental management advice to the South African

government. In the early 2000s he saw a business opportunity present itself - cleantech investing - where he could combine his business, finance, technical and environmental expertise.

Various local and international factors further converged to influence the idea of Evolution One. The most important of these included the Stern Review, published in the UK in 2006 and Al Gore's 2006 documentary film "Inconvenient Truth". Nicolas Stern was one of the first researchers who attempted to quantify climate change and show the economy of inactivity. Later, other studies were published, indicating a positive relationship between investing into cleaner environment and long term financial benefits. When the information "...reached its critical mass, recalled Clarke, *the timing was right to start. Had we started earlier, we may have struggled.*"

A British partner, Consensus Business Group, a multi-faceted principal investor in a broad range of activities, including structured finance and acquisition, was also concurrently exploring an opportunity for an environmental goods and services fund in Southern Africa. Experienced in alternative energy, bio-fuels, re-forestation and carbon dioxide projects internationally, Consensus saw Evolution One as their new business opportunity.

When Clarke and Consensus Business Group met, the fit between them, and the complementary nature of their respective expertise became evident. With potential pipelines of deals and different sets of potential investors, *"it was a good match and the partnership was consummated"*.

Michael Brooks, one of the founding members of Coronation Capital Limited and Theta Securities (Proprietary) Limited (now African Bank Investments Limited), and Pan-African Capital Holdings joined the partnership. Brooks brought in his broad and

deep experience in financial markets and structured risk management and Pan-African added their extensive experience in economic research, risk assessment as well as black economic empowerment credentials.

Today, Inspired Evolution has a dedicated team located across Cape Town, Johannesburg and London with an extensive global track record in clean technology projects.

The company's core values are sustainability, leadership, and innovation. For Inspired Evolution, sustainability is not only everybody's business as citizens of a rapidly globalizing world, but the defining factor of the future of business and investment decisions. The triple bottom line of sustainability, namely people – profit – planet, is embedded into their philosophy and the strategy of both The Fund and the fund advisor.

The philosophy of The Fund is that the development and use of cleantech products can lead to superior business performance at a lower cost, reduced environmental impacts and reinforcing benefits to the society. Led by this philosophy, the fund advisor seeks and invests capital on a long-term basis into projects and businesses that, through the application of smarter business models or the more efficient use of resources, achieve above average returns and reinforce benefits to the environment and the society.

1.3. Why clean technology investing?

*“You need a hook to hang your hat on ... and convince investors what your fund is”
(Christopher Clarke)*

According to Clarke, the idea was always for The Fund to have an environmental and new energy focus. But as the business model was being developed, it became apparent that a much narrower focus was required. *“You can’t be too loosely developed. You need a hook to hang your hat on. You need to be able to quantify the market readiness and convince investors of what your fund is”*. The decision was taken to narrow the focus from a broad area of environmental goods and services to a clean technology fund. The portfolio was however purposely kept broad because of the immature and nascent market. *“We knew”*, said Clarke, *“that it would take a pioneering push to get there and we did not want to lose opportunities by over defining it”*.

One of the challenges for Inspired Evolution has been to get people to understand what clean technology is. There has been a perception in the market that clean technology is purely about renewable energy. However, as Clarke highlighted, renewable energy had only been a small subset of their focus. *“Clean technology is absolutely crosscutting all industry sectors and through the value chains of each industry”*. Besides new technology, it is about using resources more efficiently and having more efficient production methods. It is not always a brand new technology either. Often, it is an existing and matured process that needs re-engineering or simply requires small changes.

According to Inspired Evolution, one of the most important factors in their clean technology deals is the business model of an investment company. Clarke believes that *“in South Africa, in energy efficiency deals for example, the business model is equally important to the black box of technology under evaluation”*. Therefore, clean technology investment is a “combination of the business model, the type of

technology, the financial instruments and the blend of capital used” (Inspired Evolution Investment Management, 2011). Additionally, there is an important element of human behaviour – what makes people switch and what causes the adoption of clean technology. *“This is probably the most interesting part of our work”*, said Clarke.

Part of the business strategy of Evolution One Fund is to play a leading role in convening sustainability dialogues with business and technology leaders across the Southern African Development Community¹ (SADC) region with particular focus on climate change and clean technology. Discussions are currently underway between the fund advisor and a local academic institution to lead and convene such dialogues.

1.3.1. Competitive advantage

“The leading edge or the bleeding edge” (Christopher Clarke).

Being the first mover in an industry can give a business a competitive advantage or, on the contrary, make it difficult to break into a new market. For Inspired Evolution it has been both. At the stage of raising investment capital, they knew that they were onto a very new and innovative idea. Not all investors understood what environmental investing or clean technology was. There was very little realized investment and a limited history of returns. From this perspective, it was very challenging. Yet, Inspired Evolution also had a strong advantage because they could offer niche skills

¹ SADC includes 15 member states of the Southern African geographic region and has a mission of promoting sustainable and equitable economic growth and socio-economic development through efficient productive systems, deeper co-operation and integration, good governance, and durable peace and security, so that the region emerges as a competitive and effective player in international relations and the world economy (SADC, 2010).

to niche sponsors who were looking at value creation from specific technologies. Due to the unique set of skills and the expertise that the company could offer, they immediately became the preferred player in the clean technology investment niche.

Clarke highlighted that many of the big institutions that had been sceptical about sustainability investing in 2005 were now ready to invest in The Fund. Firstly, there is significantly more information available today about investing in sustainability projects and clean technology in particular. Secondly, and most importantly, Governments around the world show their commitment to sustainable economic development, and many countries, including South Africa, have already developed comprehensive legal frameworks aimed to promote responsible finance.

Talking about the competitive advantage of Inspired Evolution, as the advisor to Evolution One, Clarke noted: *“I used to be asked the question whether we were on the leading or the bleeding edge of this, and I always said that time would tell. You have to walk the journey with us to find out.”* The Fund is still very young and does not have realized returns as yet.

1.4. What is responsible investing?

“... creating net positive development outcomes, being the combination of positive ecological and social impacts created through the investment of capital that yields competitive returns”
(Christopher Clarke)

When speaking about the concept of sustainability investing, Clarke stressed that it was a gray area. Despite the diversity of names and definitions, including socially responsible, sustainable and green, the concepts have always had major overlaps.

Inspired Evolution did not subscribe to any one particular definition of sustainable investment offered in the professional literature as none of them could fully represent the core of the business. The “sustainable investment thesis” of the company, as Clarke put it, was in promoting net positive development outcomes, being the combination of net positive ecological and social impacts created through the investment of capital that yields competitive returns.

Evolution One’s investment philosophy is based on the concept of “additionality”, the term used by The Fund, whereby the development and the use of cleantech products, services and processes not only provide competitive performance at lower costs but also reduce environmental and climate change impacts, thereby promoting mutually reinforcing benefits for society (Inspired Evolution Investment Management, 2010a). An example of Abagold Limited (Appendix A), one of the first Evolution One investments, demonstrates the concept of “additionality” and indicates how Inspired Evolution measure net positive development outcomes of their investments.

As such, the process of sustainability investing is challenging. An asset manager can do very rigorous research and evaluate all the implications that the technology and the business model might have in creating the net positive impact. However, one does not always have insight into the unforeseen consequences that might be felt in 15 or 20 years. Therefore, according to Clarke, it is very important to create a “cradle to cradle² business model”, and understand and evaluate each aspect of it to make sure that all social and environmental parameters are accounted for as far as possible.

² “Cradle to cradle” defines a concept of a closed-loop design system in which every output ingredient either biodegrades naturally or is fully recycled (Braungart *et al.*, 2009:1343)

Inspired Evolution adopts this approach to all Evolution One investments, including Abagold Limited. Once the new farm is completed, it will raise Abagold's production capacity to 475 tonnes per annum and the staff complement will increase approximately to 470 (Abagold, 2011).

1.4.1. International and local principles and policies

Evolution One Fund abides by all South African laws and regulations related to the fiduciary duty and to the legal obligations to invest responsibly contained in its limited partnership agreements with its investors. Most of The Fund's limited partners have signed up to the United Nations backed Principles for Responsible Investment (PRI, 2011) and several of them like IFC and European Development Finance Institution (EDFI) were the authors of this and similar progressive policies (Inspired Evolution Investment Management, 2011).

Evolution One is not a signatory of PRI and has no immediate plans to sign up to the Principles. The Fund used a number of investment positions offered by the industry to carve out a unique and differentiated standard suitable to their investment approach (Inspired Evolution Investment Management, 2011).

All Evolution One projects, which require debt from local commercial banks, comply with the Equator Principles³, of which all South African commercial banks are signatories.

³ Equator principles provide a credit risk management framework for determining, assessing and managing environmental and social risk in project finance transactions (The Equator Principles Association, 2011).

1.5. ESG issues and their materiality

“A thorough analysis of ESG factors is very important in evaluating the risk/return profile of a business”

(Inspired Evolution Investment Management, 2010b)

Investment managers at Inspired Evolution actively apply best practice environmental, social and governance (ESG) principles to The Fund’s portfolio of underlying investments. Across all investments, asset managers implement a detailed Social and Environmental Management System (SEMS) to evaluate and mitigate negative or enhance positive social and environmental impacts of an investment. ESG factors are fundamental at every stage of the SEMS processes and play a critical role in the deal closure and the extent of engagement. An outline of the SEMS is given in Appendix B.

After an initial inquiry about the project an investment officer of Inspired Evolution applies the Evolution One exclusions list that outlines industries and activities for which Evolution One has an avoidance policy. The exclusions list has been compiled based on the lists of activities excluded from investment by IFC and EDFI, as well as the investment criteria of individual LPs. The exclusions list of Evolution One will be discussed in more detail later in the study.

1.5.1. Social and Environmental assessment

Companies and projects that have passed the exclusions test are assigned a category A, B or C based on their adverse environmental and social impacts (Inspired Evolution Investment Management, 2009b), as shown in Figure 1.3.

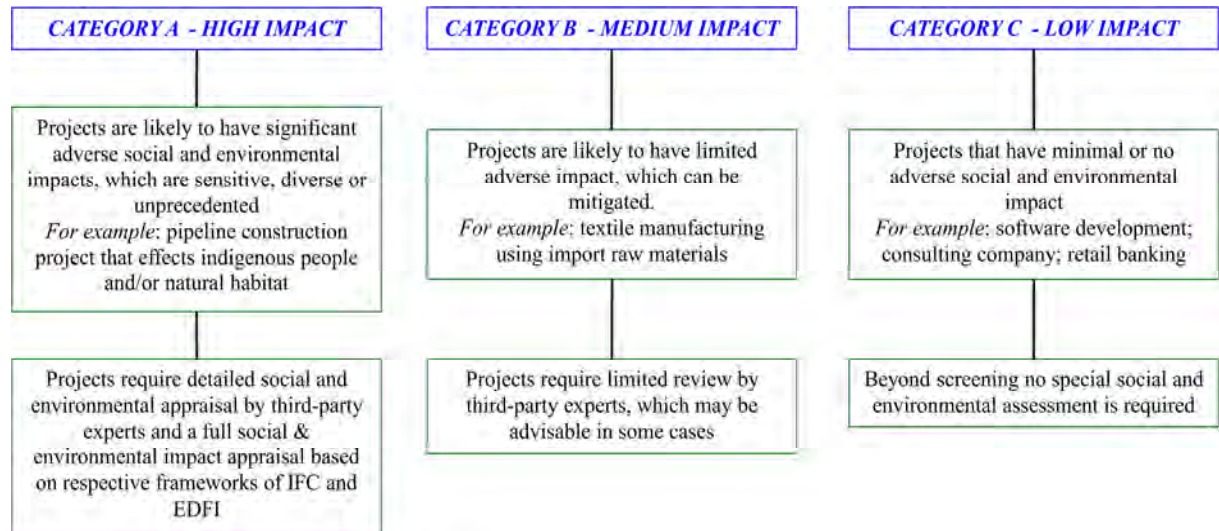


Figure 1.3. Project categorization

At the next stage of the investment process – the Social and Environmental Due Diligence (SEDD) – projects undergo a rigorous assessment of their social and environmental impacts, compliance to National Social, Environmental and Governance Laws and Regulations, as well as compliance to the IFC Performance Standards on Social and Environmental Sustainability (IFC, 2006).

The criteria for SEDD vary depending on the type of investment but a general focus is on the following:

Table 1.1. SEDD criteria

<u>Environmental issues</u>	<u>Social issues</u>
Air pollution	Land acquisition
Water pollution	Rehabilitation and resettlement
Solids and hazardous wastes	Indigenous people
Noise	Impact on local livelihood
Site health and safety	Public opinion and consultation
Chemical hazards	Sensitive receptors (local human settlements; sites of cultural importance)
Emergency management	Labour relations (no child or forced labour; compliance with national labour law)
Resource utilization (water, construction materials and other)	
Sensitive receptors (local ecologically sensitive areas)	

Following a site visit report by an appropriately qualified Inspired Evolution officer, the SEDD can be a desk review or require a full social & environmental impact appraisal by a technically qualified third-party consultant.

Information for a SEDD may be collected from some or all of the following sources:

- Public domain
- Existing social and environmental documents of the project/ company
- Personal discussions with management and project officials
- Site visit
- External consultant's reports

If specific issues are identified during or prior to the SEDD that require mitigation actions for the investment to take place, an investment officer will seek specialist's opinion on the type of actions to be taken. The officer will further produce a

Corrective Action Plan for the management's attention of the potential investment company (Inspired Evolution Investment Management, 2009a).

1.5.2. Focus on Governance

One of Evolution One's requirements to investments is the ability of the asset manager to take an active but non-executive board position. From the Governance perspective, *"we need to make sure that the business does what they say within the agreed ESG parameters"*, emphasised Clarke.

For Inspired Evolution, managing performance and business governance is critically important to manage risk. Fund Advisors bring additional management capacity into the teams of entrepreneurs to help them establish, grow and govern the company. Inspired Evolution maintains a file of professional service providers who can be called upon for assistance when necessary.

Evolution One investment agreements include appropriate ESG clauses and warrants of compliance with national social and environmental laws and regulations, and investment companies are required to produce annual ESG reports. Prior to investment disposal, asset managers identify ESG issues that require attention and insure that the company is ready to withstand close scrutiny by potential new investors.

According to Inspired Evolution, a thorough analysis of ESG factors is very important in evaluating the risk/return profile of a business. Complex models are used on each transaction to get as good an overview as possible of the risk/return profile of an investment and to measure net positive impacts of the project. These may include the number of jobs created, the amount of CO₂ equivalent greenhouse gasses saved; benefits to biodiversity and development of local communities, as the Abagold

example in Appendix A. showed.

1.6. Responsible investment strategies

“Inspired Evolution’s investment strategy centers on long-term equity investing based on active management and post investment value addition”

(Inspired Evolution Investment Management, 2011)

Evolution One’s investment strategy centres on long-term equity and equity-related investing based on active management and post-investment value addition. The Fund provides expansion, early stage and start-up capital to both public and private sector enterprises that offer efficient use of resources and energy, or which apply smarter and more sustainable business models.

Theme investing is the core investment strategy of The Fund, whereby capital is allocated to investments with a clean technology focus. These include infrastructure projects and technology-based ventures across the following areas:

- Cleaner energy generation and energy efficiency;
- Cleaner production (cleaner and more efficient manufacturing processes and techniques);
- Air quality and emissions control;
- Water quality and management;
- Waste management;
- Agribusiness and forestry (certified value-added biomass-based technologies);
- Natural products (essential oils and fibres), organics and natural health;

- Sustainable building and environmental real estate.

The investment methodology of Evolution One Fund is a dual methodology that includes negative and positive screening. Engagement strategies are applied at the stages of investment decision-making and investment management.

1.6.1. Negative screening

The Fund's Exclusion List is a clear and finite list, which includes the IFC and the EDFI excluded activities and projects (Evolution One, 2009a). The exclusion lists of IFC and EDFI can be found in Appendix C.

The job of an asset manager is to negatively screen every potential investment according to the Exclusion List, which was agreed upon by the investors into The Fund.

Sometimes, however, an in-depth analysis is required of the entire value chain of the project, from input activities and materials, through the value-adding process to the end-user, before taking an exclusion decision.

The project may sometimes appear as a clean technology project, but if it is captive to an industry that falls on the exclusion list, it has to be excluded.

One of the potential Evolution One transactions, for example, was a desalination plant in Namibia. First, the project appeared to be within the mandate of The Fund and offered a sustainable supply of water to the production industry in a water restrained country. However, when during the SEDD Inspired Evolution analysed the project's value chain, it was discovered that more than 50% of the output water was going to a uranium plant, an operation involving radioactive substances. As the production of or trade in radioactive materials falls under The Fund's exclusion list, Evolution One had

to walk away from this investment opportunity.

If the involvement of radioactive materials in the project was remedial, namely, it was on the down stream of the value chain, not captive in the project, and no more than 50% of the revenue was reliant on the extraction of radioactive materials, the project could be considered for further assessment.

Clarke highlighted that such technicalities are looked at with a high degree of rigour and “the qualified investors” of Evolution One, are engaged in this process.

1.6.2. Positive screening

Positive screening is applied to investments that have passed negative screens. Here asset managers assess aspects like the business enhancement, the value adding of the project, the uniqueness of the business model and how it can accelerate net positive environmental and social impacts. These factors give additional credibility to the transaction.

1.6.3. Engagement

Engagement strategies are applied at both the stage of decision-making and the stage of investment management.

If Inspired Evolution sees an investment potential in a business but changes need to be made in order for it to be included into the Evolution One portfolio, the asset managers engage with the management of the company about the required changes. Clarke described it as “*a tweak they do to the business model that would bring them on our side of the fence*”.

One of the requirements to the investment is the ability of the asset manager to take up a board position in a non-executive capacity. Engagement on a governance level is

very important in managing business risks and returns.

1.7. Opposition to theme investing

Recently, various researches and practitioners started to point out the drawbacks of theme investing and screening strategies. Viviers *et al.*, (2009:5), for example, believe that such strategies reduce opportunities for an efficient portfolio diversification.

A rigorous company analysis required to screen companies proves to be difficult to achieve, as full information is not always available. This may lead to incomplete or biased analysis results. Additionally, excluding, what are believed to be bad companies, does not necessarily lead to changes in their practices.

The problem that the investment managers of Sustainable Capital Ltd, a Sanlam Group company, see with regard to theme investing is its potential to be “trapped in a bubble” (Barker, 2011). An example can be found in the so-called dot-com bubble of the 1995-2000. An extreme popularity of the IT industry on the market and the investor confidence in their future profits let the values of the companies within the industry grow to superficially high levels, which they couldn’t sustain.

1.8. The future of Responsible Investment in South Africa.

“It’s going from strength to strength. There are no two ways about it”

(Christopher Clarke)

Despite the differences in professional opinions and general misconceptions that still exist with regard to RI, the sustainability market in South Africa, according to both Inspired Evolution and Sustainable Capital, is currently experiencing a dramatic

growth. The capital base for sustainability funds is growing disproportionately compared to those with neutral mandates. Many large financial corporations have started to consolidate entire business units around sustainable industries, such as clean technology and renewable energy. The main drivers of this process are, firstly, the emerging Government regulation and secondly, a growing number of data related to the financial returns that the sustainable investments can offer, combined with the possibilities to mitigate environmental and societal problems that modern economies face.

New funds start to emerge, including those that specialize in climate change and clean technology. *“All of this is good”*, says Christopher Clarke. *“It’s always good to have a healthy competition that brings bigger capital flow into the industry”*.

Inspired Evolution believes that Africa has a unique opportunity not to follow the trajectory of the developed world, but to leapfrog to a low carbon economy. It requires a lot of capital and new types of financial instruments, but many countries in Africa already embrace this idea.

Some of the clean technologies are still more expensive. However, as Clarke noted, the primary reason why renewable energy, for example, remained more expensive than coal, was because the existing accounting methods did not measure the externalities of coal, such as air pollution, water contamination, altered landscapes and safety hazards involved in the mining process. If the total economic accounting was used, Clarke continued, it would have been found that renewables might indeed be cheaper than current technologies.

Clarke added that financial markets were beginning to understand the complexities of sustainability and the shift to a new economic framework was in the making. New

initiatives such as a US\$ 100 billion Global Climate Change Fund were the first steps towards developing new financial instruments and public finance mechanisms.

1.9. Opportunity in the making

Although South Africa was one of the first emerging markets to join the RI industry, the 2011 survey by the IFC shows that the market understanding of and the demand for Responsible Investment is still low (IFC, 2011:54). A general misconception of responsible investment and the lack of responsible investment skills among investment professionals are only some of the barriers to the expansion of the RI industry in South Africa (de Jongh *et.al.*, 2007:14). The scarcity of research, particularly in emerging markets around how investment managers understand and practically apply the phenomenon of responsible investment does not encourage the educational process of either investors or the asset managers.

Although contextually bound to a single case, the current study attempted to bridge this information gap and encourage the market to get better understanding of the industry. The Evolution One case study should not be used as generalization for other sustainable and responsible investment practices and/or clean technology funds in South Africa. However, it could be used as an introduction to a series of case studies that would give a fuller picture of the industry.

Being a fairly new concept and an industry in the making, Responsible Investment still can not boast higher returns compared to neutral mandate investments. However, there is a strong indication, that investors like Evolution One, who have environmental, social and financial health and longevity as the cause of their existence, will achieve sustainably competitive long-term results. Driven by the triple-bottom-line approach to investment and the values of corporate governance,

responsible investors are expected to be mindful of the historic financial risks caused by superficial valuations, irresponsible risk taking and avoidance of human and environmental aspects in the investment process. The intent to improve the global financial industry is there and the time will show the result.

References

- ABAGOLD, 2011. *Abagold*. Abagold Limited. [Online]. Available: <http://www.abagold.co.za> [Accessed 1 October 2011].
- BARKER, G., 2011. Director of Research, Sanlam Sustainable Capital. Personal communication. 14 September.
- BRAUNGART, M., MCDONOUGH, W., BOLLINGER, A., 2007. Cradle-to-cradle design – creating healthy emissions a strategy for eco-effective product and system design. *Journal of Cleaner Production*. 15, 13:1337–1348.
- CLARKE, C., 2011. Director and Principal, Inspired Evolution Investment Management. Personal interview. 7 September.
- DE JONGH, D., NDLOVU, R., COOVADIA, C., SMITH, J. 2007. *The state of responsible investment in South Africa: A survey of approaches and perceptions of the South African investment community to environmental, social and governance issues*. Geneva: UNEP FI.
- GIAMPORCARO, S., PRETORIUS, L., VISSER, M., 2010. *Responsible investment. A vehicle for environmentally sustainable economic growth in South Africa?* Discussion Paper. EfD Initiative [Online] Available: <http://www.rff.org/rff/documents/EfD-DP-10-17.pdf> [Accessed: 20 October 2010].
- HARRISON, S., 2009. Outlook for cleantech investment in 2010. *Financier Worldwide*. [Online] Available: <http://www.financierworldwide.com/article.php?id=5514> [Accessed: 1 March 2010].
- IEIM, 2008. *Evolution One Fund: Private Placement Memorandum*. Cape Town: Inspired Evolution Investment Management.
- IEIM, 2009a. *Evolution One Fund: Social and Environmental Management System*. Cape Town: Inspired Evolution Investment Management.
- IEIM, 2009b. *Guidance note: Categorisation and assessment*. Cape Town: Inspired Evolution Investment Management.

IEIM, 2010a. *Evolution One: Pipeline ESG benefits. Limited Partners Report 2010–2012*. Cape Town: Inspired Evolution Investment Management.

IEIM, 2010b. *Inspired Evolution*. Inspired Evolution Investment Management. [Online]. Available: <http://inspiredevolution.co.za/> [Accessed 28 September 2011].

IEIM, 2011. *Profile: Evolution One fund*. Cape Town: Inspired Evolution Investment Management [Online]. Available: <http://inspiredevolution.co.za/wp-content/uploads/2011/03/IEprofile-08b.pdf> [Accessed 14 June 2010].

IFC, 2006. *Performance Standards on social and environmental sustainability*. International Finance Corporation [Online]. Available: [http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/pol_PerformanceStandards2006_full/\\$FILE/IFC+Performance+Standards.pdf](http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/pol_PerformanceStandards2006_full/$FILE/IFC+Performance+Standards.pdf) [Accessed 28 September 2011].

IFC, 2011. *Sustainable investment in sub-Saharan Africa*. Nairobi: International Finance Corporation.

MITCHELL, P., 2008. *Socially responsible investing assets in U.S. surged 18 percent from 2005 to 2007, outpacing broader managed assets*. Report for Social Investment Forum. [Online]. Available: <http://www.socialinvest.org/news/releases/pressrelease.cfm?id=108> [Accessed: 21 October 2010].

PRI, 2011. *Responsible Investment in private equity. A guide for limited partners*. (2e). Principles for Responsible Investment Initiative [Online]. Available: http://www.unpri.org/files/lp_guide_2.pdf [Accessed 11 July 2011].

SADC, 2010. *SADC Years of Progress 1980–2010*. Southern African Development Community. [Online]. Available: <http://www.sadc.int> [Accessed 11 Oct 2011].

THE EQUATOR PRINCIPLES ASSOCIATION, 2011. *Equator principles*. [Online]. Available: <http://www.equator-principles.com> [Accessed 28 September 2011].

WHEELAN, H., 2010. European RI market doubles to €5 trillion in 2 years, despite crisis: Eurosif survey. *Responsible Investor* [Online]. Available: http://www.responsible-investor.com/home/article/european_eurosif [Accessed: 21 October 2010].

Appendix A.

**NET POSITIVE DEVELOPMENT OUTCOMES OF INVESTMENT:
ABAGOLD LIMITED CASELET**

Abagold Limited is a Hermanus, Western Cape-based company that produces abalone, the world's most desirable seafood, in close harmony with nature at the most southern tip of Africa. The pristine cool water of the Atlantic Ocean provides all the necessary nutrients for the cultivation of the highest quality abalone.

Abalone is one of the endangered species in South Africa. The situation is exacerbated by a wide spread abalone poaching, illegal harvesting and smuggling into the Far East by organized crime syndicates.

The history of Abagold is remarkable. The company has grown from a pilot hatchery in 1991 to a public company and one of the largest land-based marine aquaculture operations in the world, incorporating several abalone farms and a world-class processing farm.

Today, Abagold has three fully developed farms, namely Sea View, Bergsig and Amaza, with a production capacity of 275 tons per annum. In July 2010 the next chapter of the Abagold story unfolded when a 7Ha piece of land was bought to build a fourth farm, called Sulamanzi. This farm will be different from the other three. It will use integrated seaweed production to strip nutrients from the water before returning it to the sea, and thereby also providing feed for the abalone. Sulamanzi, once completed, will provide 200 employment opportunities to residents of Hermanus and almost double the production capacity of Abagold (Abagold, 2011).

The expansion project of Abagold became one of the first investments of Evolution One. A pre-investment base-line study was conducted by Inspired Evolution to evaluate potential financial returns of the investment and to measure a positive social and environmental value contribution of the project.

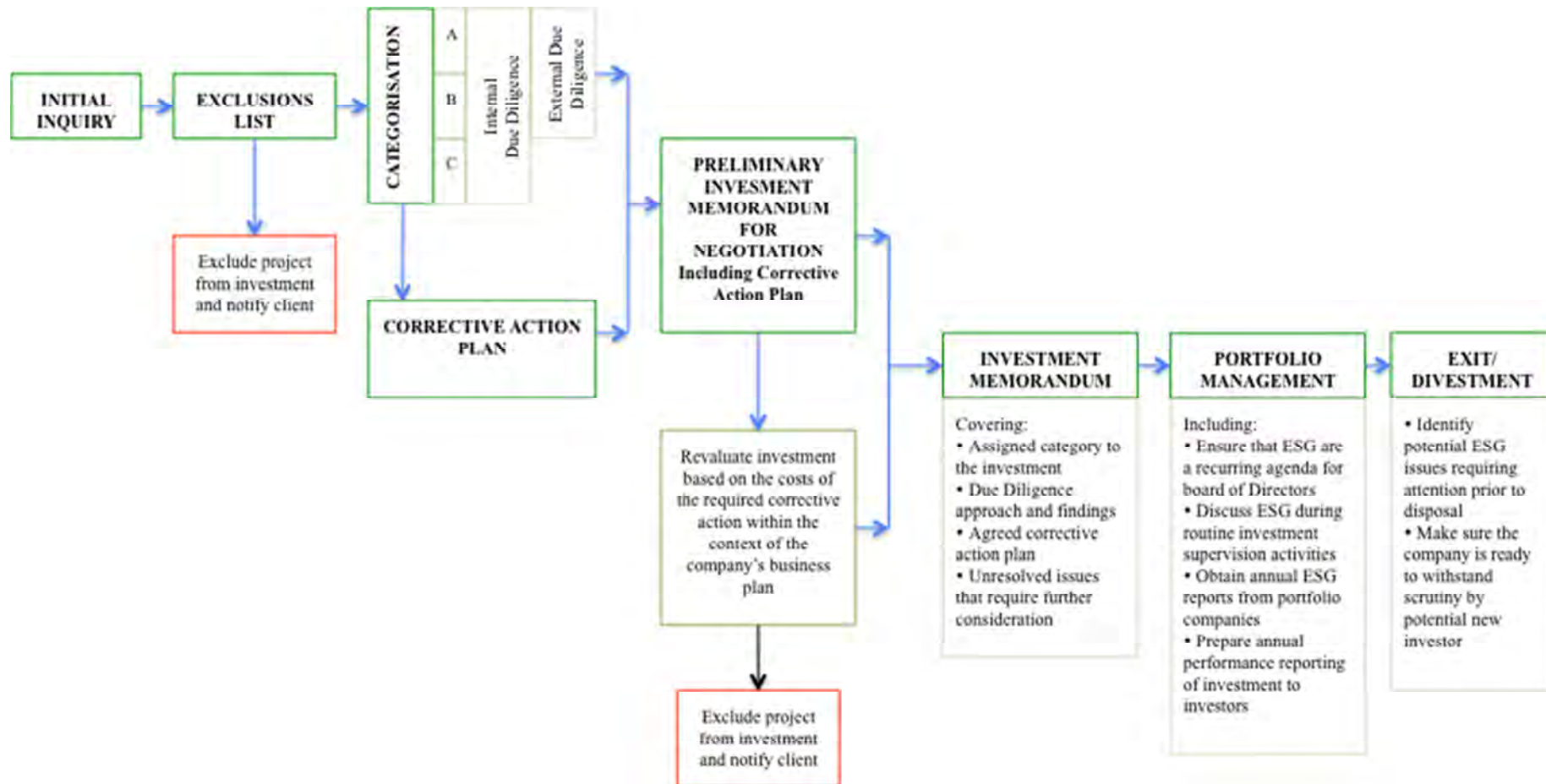
The study established that the Abagold business model offered Evolution One three aspects of the so-called “additionality” over and above financial benefits to investors, namely:

1. A new and a more sustainable method of farming abalone near the Harbour of Hermanus in South Africa. The new method had some of the best disease control techniques (which is generally one of the challenges in abalone farming), the sustainability of the feed, and the reduction of water pollution.
2. Sustainable farming of abalone in a controlled environment and a properly managed and certified food supply to the market. The increased production was expected to substitute a large component of illegally harvested product.
3. Additional employment to the local farmers. Most of the staff came from nearby communities and underwent training and mentoring programmes.

The net positive outcomes of the project were estimated as the number of created jobs, sustainable annual revenue and a sustainable annual Tax Contribution, mitigation of biodiversity loss, and the value of the illegally harvested abalone supplemented with abalone that was farmed in controlled environment.

Appendix B.

Procedures of Social & Environmental Management systems (SEMS)



Appendix C.

IFC and EDFI Lists of excluded activities and projects

List of IFC excluded activities or projects

- Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements.
- Production or trade in weapons and munitions.
- Production or trade in alcoholic beverages (excluding beer and wine).
- Production or trade in tobacco.
- Gambling, casinos and equivalent enterprises.
- Trade in wildlife or wildlife products regulated under CITES (Convention on International Trade in Endangered Species or Wild Fauna and Flora)
- Production or trade in radioactive materials.
- Production or trade in or use of unbonded asbestos fibres.
- Purchase of logging equipment for use in primary tropical moist forest.
- Production or trade in pharmaceuticals subject to international phase outs or bans.
- Production or trade in pesticides/herbicides subject to international phase-outs or bans.
- Drift net fishing in the marine environment using nets in excess of 2.5 km in length.

List of European Development Finance Institution (EDFI) excluded activities and projects

- Production or activities involving forced labour or child labour
- Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements.
- Production or trade in:
 - weapons and munitions
 - tobacco
 - alcoholic beverages
- Gambling, casinos and equivalent enterprises.
- Any business relating to pornography or prostitution.
- Trade in wildlife or wildlife products regulated under CITES
- Production or use of or trade in hazardous materials such as radioactive materials, unbounded asbestos fibres and products containing PCBs (Polychlorinated biphenyls, a group of highly toxic chemicals)
- Cross-border trade in waste and waste products unless compliant to the Basel Convention and the underlying regulations.
- Drift net fishing in the marine environment using nets in excess of 2.5 km in length.
- Production, use of or trade in pharmaceuticals, pesticides/herbicides, chemicals, ozone depleting substances, and other hazardous substances subject to international phase-outs or bans.
- Destruction of Critical Habitat.
- Production and distribution of racist, anti-democratic and/or neo-Nazi media.

SECTION TWO: LITERATURE REVIEW

2.1. Introduction

Although the first ethical fund, The Society of Friends (Quakers), was recorded at the end of the 19th century, the modern concept of responsible investment (RI) is believed to have emerged in the 1970s, fuelled by the issue of apartheid South Africa, global environmental concerns surrounding the ways economies grew, and the latest issues of global warming and business ethics.

During the past decade the public interest in RI has grown significantly and today an increasing number of RI funds offer a variety of investment products that are developed to address environmental, social and governance (ESG) issues through the investment of capital. However, the statistics describing the growth of the RI industry are complicated by the diversity of names used to describe this emerging type of investment, and the variety of definitions and approaches to investment used.

Frameworks like the Equator Principles and the Principles for Responsible Investment attempt to provide consistency and guidelines to investors and clarify boundaries across borders.

South Africa is one of the first developing economies that joined the RI industry. However, despite a growing public interest in the ESG issues, there is still a shortage of demand for responsible investment products and a general misconception about RI investing.

This section presents the results of the literature review on the subject of responsible investment. It served to create a context for the research and form a theoretical foundation for the development of the conceptual framework of the case study.

2.2. The history of Socially Responsible Investment

It is widely accepted that the Society of Friends (Quakers) were the first investors to apply social screens to their investment at the end of the 19th century (Dillenburg *et al.*, 2003; Heese, 2005; ORSE (Observatoire sur la Responsabilité Sociétale des Entreprises), 2007). After the Volstead Act, which was the 18th Amendment to the US Constitution, prohibited the production and sales of alcohol and tobacco as well as gambling in the US, social screens barring these products became common. 1928 saw the establishment of the world's first socially responsible fund, The Pioneer Fund, which banned investment in alcohol and tobacco (Sparkes, 2002:48).

2.2.1. The issue of South Africa

The modern concept of socially responsible investment (SRI) emerged in the 1960s. It was driven by the shareholder activism against the controversial Vietnam War in 1969 and the US consumer activism in 1970 reflecting the public's concern that large businesses like General Motors put profits ahead of consumer interests. In 1971 a number of social activism groups were formed in the US followed by the creation of the Pax Fund and the Third Century Fund that focused on environmental and social factors.

The South Africa divesture movement and the 1977 Global Sullivan Principles further fuelled socially responsible investing worldwide (Sparkes, 2002:52; Heese, 2005:73). In 1983 the states of Massachusetts and California prohibited the investment of state

funds in companies or banks doing business in South Africa. UK companies and banks involved in South Africa were put under a similar pressure and in 1985 Barclays South Africa changed its status from a subsidiary to an associated company with only 40% ownership.

The issue of South Africa played a crucial role in the growth of socially responsible investment. In the US alone the amount of funds using SRI screens grew tenfold and the value of screened assets increased from US\$ 40 billion to over US\$ 400 billion (Sparkes, 2002:54). Public demands against corporate involvement in South Africa led to the establishment of the Ethical Investment Research Services (EIRIS) in 1983. Today EIRIS plays a leading role in independent research into environmental, social, governance and ethical performance of companies in Europe, the UK and South Africa.

2.2.2. Environmental and social concerns

During the 1980s, global environmental concerns had another dramatic effect on the increasing public support of socially responsible investment. A toxic gas leak at Bhopal in India, which killed 3500 people, severe pollution of the Rhine River in Switzerland by a chemical plant that killed all fish in the area, the Chernobyl nuclear plant disaster and the Exxon Valdez oil spill resulted in strong environmental movements worldwide. In 1988 the Social Investment Forum in the US formed a Coalition for Environmentally Responsible Economies (CERES) and launched a set of principles for better environmental performance of companies (Sparkes, 2002:61).

The 1990s saw growth in consumer awareness of the environmental and societal effects of the manufacturing and sales of consumer products. The launch of the Fairtrade foundation in the UK in 1994 was one of the factors leading to the public

awareness of ethical consumerism followed by the growth of social issues within SRI (Sparkes, 2002:63).

2.2.3. Clean technology investment

At the end of the 20th century, a new phenomenon emerged on the market that was specifically geared towards profiting from the transition to a low-carbon economy. The first targeted green (cleantech) fund, the Jupiter Ecology fund, was launched in 1988, but 2007 saw a dramatic increase in the number of cleantech funds internationally, following the release of the Stern Review in the UK in 2006, in which Nicolas Stern quantified climate change and showed the economy of inactivity, and the release of Al Gore's documentary film, "An Inconvenient Truth", aimed at exposing the myths and misconceptions about the progress of the global warming.

In 2008, the Clean Edge Clean Energy Trends report estimated that cleantech would grow to US\$ 254 billion within the decade (Lambrechtsen, 2008:15).

2.2.4. The tipping point of responsible investment

An increasing number of financial institutions now offer ethical, environmental or socially responsible products. This is particularly true for the United States and Europe. According to the Social Investment Forum (SIF), in the US socially responsible investment assets increased more than 18% from 2005 to 2007 and reached US\$ 2,71 trillion of total assets under management (Mitchell, 2005). The 2010 European SRI study by the European Sustainable Investment Forum (EuroSIF) estimated an 87% increase in total SRI assets from EUR 2,7 trillion in 2007 to EUR 5 trillion in 2009 (Wheelan, 2010).

The 2008–2009 financial crisis and growing environmental concerns fuelled by the BP oil spill in the Gulf of Mexico have accelerated the pressure for corporations and

institutional investors to take note of the ESG issues. Penny Shepherd, the chief executive of UK SIF, the sustainable investment and finance association, believes that responsible investment is “... approaching a tipping point. It is now reasonable to assume that responsible ownership and investment will become the norm for major occupational pension funds, insurance companies and other significant investors worldwide by 2020” (Shepherd, 2010). However, she adds, to achieve this, major institutional investors need to increase their “sustainability governance” skills; governments must demand asset owner transparency and civil society needs to build capacity to understand and challenge investment decisions.

2.3. The variety of funds

Rising demand for responsible investing has led to the expansion of sustainable investment products. Research conducted by Deutsche Bank (Schmidt *et al.*, 2010) showed that, at the end of 2009, there had been 313 equity funds, fixed-income funds, microfinance funds and exchange traded funds that adhered to RI criteria licensed for distribution in Germany, Austria and Switzerland alone (Schmidt and Weistroffer, 2010:4). The variety of investment products can be further classified based on which types of individual ESG factors are given a stronger weighting.

Sustainability funds generally consider social and environmental aspects together with economic criteria of investments. Eco-friendly, in some literature green funds (Hanna, 2010:5), are funds that invest in companies with a strong focus on environmental protection. Ethical funds tend to deal with ethical and morally sound financial instruments and tend to screen out “sinful stock”, such as tobacco, alcohol, gambling and arms manufacturing (Gee-Janssens, 2004:10). Ethical-ecological funds use

combined investment strategies and assess investment based on the ethical, economic and environmental standards.

Today, it is not unusual to find sustainability investment funds with an even narrower investment focus. Hanna (2010:6) identifies green funds that target particular areas, for instance funds that invest in clean technology or companies tackling environmental problems in Asia.

Evolution One Fund is an example of a sustainability fund with a narrow focus on clean technology. Although social and governance issues play a big role in the investment analysis process, projects are essentially selected for their ability to contribute to a cleaner environment.

2.4. Socially responsible private equity

In their 2011 report on sustainable investment in Sub-Saharan Africa, IFC suggests that among the various forms of investment, “private equity (PE) is a good fit with sustainability because the PE investor and investee company have the longer time horizon and a common interest in building a firm with lower risks, higher potential returns, and better corporate governance...” (IFC, 2011:47).

Private equity is a specialized form of investment that focuses on unlisted companies and can be used to invest in new businesses or in turning around companies. The funding is long-term and generally spreads to 4 to 12 years. Private equity investors generally achieve high rates of return but take on a higher degree of risk (Correia *et al.*, 2007:13–14).

Private equity funds are normally structured as Limited Partnerships, managed by a General Partner (GP). The GP is responsible for sourcing and analyzing investments,

executing investment decisions, monitoring and advising The Fund's investments, and selling portfolio companies.

Some characteristics of private equity are well suited to promote ESG integration into the business strategy. Having a certain degree of influence over portfolio companies, a GP can exert influence both as a significant equity investor or through nominated board representatives. The PE ownership and governance model, which is based on a close alignment of a general partner, a capital provider and portfolio companies, increases the ability of the investor to influence how ESG issues are addressed within portfolio companies (PRI, 2011:5).

2.5. The diversity of definitions

To proceed with the discussion of responsible investment, it is important to first define the concept. This, however, proves to be difficult, given the diversity of names used by researchers and practitioners to describe this emerging type of investment and consequently the variety of definitions used. The terminology varies between “ethical investing”, “green investing”, “sustainability investing”, “socially responsible investing” and “responsible investing” (Sandberg *et al.*, 2008:521 and Viviers *et al.*, 2009:3).

Russell Sparkes, for example uses terms “ethical” and “socially responsible investment” interchangeably but highlights a distinctive trend to replace “ethical” with “socially responsible investment” as a standard descriptive term (Sparkes, 2002:23).

In his book “Socially responsible investment, a global revolution” Sparkes (2002), referring to Chris Cowton, Professor of Accounting at Huddersfield University

Business School, defines ethical investment as “the exercise of ethical and social criteria in the selection and management of investment portfolios, generally consisting of company shares (stocks)”. He adds that “ethical investors care not only about the size of their prospective financial return and the risk attached to it, but also its source – the nature of the companies goods or services, the location of its business or the manner in which it conducts its affairs” (Sparkes, 2002:22).

Sparkes emphasizes that many definitions of SRI do not sufficiently stress financial concerns and argues that financial returns is “one of the key factors distinguishing SRI from a charitable giving” (Sparkes, 2002:22)

EIRIS use the term SRI and define it as an investment that “may incorporate environmental, social and governance issues as well as other criteria more closely linked to a values-based approach. Investors may choose to exclude or select particular companies or sectors because of their impact on environment or stakeholders” (EIRIS, 2009:6).

Social Investment Forum cited in Observatoire sur la Responsabilité Sociétale des Entreprises (ORSE), a French network designed to study and promote socially responsible investment (ORSE, 2007), defines SRI as an investment that embraces three strategies, namely, screening, shareholder advocacy and community investment (ORSE, 2007:13).

Christopher Clarke of Evolution One Fund (2011) confirmed that the concept of socially responsible investment had been a gray area. Although the industry offers a variety of definitions, none of them can fully represent the core of Evolution One’s business. For Evolution One, SRI is in creating superior financial returns combined

with net positive benefits to the environment and the society through the investment of capital.

This broad understanding of socially responsible investment has led to a critique of the SRI industry by some authors. Allan Struder, quoted in Dillenburg *et al.* (2003:169), states that “... some funds think they are doing the right thing by simply eliminating sin stock”. Selling yourself as ethical, he concludes, involves a higher duty of information. He refers to a large number of SRI funds that do not provide sufficient or sometimes no information about why companies do and don’t make it to their portfolios.

Johnsen (2003) notes that “much of what passes as socially responsible investment in many cases is nothing more than a panacea for those who want to rid themselves of the misplaced guilt of western capitalism” (Johnsen, 2003:219). Johnsen challenges, for example, the “irresponsible industry” label put on the firearms manufacturing and asks the question, whether “a woman is immoral for carrying a handgun while walking alone to her car after work in a dark, crime-ridden section of the city”.

2.5.1. Conceptual shift

De Jongh, Ndlovu, Coovadia and Smith (2007:7) highlight a major conceptual shift from Socially Responsible Investment, which is identified by the screening processes and motivated by social and environmental agenda, toward Responsible Investment, where ESG issues are considered on the basis of their financial materiality. They define RI as “investment that incorporates an active consideration of environmental, social and governance issues into investment decision-making and ownership”. They believe that “... the shift toward a financial materiality is likely to be a more powerful driver for sustainability than conventional SRI practices”.

2.6. Regulatory framework

The uncertainty around the concept of SRI and its practical application has led to the development of regulatory frameworks that would provide a standard and consistency among practitioners. However, most of the existing frameworks are voluntary and apply only to their subscribers.

2.6.1. Principles of responsible investing

In 2006, the United Nations Environmental Programme Financial Initiative launched Principles for Responsible Investment (PRI) in an attempt to provide consistency and a framework for investors that would clarify the definitions and investment boundaries across borders (Herringer *et al.*, 2009:17). They introduced a notion of Responsible Investment and defined it as “the integration of environmental, social and governance criteria into mainstream investment decision-making and ownership practices” (Sandberg, 2009:522).

The Principles reflect the view that environmental, social and corporate governance issues can impact the performance of investment portfolios and therefore must be given appropriate consideration by investors (PRI, 2011).

2.6.2. Equator principles

In 2003 The International Finance Corporation together with ten global financial institutions launched the Equator Principles (EP), aimed to provide a credit risk management framework for determining, assessing and managing environmental and social risk in project finance transactions (The Equator Principles Association, 2011). Since their launch in 2003, the equator principles have become the industry standard for ESG risk management and 72 financial institutions from 27 countries have already officially adopted the principles.

2.7. Environmental, Social and Governance Issues

A growing body of research (Garz, H. *et al.*, 2002; Schroeder, 2003; Bauer *et al.*, 2004; Bello, 2005; Viviers *et al.*, 2009; Schmidt *et al.*, 2010) suggests that integrating ESG factors into investment analysis and decision-making may offer investors long-term financial advantages.

Referring to a number of academic and broker pieces of research, UNEP FI and Mercer (2007) acknowledge the materiality of ESG issues and their influence on the business strategy. For example, studies by Abramson and Chung (2000), Gompers *et al.*, (2003), Orlitzky *et al.*, (2003) show a positive relationship between ESG consideration and financial performance of investments; Schroeder (2004), Brammer *et al.*, (2006), and Barnett and Solomon (2006) indicate a neutral to positive relationship; conversely, Chong *et al.*, (2006) show that ESG affects investment performance negatively.

Financially relevant ESG factors vary depending on the profile of the business and the industry it operates in. They can arise from the government regulation, customer demand, social and environmental groups, employees and financial markets. For example: media scandals relating to the child labour in some of the well-known apparel manufacturers illustrate how societal issues can affect the company's reputation and revenues. Changing weather conditions in which companies will have to operate, pending regulation regarding CO₂ emissions, natural resources and energy security are some of the environmental issues that already face the extraction and energy industries and affect financial markets. The importance of governance has recently been demonstrated by the financial crisis and the collapse of major financial institutions.

The range of material ESG factors is very diverse and hence it is quite difficult to compile a comprehensive list. Morningstar Associates and PAX World Management give suggestive areas of focus (Morningstar, 2011).

Table 2.1. Morningstar ESG focus areas and activities

<i>Focus area</i>	<i>Activity</i>		
<i>Environment</i>	<ul style="list-style-type: none"> • Resource management and pollution prevention • Reduced emissions and climate impact • Environmental reporting and disclosure 		
<i>Social</i>	<u><i>Workplace</i></u> <ul style="list-style-type: none"> • Diversity • Health and safety • Labour-management relations • Human rights 	<u><i>Product integrity</i></u> <ul style="list-style-type: none"> • Safety • Product quality • Emerging technology issues 	<u><i>Community impact</i></u> <ul style="list-style-type: none"> • Community relations • Responsible lending • Corporate philanthropy
<i>Corporate governance</i>	<ul style="list-style-type: none"> • Executive compensation • Board accountability • Reporting and disclosure 		

It is, however, still unclear from the literature how investment managers measure the financial impacts of ESG.

2.8. Investment strategies

SRI and RI industry offers a diversity of responsible investment approaches and strategies, ranging from historic negative and positive screening of investment to more advanced strategies of engagement and integration. Generally, asset managers choose strategies that suit their investment focus, investor requirements and available skills. Of the above listed strategies, Inspired Evolution, for example, uses screening and engagement strategies in their investment process and does not yet actively apply the integration strategy.

Herringer *et al.* (2009:13), referring to EuroSIF (2008), classify SRI strategies as either Core or Broad strategies. Core strategies include ethical exclusions, positive screening, best-in-class and theme investing. Broad SRI strategies comprise simple screening, norms-based screening, engagement and integration.

2.8.1. Screening

Screening strategies were originally used by ethical investors, when religious groups applied social screens to their investments. Screening is still widely popular among sustainability and responsible investors. Schueth (2003:190) defines screening as “the practice of including or excluding companies from portfolios based on social and/or environmental criteria”. Similarly, Kreander (2001:21) identifies screening as “...avoiding certain harmful sectors and prioritizing certain beneficial industries/products”.

2.8.1.1. Negative screening

One of the best historic examples of negative screening is the avoidance of South African investment during the Apartheid regime by the US and European investors. Today, negative screening still remains one of the most popular strategies among

responsible investors. EuroSIF (2010) refers to negative screening as “barring investment in certain companies, economic sectors or even countries for corporate governance, social, environmental and ethics related reasons”. EuroSIF also identifies *norm-based screening* as a type of negative screening, where exclusions are based on the company’s compliance with international norms and standards (Herringer *et al.*, 2009:14).

Negative screens can be used for a variety of reasons, among which are:

- To eliminate specific risks from the portfolio (share price of an oil company drop after causing an environmental disaster);
- To make an ethical statement (avoidance of companies involved in the production of alcohol or pornography, or having a poor human rights record);
- To communicate in an effective way with investors and general public on ethics.

Various researchers pointed out the drawbacks of negative screening. Viviers *et al.*, (2009:5) sum them up as follows. The main disadvantage of negative exclusion is that it reduces efficient portfolio diversification. Secondly, excluding bad companies does not necessarily lead to changes in their practices. And finally, negative exclusions are subjective and depend on the personal perceptions of individual investors.

2.8.1.2. Positive screening

Contrary to negative screening, positive screening is “the selection, within a given investment universe, of the stock of companies that perform best against a defined set of sustainability or ESG criteria” (EuroSIF, 2010:29). Similarly, Viviers *et al.* explain

positive screening as inclusion into portfolios of companies that are perceived as good corporate citizens.

The most popular form of positive screening is *best-in-class*, where best performers are identified in each sector and included into the portfolio (EuroSIF, 2010:29).

Another form of positive screening is *cause-based investing* or *theme investing*.

Thematic funds, according to Herringer *et al.* (2009:14) may focus on specific industries, such as clean technology, water, energy, or certain issues like low carbon economy. It is believed to be a direct investment in the “real economy” (Viviers *et al.*, 2009: 7).

In South Africa positive screening strategies appear to be among the most popular (Giamporcaro *et al.*, 2010:13). JSE SRI index uses a set of criteria for inclusion of companies into the index.

Weaknesses of positive screening, as identified by Viviers *et al.*, (2009:6), include the difficulty to administer investment analyses, as a thorough evaluation of corporate policies and practices is required. In many cases the information is unavailable or difficult to obtain. Positive screening sometimes also requires investors to compare performances across diverse areas, where the measures of strong or poor performance can be essentially different.

2.8.2. Engagement

One of the arguments against screening approaches to investment is that they do not necessarily change negative behaviours of organizations. Engagement strategies are believed to overcome this weakness and encourage companies to improve their ethical and financial performance.

Active engagement is also called shareholder activism and refers to a long term dialogue in which investors seek to influence company policy in relation to environmental, social and governance issues through their rights as debt or shareholders (Herringer *et al.*, 2009: 14; Schmidt and Weistroffer, 2010:8).

EuroSIF (2010: 32) identifies three levels of engagement: general dialogue, active stance and reactive dialogue.

The major limitations of this strategy, as noted by EuroSIF (2010) and Viviers *et al.*, (2009), are that, for active engagement to be effective, the shareholder needs to hold a significant stake in the company and be represented by a strong dialogue team.

2.8.3. Integration

Integration is a new, but growing in popularity, practice, which involves a more comprehensive consideration of ESG criteria. It has emerged as a result of a shift towards a greater investor focus on financial materiality as a driver for sustainability and was based on the premise that extra-financial criteria can influence long-term corporate performance.

Herringer *et al.*, (2009: 14) define integration as “an explicit inclusion of ESG risks into traditional financial analysis”. On an integrated basis, fund managers include both sustainability and financial analysts into unified teams and engage with companies on both financial and extra-financial issues. It is expected that, in the future, ESG assessment is likely to become the responsibility of mainstream analysts.

EuroSIF believes that integration is an important step towards attracting a larger audience of mainstream investors and asset owners to sustainability practices.

2.9. Responsible investment in South Africa

South Africa is one of the first emerging markets to join the RI industry. The introduction of the Johannesburg Stock Exchange (JSE) SRI index in 2004 indicated a growing awareness of ESG issues in the local financial sector (Giamporcaro *et al.*, 2010:6). The King Code of Governance provided further guidance on corporate governance in South Africa (IODSA (Institute of Directors in South Africa), 2009).

According to the research by Giamporcaro *et al.* (2010), in 2006 there were 35 SRI funds on the South African market representing R18 billion of assets under management. In 2009 the number of SRI-labelled products grew to 38 with an approximate market value of R23.28 billion.

A survey by UNEP FI, Noah Financial Innovation and UNISA centre for corporate citizenship (de Jongh *et al.*, 2007) found that, although there is a growing interest in the ESG issues in the South African investment market, the RI industry is still in its infancy. The lack of demand combined with general misconception of responsible investment both on the demand and the supply side were identified as some of the barriers to the expansion of the RI industry.

2.9.1. Enablers of growth

UNEP FI and Mercer's (2007) research showed an almost unanimous agreement among the interviewed fund and asset managers, and providers of investment advisory services, that responsible investment benchmarks, like JSE SRI, PRI and Code for responsible investing in South Africa (CRISA) were important in the RI growth in South Africa.

According to IFC (2011:59), the South African drivers of RI include institutional investor demand, appetite from specialist practitioners, and legislative drivers.

“Investors prefer certainty to ambiguity”, says IFC (2011). Greg Barker (pers. comm., 2011) of Sanlam Sustainable Capital, and Ewan Middlemiss and Dudley Baylis (pers. comm., 2011) of Bridge Capital agree with this view and say that government regulation is probably the most important factor in growing the RI industry in South Africa.

2.10. Conclusion

Section Two presented the results of the literature review on the subject of responsible investment. The review introduced the concepts of responsible investment and ESG and explored the attempts of researchers and RI practitioners to define and describe both concepts. It looked at the history of responsible investment both internationally and in the context of South Africa. Existing RI approaches and strategies as well as responsible investing in the private equity context were explored in the review.

The following patterns emerged from the literature review:

- There is no consensus among the researchers and RI practitioners around defining responsible investment. The issue is complicated by the variety of names used to describe it. Evolution One does not subscribe to any of the existing definitions offered by the industry, but the company referred to many of them to carve their unique investment philosophy.
- There is a broad range of ESG issues, and financially relevant factors vary depending on the profile of the business and the industry it operates in. It is still unclear from the literature how ESG materiality is measured. Evolution

One puts a stronger weighting on the environmental and social issues, and critically analyses business governance as one of the important investment risk factors. It measures net positive impacts of investments, such as the number of jobs created, the amount of green gasses saved, etc.

- There is a variety of RI approaches and strategies, all of which have their advantages and disadvantages. The adoption of certain strategies depends on investor requirements and the set of skills that asset managers have. Evolution One investment managers actively apply screening and engagement strategies to the investment process.
- South Africa has a growing interest in addressing ESG issues and an advanced RI regulatory framework. However, there is still a shortage of knowledge about responsible investing and of available skills to practice it locally.

References

- ABRAMSON, L., CHUNG, D., 2000. Socially responsible investing: viable for value investors? *Journal of Investing*. 9, 3:73-80.
- BARKER, G., 2011. Director of Research, Sanlam Sustainable Capital. Personal communication. 14 September.
- BARNETT, M., SOLOMON, R., 2006. Beyond dichotomy: the curvilinear relationship between social responsibility and financial performance. *Strategic Management Journal*, 27, 11:1101-1122.
- BAUER, R., KOEDIJK, K., OTTEN, R., 2005. International evidence on ethical mutual fund performance and investment style. *Journal of Banking and Finance*. 29: 1751–1767.
- BAYLIS, D., 2011. Director, Bridge Capital. Personal communication. 4 October.
- BELLO, Z.Y., 2005. Socially responsible investing and portfolio diversification. *The Journal of Financial Research*. XXVIII, 1: 41–57.
- BRAMMER, S., BROOKS, C., PAVELIN, S., 2006. Corporate social performance and stock returns: UK evidence from disaggregate measures. *Financial Management*, 35, 3:97-116.
- CORREIA, C., FLYNN, D., ULIANA, E., WORMALD, M., 2007. *Financial management (6e)*. Cape Town: Juta.
- CHONG, J., HER, M., PHILLIPS, G.M., 2006. To sin or not to sin? Now that's the question. *The Journal of Asset Management*. 6, 6:406-417.
- DE JONGH, D., NDLOVU, R., COOVADIA, C., SMITH, J. 2007. *The state of responsible investment in South Africa: A survey of approaches and perceptions of the South African investment community to environmental, social and governance issues*. Geneva: UNEP FI.

DILLENBURG, S., GREENE, T., EREKSON, H., 2003. Approaching socially responsible investment with a comprehensive rating scheme: Total social impact. *Journal of Business Ethics*. 43, 3: 167–177.

EIRIS, 2009. *The value of social, environmental and governance factors for foundation investments*. Unpublished research. London: EIRIS Foundation.

EUROSIF, 2010. *European SRI study. Revised edition*. Paris: Eurosif.

GARZ, H., VOLK, C., GILLES, M., 2002. *More gain than pain. SRI: sustainability pays off*. Study for West LB AG. New York: West LB Panmure Securities Inc.

GEE-JANSSENS, P., 2004. *The socially responsible investment fund markets in Belgium and The Netherlands*. Unpublished Master of Arts thesis. Leuven: Katholieke Universiteit Leuven.

GIAMPORCARO, S., PRETORIUS, L., VISSER, M., 2010. *Responsible investment. A vehicle for environmentally sustainable economic growth in South Africa?* Discussion Paper. EfD Initiative [Online] Available: <http://www.rff.org/rff/documents/EfD-DP-10-17.pdf> [Accessed: 20 October 2010].

GOMPERS, P., ISHII, J., METRICK, A., 2003. Corporate governance and equity prices. *The Quarterly Journal of Economics*. 118, 1:107-155

HANNA, N., 2010. *The green investing handbook. A detailed investment guide to the technologies and companies involved in the sustainable revolution*. UK: Harriman House.

HEESE, K., 2005. The development of socially responsible investment in South Africa: experience and evolution of SRI in global markets. *Development Southern Africa*. 22, 5: 729–739.

HERRINGER, A., FIRER, C., VIVIERS, S., 2009. Key challenges facing the socially responsible (SRI) sector in South Africa. *Investment Analysts Journal*. 70: 11–26.

IFC, 2011. *Sustainable investment in sub-Saharan Africa*. Nairobi: International Finance Corporation

IODSA, 2009. *King code of governance for South Africa 2009*. Parklands: Institute of Directors in South Africa.

IODSA, 2011. *Code for responsible investing in South Africa*. Parklands: Institute of Directors in South Africa.

JOHNSEN, D.B., 2003. Socially responsible investing: a critical appraisal. *Journal of Business Ethics*. 43, 3: 219–222.

KREANDER, N., 2001. *An analysis of European ethical funds*. Unpublished research paper for Certified Accountants Educational Trust. London: University of Glasgow.

LAMBRECHTSEN, F., 2008. Asking the awkward questions. *Responsible Investment Landscape 2008: Asset Managers*. June: 14–15.

MIDDLEMISS, E., 2011. Director, Bridge Capital. Personal communication. 4 October.

MITCHELL, P., 2008. *Socially responsible investing assets in U.S. surged 18 percent from 2005 to 2007, outpacing broader managed assets*. Report for Social Investment Forum. [Online]. Available: <http://www.socialinvest.org/news/releases/pressrelease.cfm?id=108> [Accessed: 21 October 2010].

MORNINGSTAR ASSOCIATES, PAX WORLD MANAGEMENT LLC, 2011. *ESG managers' portfolio*. [Online]. Available: http://www.esgmanagers.com/Sustainable_Investing/What_is_ESG [Accessed: 20 August 2011].

ORLITZKY, M., SCHMIDT, F.L., RYNES, S.L., 2003. Corporate social and financial performance: a meta analysis. *Organisation studies*. 24, 3:403-441

ORSE, 2007. *Guide to sustainability analysis organizations*. Unpublished report. Paris: Observatoire sur la Responsabilité Sociétale des Entreprises.

PRI, 2010. *Annual Report of the PRI initiative 2010*. Geneva: Principles for Responsible Investment Initiative.

- PRI. 2011. *Responsible Investment in private equity. A guide for limited partners*. (2e). [Online]. Available: http://www.unpri.org/files/lp_guide_2.pdf [Accessed 11 July 2011].
- SANDBERG, J., JOURAVLE, C., HEDESSTROEM, T., M., HAMILTON, I., 2009. The heterogeneity of socially responsible investment. *Journal of Business Ethics*. 87: 519–533.
- SCHMIDT, S., WEISTROFFER, C., 2010. *Responsible investments: A new investment trend here to stay*. Unpublished research for Deutsche Bank. Frankfurt am Main: Deutsche Bank Research.
- SCHROEDER, M., 2003. *Socially responsible investments in Germany, Switzerland and the United States: An analysis of investment funds and indices*. Discussion paper No. 03–10. Mannheim: Centre for European Economic Research.
- SCHUETH, S., 2003. Socially responsible investing in the United States. *Journal of Business Ethics*. 43, 3: 189–194.
- SHEPHERD, P., 2010. Responsible investment nears a tipping point. *Financial Times*. [Online]. Available: <http://www.ft.com/intl/cms/s/0/7a3b0a52-8091-11df-be5a-00144feabdc0.html> [Accessed: 22 June 2011].
- SPARKES, R., 2002. *Socially responsible investment: The global revolution*. Chester, West Sussex: John Wiley.
- THE EQUATOR PRINCIPLES ASSOCIATION, 2011. *Equator principles*. [Online]. Available: <http://www.equator-principles.com> [Accessed 28 September 2011].
- UNEP FI, MERCER, 2007. *Demystifying responsible investment performance. A review of key academic and broker research on ESG factors*. [Online]. Available: http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf [Accessed 11 July 2011].
- VIVIERS, S., BOSCH, J.K., SMIT, E.vd M., BUIJS, A., 2009. Responsible investing in South Africa. *Investment Analysts Journal*. 69: 3–16.

WHEELAN, H., 2010. European RI market doubles to €5 trillion in 2 years, despite crisis: Eurosif survey. *Responsible Investor* [Online]. Available: http://www.responsible-investor.com/home/article/european_eurosif [Accessed: 21 October 2010].

SECTION THREE: RESEARCH METHODOLOGY

3.1. Introduction

In August 2011 IFC (2011:15) reported that the global sustainable investment market during 2009–2011 estimated in excess of US \$11 trillion assets under management (AUM) and it continued to grow. 20% of total estimated AUM was allocated to Sub-Saharan Africa.

For asset owners, RI is no longer a simple matter of compliance; it has become a source of competitive advantage and a matter of concern in relation to investment risk and return.

For asset managers, RI is a way to meet increasing investor interest in ESG issues and fulfil their fiduciary duty under the growing regulation of the investment and financial markets industry globally.

Despite significant improvements that have been achieved in recent years in defining the concepts of ESG and RI, both asset owners and asset managers acknowledge that “... there is still a wide variation in the interpretation of what constitutes a good, responsible investment practice”(Oulton, 2008:6).

As the literature review shows, a significant attempt has been made in the industry to provide consistency and a framework for investors that would clarify definitions, investment boundaries and tools of responsible investment. Nevertheless, Responsible Investor metrics survey shows that many asset managers globally are still struggling to fully understand how to measure and manage ESG issues in their investments (Oulton, 2008).

There is still a scarcity of research, particularly in emerging markets around how investment managers understand and practically apply the phenomenon of RI. Among the top barriers to responsible investment in Sub-Saharan Africa, as identified by IFC (2011:62), are knowledge gaps and an inaccurate perception of sustainable investment as only ethical investment and/or investment based on negative screening.

3.2. Purpose of research

The purpose of the research is to better understand responsible investment principles and practice as seen through the eyes of a South African private equity fund, which specializes in clean technology.

3.3. Research objectives

The current research describes the conceptual understanding and the practicing of responsible investing by individual fund managers in South Africa.

The specific objective of the study is to explore the following:

- a) How individual fund managers understand and define responsible investment;
- b) How ESG factors are incorporated in the investment process, notably
 - What ESG criteria are used?
 - What responsible investment strategies are followed?

Secondary to the research objectives, the research seeks the view of the fund managers of the future of responsible investment in South Africa.

3.4. The object of the study

The object of the study is Evolution One Fund (Evolution One), the first dedicated clean technology fund in Africa. The Fund has a 5-year history and total assets under management of US\$ 100 million.

The fund manager is Inspired Evolution Investment Management (Proprietary) Limited (Inspired Evolution), a fund management company set up to lead clean technology investments in Southern Africa. Inspired evolution has dedicated teams in Johannesburg, Cape Town and London.

3.5. Research paradigm

Based on the purpose of the study, which aimed to reconstruct and understand individually held concepts, namely how asset managers of Evolution One understood responsible investment, and the nature of the investigated knowledge, which resides within individual constructions and interpretations, the research adopted a constructivism paradigm with a relativist's ontological view of reality.

The relativist's approach assumes local and specific constructions to be dependent in their form and content on individual persons and/or groups (Guba and Lincoln, 1994:110). An attempt, therefore, was made by the researcher to get to know the people behind Evolution One and reconstruct the reality as close as possible to how it is viewed by them.

An adopted epistemology was that of a subjectivist approach, in which the researcher and the object were assumed to be interactively linked (Guba and Lincoln, 1994:105), and constructions were described as the study proceeded.

3.6. The case study approach

Since the aim of the research was to explore and describe a phenomenon by answering the “How?” question, a case study was selected as an appropriate research method.

Yin (2009:18) proposes that a case study is suitable when a researcher wants to understand a contemporary phenomenon in depth and within a real-life context. The case study, therefore, tends to focus on up-to-date information.

Case studies can be useful in exploring themes and subjects from a focused group of people and contexts, in understanding a subject or uncovering a relationship between a phenomenon and the context in which it occurs (Gray, 2004:124). Yin (2009) and Babbie (2008) note that additionally to the exploratory nature of a case study, it can be successfully used for explanatory and descriptive purposes.

Case studies can be based on single or multiple case designs and on single (holistic) or multiple units of analysis (embedded).

The current research adopted a holistic single case study method. With this approach the study aimed to represent a “revelatory case”, where the researcher had a unique opportunity to observe a phenomenon inaccessible to social science inquiry (Yin, 2009:48). With reference to existing literature the case study sought to explore and describe the phenomenon, and yielded insights into the topic of the research, thus contributing to the body of knowledge.

The current research followed an inductive approach, where no theoretical proposition was made before the start of the fieldwork. Data collection and analysis were premised on the patterns identified in the preliminary review of literature.

3.7. Data collection

Multiple sources of evidence were used to collect study data to add strength and accuracy to the analysis. These included a personal interview with the Executive Director and Principal of Inspired Evolution, and the review of fund documents and archival records. The reviewed documents included Evolution One Fund Corporate Profile, Private Placement Memorandum, Social and Environmental Management System, Categorisation and Assessment Guide, Pipeline ESG Benefits: Limited Partners Report 2010-2012, Investment Prioritisation Guide.

Data triangulation technique was used, as proposed by Yin (2009:116), whereby information was collected from various sources of evidence and used to support the same facts and provide various measures of the same phenomenon. For example, information from a personal interview, Evolution One Private Placement Memorandum and a Guide on Evolution One Social and Environmental Management System were used to obtain a fuller picture of the investment strategies applied by the investment managers to their investing practices.

3.7.1. Interview

Additional to the review of internal documents, which are included in the list of references, a semi-structured personal interview with Mr. Christopher Clarke, a founding partner of Evolution One Fund, and an Executive Director and a Deal Principal at Inspired Evolution Investment Management. Although the interview followed a certain structure derived from the questions of the case study, open-ended questions were used and the interview assumed a conversational manner.

3.7.2. Interview guideline questions

Based on the patterns identified in the literature, the following questions were drawn up that guided the research and helped to organize the case study analysis. The questions were sent to the interviewee prior to the interview for the interviewee to confirm the adequacy of the questions and prepare himself for the interview. The face-to-face interview with Mr. Clarke took place on the 7th of September 2011.

Questions.

- 1) Inspired Evolution Management is a fund management company that was set up to lead clean technology investments in Southern Africa. The company advises Africa's first clean technology private equity fund – Evolution One Fund, which was launched in 2007.
 - a. *Where did the idea of Evolution One come from?*
 - b. *What is Evolution One now in terms of its size, structure, and its position on the market?*
- 2) In 2007, when emerging markets were very popular among investors for their high growth rates, sustainability investing was still an emerging concept and many theorists and practitioners globally argued that sustainable investments tended to underperform the market.
 - a. *Why did you decide to enter sustainability field and why did you choose clean technology in particular?*
- 3) Although since 2007 there has been a distinctive growing trend towards the ESG based investing, particularly in Europe and the US, according to the literature on the subject, there is still no clarity of the concept and the

definition of it. Asset managers still struggle to understand how to measure and integrate ESG issues into the investment process.

- a. The terminology varies between “sustainable”, “ethical”, “green”, “socially responsible” and “responsible” investment, and so do the definitions.
- b. *How do you refer to the type of investment you practice and how do you define it?*

4) In 2006 The United Nations Environmental Programme Financial Initiative launched Principles for Responsible Investment (PRI) in an attempt to provide consistency and a framework for investors that would clarify the definitions and investment boundaries across borders. They introduced a notion of Responsible Investment and defined it. According to the Annual Report of the PRI Initiative 2010, seven hundred and eighty four signatories from forty-five countries and a total of US\$ 22 trillion of assets have been signed up to the Principles of Responsible Investment. Twenty-nine signatories are in South Africa.

- a. *Are you a PRI signatory and if yes, how does it help you to understand and practice responsible investment? If not, do you consider signing up to the Principles and why?*
- b. *What other regulations and policies do you abide by?*

5) As mentioned before and according to IFC and Response Global Media, the publisher of an annual Responsible Investor Landscape report, asset managers still struggle to understand what constitutes a good, responsible investment practice. SRI and RI industry offers a diversity of responsible investment

approaches and strategies, ranging from historic negative screening of investment to more advanced strategies of engagement and integration.

How does Evolution One approach responsible investment, namely:

- a. What ESG factors are important to your analysis and investment management and how material are they?*
- b. What sustainable investment strategies do you use?*
- 6) What do you think is the future of responsible investing in South Africa?*

3.8. Data analysis

To analyse collected data and organize the case study, a descriptive framework was used to fulfil the descriptive purpose of the case study. The framework was developed under five themes, namely:

Theme 1: Who is Evolution One?

Theme 2: Why clean technology investing?

Theme 3: What is responsible investing?

Theme 4: ESG issues and their materiality

Theme 5: Responsible investment strategies

The themes were developed based on the patterns identified in the literature. A pattern matching technique was further applied to the data analysis, whereby collected data was matched to the themes of the study.

Under the first theme the research explored what type of fund Evolution One is, its size and investment portfolio, how The Fund was set up and who the asset managers were.

Under theme two the research answered the question why The Fund chose to specialize in clean technology, given the novelty of the concept and the uncertainty around its performance and market acceptance.

Theme three investigated how asset managers understood sustainability and how they defined sustainable investment. Under this theme the research also looked at what local and international responsible investment principles and policies Evolution One was signed up.

Under theme four the research dealt with the variety of ESG factors that were used to assess and manage investment and the materiality of these factors to the investment process.

Theme five explored the investment methodology of Evolution One and the combination of strategies that asset managers applied in their investment process.

Additionally, the research explored the view of Evolution One fund asset managers on the state and the future of RI in South Africa.

3.9. Quality of the study

To evaluate and enhance the quality of the case study, design tests for external validity, reliability and objectivity were applied, as proposed by Guba and Lincoln (1994), Gray (2004) and Riege (2003).

Gray argues that an important factor of the case study's external validity is the generalizability of its findings beyond the study itself. Although the current case study is not representative of the entire population of sustainable investment or cleantech investment funds, the data collected in the study was matched against the data found in the literature review to identify an existing fit. This test, according to Gray, improves empirical generalizability of the case study.

To strengthen the reliability of the study, the researcher described in the research methodology the procedures followed in it, reviewed data and asked questions, so that the findings of the case study could be replicated by another researcher doing the same case study, thereby confirming the reliability of it.

To avoid subjectivity in the final presentation of evidence, results were made available to the respondents for validation.

3.10. Research ethics

Due to the sensitivity of the research data, prior to commencing the research, the researcher agreed with the respondents on the rules of conduct and the ethics to be adhered to by both parties during the process. A confidentiality agreement was signed between the parties.

A general guidance to the researcher's ethics proposed by Babbie (2008:67) and Remenyi (1998:111) was followed during the research process, including: full openness and honesty of the researcher with the participants; respecting the rights of the participants to privacy; insuring that the participants are aware of the final use of evidence.

3.11. Research limitations

The current research is contextually bound to South Africa, specifically to Evolution One Fund. Therefore, any inferences made in the findings of the research cannot be used as generalization for other sustainable and responsible investment, and/or clean technology funds within and outside the borders of South Africa. The findings should be seen as a contribution to the development of the body of knowledge around responsible investment.

Other sustainability funds represented locally and in other African countries can be added to the scope of the research population in order to get a fuller picture of the research topic.

With the researcher not having close contact with the research company prior to the research, the researcher did not have a deep understanding of the company's culture and the finer particulars of its work. Therefore, the researcher made the best effort in getting to know the people and the personalities behind the investment process, and explored the organisation in detail, so as not to misinterpret the data.

Due to the extensive literature review conducted prior to the fieldwork, the theoretical insights gained by the researcher could have created a researcher bias and limited the scope of the research. To reduce this bias, the researcher used open-ended questions during the interviews; care was taken to avoid data manipulation and data omission; the results of the research were made available to the researched company for validation.

3.12. Conclusion

The purpose of the research was to better understand responsible investment principles and practice as seen through the eyes of a South African private equity fund, which specializes in clean technology. With a single case study approach the research explored how individual fund managers understood and defined responsible investment, and how ESG factors were incorporated into the investment process. Additionally, the research sought the view of the fund managers on the future of responsible investment in South Africa.

The study adopted a constructivism paradigm with a relativist's ontological view of reality. Multiple sources of evidence were used to collect research data, including internal company documentation and archives, and a personal interview with one of the founding partners of the researched company. Collected data was analysed based on a descriptive framework.

References

- BABBIE, E., 2008. *The basics of social research (4e)*. Belmont: Thomson Higher Education.
- GRAY, D., 2004. *Doing research in the real world*. London: Sage Publications.
- GUBA, E.G., LINCOLN, Y.S., 1994. Competing paradigms in qualitative research. In: Denzin, N.K. and Lincoln, Y.S. (eds). *Handbook of qualitative research*. Thousand Oaks: Sage Publications.
- IFC, 2011. *Sustainable investment in sub-Saharan Africa*. Nairobi: International Finance Corporation.
- OULTON, W., 2008. How serious are fund managers about RI? *Responsible Investment Landscape 2008: Asset managers*. June 2008: 6–7.
- REMENYI, D., 1998. Central ethical considerations for masters and doctoral research in business and management studies. *South African Journal of Business Management*. 29, 3: 109–118.
- RIEGE, A.M., 2003. Validity and reliability tests in case study research: a literature review with “hands-on applications for each research phase”. *Qualitative Market Research: An International Journal*. 6, 2: 75–86.
- YIN, R.K., 2009. *Case study research. Design and methods (4e)*. Thousand Oaks: Sage Publications Inc.