SUSTAINABLE INVESTING THROUGH

PRIVATE EQUITY

LEGAL WHITE PAPER SERIES

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EXECUTIVE SUMMARY

Sustainable investing, driven by environmental, social, and governance (ESG) considerations, has become an integral focus for businesses and investors alike. Private equity (PE), a powerful investment vehicle, has evolved to incorporate sustainability principles, allowing businesses to pursue growth while adhering to ESG goals.

This white paper explores the legal aspects of sustainable investing through private equity in Kenya, including its benefits, risks, and the key legal clauses and frameworks required for successful transactions.

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INTRODUCTION TO SUSTAINABLE INVESTING & PRIVATE EQUITY

Sustainable investing involves the integration of ESG factors into investment decision-making processes to create long-term financial and social value propositions. Private equity, traditionally associated with maximizing financial returns through acquisitions and growth, is increasingly incorporating ESG metrics into its strategies. Indeed, PE firms are requiring ESG compliance by Target companies.

In Kenya, sustainable investing through private equity offers businesses an opportunity to attract capital while contributing to sustainable development goals (SDGs). This trend aligns with the broader global shift towards impact investing, where investments seek to generate measurable positive impacts on society and the environment alongside financial returns.

PROS & CONS

PROS

- **Access to Capital:** Private equity firms with an ESG focus are willing to invest in businesses that prioritize sustainability. This opens doors to funding opportunities for Kenyan enterprises that meet ESG criteria. This is on the back of investor pressure to have PE firms comply with ESG standards and by extension, their subsequent investments.
- **Long-Term Value Creation:** Businesses that embrace ESG principles often achieve better long-term performance, resilience, and reputation. Sustainable practices can reduce operational risks, improve efficiency, and enhance relationships with stakeholders.
- **Regulatory Compliance and Risk Management:** With increasing global and local regulations on environmental and social issues, adopting ESG-focused private equity helps businesses stay ahead of regulatory changes, such as the Kenyan environmental laws and the Companies Act (Cap 486).
- **Competitive Advantage:** A strong ESG strategy can differentiate a business in the marketplace, attract top-tier talent, and meet the growing demand from consumers for responsible corporate behavior.

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CONS

- Increased **Compliance and Reporting** Requirements: Adopting ESG principles requires businesses to comply with additional reporting and disclosure obligations, increasing administrative costs.
- **Longer Investment Horizon**: ESG investments tend to prioritize long-term growth, which may delay short-term returns, making them less appealing to investors focused on immediate gains.
- Difficulty in **Measuring Impact**: Quantifying the social and environmental impact of investments can be challenging, particularly in markets where reliable data is scarce or inconsistent.
- Potential for **Greenwashing**: Companies may overstate their commitment to sustainability without making substantive changes to their operations. This presents reputational risks and possible legal liabilities for private equity investors.

KEY LEGAL TERMS

TERM #1: ESG CLAUSES IN SHAREHOLDER AGREEMENTS

Shareholder agreements could include ESG-specific clauses to ensure that portfolio companies adhere to agreed-upon sustainability standards. These clauses may cover:

- **Commitment to ESG Goals:** Outline the company's obligation to implement and maintain ESG policies.
- **Disclosure and Reporting Requirements**: Define the scope and frequency of ESG-related reporting to investors, such as greenhouse gas emissions, labour practices, or community impact.
- **ESG Integration in Business Strategy**: Include a clause that mandates ESG considerations in the company's strategic decision-making, ensuring that sustainability is embedded in operations and growth plans.

GREEN WASHING

The international trend, led by initiatives such as the EU Corporate Sustainability Reporting Directive (2023), is pushing corporations to be transparent about their environmental and social impacts. Kenya's regulatory environment is not yet as advanced in this area, but certain steps are being made, including the Climate Risk Disclosure Framework by the Central Bank of Kenya (CBK).

CURRENT STATE IN KENYA

The Climate Risk Disclosure Framework aims to provide investors with necessary information on the climate impact of potential investments in the banking sector. However, there is room for improvement. The framework could be expanded to include other sectors such as manufacturing, agriculture, and real estate, which have significant environmental footprints.

TERM #2: REPRESENTATIONS & WARRANTIES

Investors should seek specific ESG-related representations and warranties when investing in or acquiring a business. These legal assurances provide investors with protection against undisclosed risks and liabilities. For example:

- Environmental Compliance: Warranties that the company complies with all relevant environmental laws, such as Kenya's National Environmental Management Authority (NEMA) regulations.

- Labor and Human Rights Practices: Representations ensuring compliance with labor laws, including the Employment Act (Cap 226) in Kenya and internationally recognized human rights standards, for example, right to paid maternity leave of absence

TERM #3: EXIT PROVISIONS

- Exit provisions in PE agreements should consider the **long-term sustainability of the business.** For instance, investors may want to include clauses that incentivize portfolio companies to continue implementing ESG practices even after the investor's exit, through mechanisms such as:

- **Sustainability Performance Metrics**: Exit payouts or bonuses linked to the company achieving specific ESG targets before the investor's departure.

- **Drag-Along and Tag-Along Rights**: Ensuring that ESG commitments transfer to any future owners or acquirers of the business.

TERM #4: INDEMNITY CLAUSES

Focused PE transactions can protect investors from financial losses arising from ESG non-compliance.

For example, if a portfolio company is found to be in violation of environmental regulations, the indemnity clause can require the company to compensate the investor for any resulting fines or reputational damage.

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REGULATORY FRAMEWORK FOR SUSTAINABLE INVESTING

Kenya has a growing regulatory framework that supports sustainable investing, particularly in the areas of environmental protection, corporate governance, and social responsibility.

Key legal frameworks include:

- Environmental Management and Co-ordination Act (EMCA): This law regulates environmental conservation and management, ensuring businesses comply with environmental impact assessment (EIA) requirements.
- The Climate Change Act, 2016: This Act mandates that businesses and investors consider climate-related risks and incorporate climate resilience into their operations.
- The Capital Markets Authority (CMA) Guidelines: The CMA provides guidance for sustainable investments in Kenya's capital markets, emphasizing the need for businesses to disclose their ESG practices to potential investors.

BEST PRACTICES :

SUCCESSFUL USE OF PRIVATE EQUITY IN SUSTAINABLE INVESTING

1. **Conducting Thorough Due Diligence**

Due diligence is critical in assessing a company's ESG risks and opportunities. Investors should evaluate a company's environmental impact, labour conditions, and governance practices before committing capital. Legal counsel plays a pivotal role in this process by identifying any red flags that may hinder the investment's success.

2. **Incorporating ESG in Investment Decision-Making**

Private equity firms should integrate ESG considerations into their investment criteria from the outset. This involves not only screening for ESG compliance but also identifying opportunities where sustainable practices can enhance business value.

3. **Monitoring and Reporting**

To ensure ongoing compliance, businesses must implement systems for monitoring ESG performance and regularly report this information to stakeholders. Legal counsel can assist in drafting comprehensive ESG reporting frameworks that align with both local and international best practices.

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CONCLUSION

Sustainable investing through private equity offers significant opportunities for businesses in Kenya to achieve both financial success and social impact. However, it also requires navigating complex legal frameworks, managing ESG risks, and maintaining transparency in reporting. By embedding ESG principles into shareholder agreements, representations and warranties, and exit strategies, businesses and investors can protect themselves from potential risks while fostering long-term growth and positive impact.

CASE IN POINT: ESG IN MINING

Environmental, Social, and Governance (ESG) considerations have grown increasingly important in industries such as mining, shaping the future of Africa's natural resource sectors. As Private Equity investors increasingly prioritize ESG, sectors like mining provide a clear view of how these principles influence long-term investment strategies and operations.

ENVIRONMENTAL STANDARDS:

PE firms emphasize minimizing environmental damage by encouraging portfolio companies to adopt sustainable practices. This includes energy efficiency, reducing carbon footprints, and complying with local environmental regulations. In Kenya, adherence to National Environmental Management Authority (NEMA) standards ensures compliance with environmental impact assessments, which is crucial for both protecting ecosystems and reducing legal risks.

SOCIAL RESPONSIBILITY:

In industries with high community involvement, such as mining, addressing labor rights, community relations, and safety standards is essential. Ensuring companies meet local employment standards and international human rights benchmarks helps mitigate reputational and operational risks, thus securing long-term investments.

GOVERNANCE:

Strong governance frameworks are critical. PE firms demand transparency, robust ESG reporting, and ethical management practices, which not only align with investor expectations but also protect against financial and reputational damage.

By prioritizing ESG in investments, particularly in high-impact sectors such as mining, PE firms contribute to more sustainable, long-term growth for businesses, aligning with global and local development goals.

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