Impact Delta

Rethinking ESG in Private Equity

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A new chapter for ESG

The 2010s were good to private equity (PE): assets grew from $1.5tn in 2010 to $3.8tn in 2020, and a long economic expansion buoyed returns. Faced with rationed access to oversubscribed funds, limited partners (LPs) applied only modest pressure on general partners (GPs) around the environmental, social, and governance (ESG) dimensions of their investments.

On this front, the 2020s promise to be different. ESG demands from public markets investors have increased dramatically. Today, against a backdrop of recession, covid-related scrutiny of company benefits, as well as mobilization around racial injustice and climate change, those demands will intensify.

Furthermore, private capital is in an unprecedented position to drive outcomes: not only can private owners do more with companies than public shareholders, they control more of the economy in general. Over the last 40 years, the number of listed companies per million U.S. inhabitants is down by half. As GPs now explore expansion of their ESG efforts, we examine why and how to do things differently.

KEY TAKEAWAYS

1 Growing evidence for ESG's materiality to returns

Most academic work has reviewed public markets data on this question, mapping share prices and credit spreads on to a company's ESG practices. Surveys of the literature find many more examples of positive relationships between ESG and corporate financial performance than negative ones. In the context of climate change, covid-19, and racial injustice, ESG factors will become even more financially material.

2 Increased LP expectations

LP and societal expectations on ESG are increasing quickly, with respect to carbon emissions, virus-related workforce benefits, and diversity. Many LPs have multi-generational investment horizons; for them, addressing climate change will be a central driver of portfolio performance.

3 The present: ESG efforts focused on risk and compliance

In a world of rising demand for the private equity asset class, private equity asset class, GPs have allocated few resources to their ESG capabilities. Today's ESG professionals often lack influence. ESG teams are small and more focused on risk mitigation than value creation. Overall, private equity's ESG efforts lag those at public companies, which have been working on their sustainability strategies for many years.

4 The future: Leadership, innovation, and cultural change

To close the expectations gap, firms must add or develop senior ESG leaders with strong leadership skills. These people will come from a wider range of backgrounds than most currently serving ESG professionals. Expect more automation, standardization, transparency and innovation, as well as broader pro-ESG shifts in firm culture.

5 The bottom line: A structural change in approach is required to address the challenge

GPs may be tempted to take their old ESG approach, and just do it better. We suggest a different mindset is required: one where ESG becomes a substantial corporate function and value lever, informing strategy and operations of a firm and of its portfolio companies, driving cross-portfolio projects and best practice sharing. This approach can be thought of as "horizontal"— in that it is integrated into and cuts across all of the firm's activities. A reimagined ESG approach could dramatically alter how deals are sourced, and not just confirm to an investment committee that ESG risks have been assessed.

The shift in societal expectations over the last year represent an inflection: Greta Thunberg rose from obscurity to become Time Person of The Year, the United Kingdom became the first major economy to commit to carbon-neutrality by 2050, and the 2019 Nobel Prize for Economics went to researchers who study poverty alleviation. The covid-19 pandemic has disrupted markets and supply chains, and aftershocks lie in store. The police killings of George Floyd and Breonna Taylor have catalyzed changes in the private sector, among them the resignations of the CEOs of CrossFit and The Wing. As we move beyond these crises, ESG considerations will be central to a more resilient new normal.

In the investment industry, public market ESG funds set a new quarterly-inflows record in Q1 2020, despite the bear market catalyzed by the novel virus. Larry Fink made sustainability the central theme, again, of his annual letter to CEOs, and in April 2020, the Harvard endowment announced its intention to be greenhouse-gas-neutral by 2050. It also announced a plan to monitor the emissions of the portfolios of its underlying managers.

Most relevant to private equity funds was the March 2020 open letter jointly published by GPIF in Japan, CalSTRS in the United States, and USS in the United Kingdom. These three asset owners control two trillion dollars, and they wrote:

> “*Asset managers that integrate ESG factors throughout their investment process, vote according to the mandate to which they have pledged, and are transparent with us about their level of corporate engagement, demonstrate to us that they are committed to long-term value creation in line with our interests. We prefer to build and maintain relationships with asset managers who fit this description over those who do not.*”

…as evidence of ESG’s financial materiality grows

The expectations of asset owners with multi-generational time horizons make sense. For them, climate change will be a central driver of investment outcomes. Furthermore, the last five years have also seen growing evidence from the public markets that good ESG practices are associated with good corporate financial performance (CFP). One paper reviewed 2,000 prior studies, and concluded 6 out of 10 of them found a positive relationship between ESG and CFP, and less than 1 in 10 found a negative relationship. Other work has studied ESG and credit risk, by examining changes to credit ratings and credit default swap spreads.

As evidence of the financial materiality of ESG factors has mounted, have private equity firms adjusted their investment processes? As expectations have ratcheted up, have private equity firms kept pace? How have they set about investing in improving their ESG capabilities? To what extent do these firms staff their ESG teams in ways that mirror those at public companies?

The picture is mixed, and opportunities for improvement exist. That said, the space is evolving, and talent is flowing into it. Using a review of recent private equity ESG job specifications, as well as several industry participant interviews, we have formed a picture of the current state of the art. The balance of this paper outlines what that is, explores how it is evolving, and offers some practical suggestions for how a new ESG hire can add value quickly.

The past and the present: Thinly staffed, and focused on risk and compliance

With some simplification, the ESG effort at many private equity firms is characterized as follows:

1 ESG staff lack influence

One deal partner at a leading firm described the head of ESG as "very junior, actually." Job specifications for open head of ESG positions tended to target professionals with under ten years of experience, or with reporting lines that suggested that ESG is not integrated into the core of the firm (e.g., head of ESG reporting to the head of brand/communications, rather than the CEO or CIO). Few heads of ESG are partners; at best, they are one notch below partner, such as managing director or principal, and often they are a rank below that. If the firm is serious about using ESG to create value and mitigate risk, the head of ESG must be sufficiently seasoned to influence the investment process.

2 Relatively few staff

One firm we studied, with $350bn in assets, spread across four asset classes, had two professionals focused on ESG. Another firm, with over $100bn, was described by its retained executive search firm as "interested in people who aren't afraid to be players as well as coaches" because "they won't get an associate to help in this role…the hire should expect to do it all – at least initially." One person cannot monitor hundreds of portfolio companies and deliver effective outcomes, because company engagement is labor intensive. As Tessa Hebb has noted, pension funds themselves only do it very selectively.

3 Risk-focused backgrounds

ESG staffers often come from law or policy backgrounds. These are important perspectives from which to look at ESG, as such professionals are trained to ask what could go wrong. But in a world which is shifting quickly, and where we have less than a decade to halve carbon emissions from 2017 levels, innovation from a mix of mindsets is in order. Professionals with business development, operating company, or product development backgrounds have a role to play, as do deal people who can be held accountable for their investments' ESG outcomes.

4 Compliance versus opportunity

Given the profile of ESG professionals, it is unsurprising that they have focused on risk-mitigation: they are seen as "box-checkers" as a deal moves through the investment process, but who then play a modest role during the ownership period. Firms that see ESG-related value creation as a revenue opportunity remain relatively rare. And even fewer firms appear to be launching strategies that reflect the growing appetite for ESG-themed strategies we observe in the public markets.

5 Inconsistent approach to reporting lines

No consensus has emerged as to where the ESG team should sit in PE firms. Some have historically placed them under branding/communications; in others, they report to government affairs. A communications home risks accusations of greenwashing, and government affairs seems distant from the investment process. This inconsistency exists among public companies too.

6 Innovative leadership needed

In a fast-changing world, the interdependence of "E" and "S" factors (such as environment, health and racial justice) has come under unprecedented scrutiny. ESG work focused at the margins will not contribute to real progress. ESG professionals must bring not just technical knowledge to the job, but adaptability, an inclination to see around corners, and influencing skills to work. These abilities have not been central to ESG job descriptions up to now.

To be sure, exceptions to this picture exist. Some of the largest PE firms in the U.S. were early adopters of ESG integration, and Europe leads here as it does in corporate sustainability. For example, EQT and Permira, both headquartered in Europe, have embraced ESG questions as central to delivering returns, and not merely topics for stakeholder engagement. EQT launched the largest-ever ESG-linked credit facility in June 2020, which ties financing terms to ESG performance. Furthermore, the firm is known for being transparent about its sustainability efforts: starting in 2015, it has published its total and per-employee greenhouse gas emissions.

But in sum, the private equity industry has underinvested in its ESG effort for the world it now inhabits. It has been sufficient to meet historical LP and societal needs, but not the requirements firms now face, let alone the requirements firms will face over the next five to seven years.

The future: Leadership skills to the fore

Faced with a fast-changing present and an uncertain future, the single biggest competency heads of ESG will need is leadership. They will need to be vocal and proactive with their colleagues on deal teams, seek out and develop new products, and proactively engage with clients, regulators and policymakers. To a culture of risk-control – which must remain in place – they should add a mindset of constant innovation. What has been seen as a seat peripheral to the activities of an investment firm must move to the center. And all along the way, the head of ESG will have to be selling, persuading, causing and regulating discomfort, re-imagining outcomes, exploring what is possible, and employing all the tools of what leadership scholars have called adaptive leadership – the leadership that is required when things must change.

Our prediction, then, is the type of professional who will move into head of ESG seats will change. They will be more senior, and be drawn either from the investment staff, or from outside the private equity industry, because the pool of candidates that are both very seasoned and have PE experience is small. Akiba Smith-Francis, an Egon Zehnder consultant who serves clients in the firm's consumer, sustainability, and public and social sector practices summarizes it well:

> *"As ESG concerns have become more pressing and more complex, PE firms will need to elevate and empower ESG leaders, identifying senior business people who have a sophisticated understanding of strategy and can embed ESG initiatives holistically into investment platforms and their portfolio companies. This includes the ability to influence how their businesses approach environmental as well as social issues. For this to be successful, ESG executives must be seen as peers with senior leadership on PE platforms."*

Given the dynamics outlined above, it is not surprising that talented ESG professionals may have historically preferred roles in public operating companies rather than PE firms. In some cases, a candidate with strong leadership and problem-solving skills may be paired with someone with decades of technical ESG experience. Various models could work.

A key success factor is the way in which the new head of ESG is viewed by the investment partners. Is that person seen as a true peer, with real weight in the investment process, and with the ability to enhance returns? If not, what would it take for that to change? Is the leadership team bought into the importance of ESG to investment outcomes in general? PwC in 2016 found only one in five of 111 GP respondents actually values the impact of ESG initiatives (up from one in ten, in 2013) and less than half provide formal ESG training to their investment teams.

The first 100 days: Some practical considerations

What are the conditions for success for the new hire, and the ESG effort as a whole? What must the new hire get right in her or his first 100 days? We see four areas.

1 Leadership buy-in

The arrival of the new hire must be accompanied by a clearly communicated shift in tone from the CEO, which in turn is adopted by all the members of the senior investment staff. A recent example of this is Ares, a $100bn+ firm that in April 2020 made a notable hire in the form of Adam Heltzer to lead a revamped ESG effort. Heltzer reports to Ares CEO Michael Arougheti, and the firm signed UN PRI on May 21, 2020. Another approach to enhance the entire investment firm's accountability for ESG outcomes is to designate one senior partner as the ESG "ambassador" for a particular section of the firm's investing activities. That partner is accountable to the CEO, and underlying deal teams are accountable to that partner. EQT has adopted a similar system.

2 Portfolio review

The new hire must quickly get his or her arms around the entire portfolio, and review all the data associated with each holding. This is likely to be a manual process, with information stored on spreadsheets, slides and shared drives, so some short-term additional staffing may be needed. This must be complemented by deal-by-deal color for each position, gained from meetings with members of each of the deal teams. The information review and filtering process must be guided by a consistent framework, which may include questions such as:

- What are the most material ESG factors for this portfolio company?
- Where are the biggest risks?
- Who is accountable for managing them, and what plans are in place already to manage these risks?
- What benchmark data exists? How relevant is it? Can it be improved?
- What are the biggest opportunities for value creation?
- What existing ESG review processes are in place for each company? Are they rigorous, or cursory? Does each portfolio company have an improvement plan for its most material ESG factors?

3 ESG integration process for new deals

Most firms will already have an ESG review process for new deals, but it may be not be perfect. An early assessment of the quality of that process will prompt immediate learnings, and quick wins. A more thorough-going integration of ESG for new deals will take place after the first 100 days. But it is worth beginning the process early. Questions for deal teams to uncover those quick wins include:

- What is the biggest pain point in the ESG review process now?
- Which of your peer firms does ESG review well?
- At what point in the investment process do you consider ESG questions?
- Do you see improving any given firm's ESG profile a way to create value? Why or why not?
- What is the biggest ESG mistake you have seen this firm (or a prior firm) make in your career so far? What does the firm now do differently?

4 Prioritization

The review exercise for both existing portfolio companies and new deals will reveal which need immediate attention. In most cases, it will be the existing portfolio, of which a handful of portfolio companies will warrant further immediate work. The key here is to identify a small number of ESG factors that can create value over the hold period and at exit.

Longer term considerations

Participants in the investment business are subject to widely varying time horizons and incentives. Hiro Mizuno, the head of Japan's Government Pension Investment Fund (GPIF) – at $1.6tn, the largest pool of retirement savings in the world – has described its investment horizon as "long term, cross generational" and "as long as 100 years." It cannot therefore afford to think of environmental considerations separately from financial returns. The International Panel on Climate Change (IPCC) estimated in its October 2018 report that global economic damage by 2100 would be $54tn in the 1.5-degree scenario, and $69tn in the 2-degree scenario. Recent work by Moody's breaks that down into specific pathways, such as sea-level rise, human health effects, heat effects on labor productivity, agricultural productivity, tourism, and energy demand. Asset managers think more in terms of the classic fund horizon of five to seven years. Here, environmental and financial incentives are less automatically aligned, but the urgency of the IPCC's latest climate change predictions are making that alignment closer than ever.

The industry, and particularly the asset managers, must get the next decade right. For the firms that invest in their ESG capabilities, the challenges which we face – climate, emerging public health threats, and meaningful inclusion and racial justice – also present opportunity. Rethinking the ESG effort begins with talent, but it also encompasses how data is captured and shared. Private capital investors have more freedom to re-tool companies, but the bias towards non-disclosure in the industry need not stretch to ESG questions. Here are five ways in which the industry's approach to ESG could change:

FEWER MANUAL PROCESSES

A lot of ESG tracking is done company-by-company, with bespoke plans for each. Better software is probably part of the solution, with portfolio companies able to upload data into some form of portal (or, even better, certain data feeds automatically into it, such as electricity or water usage from local utilities). Human judgment will not go away, but relatively little automation currently exists. Companies such as Mercatus, Accuvio, EcoVadis, SupplyShift and WeSustain are working on this and the next point below.

MORE TRANSPARENCY AND STANDARDIZATION

Currently, ESG-related benchmarking is only done with publicly available peers. But there are problems with this approach. First, ESG data collated by MSCI or Sustainalytics is based on voluntary disclosure from public companies, which happens in a non-standardized way. And second, private company data (if only it were available) is more likely to be relevant. One part of the solution might be a "give-to-get" model, where portfolio companies can report ESG metrics, and then have access to peer data on an anonymized basis. Direct asset owner access to ESG data and outcomes at portfolio companies will likely be of interest to asset owners, too. The portal idea above could be made directly available to asset owners, in the same way current fund administration data is available to them. This would drive accountability.

CLOSER BENCHMARKING WITH PUBLIC OPERATING COMPANIES

Most industry participants agree large operating companies tend to be ahead of their private equity counterparts with a similar economic footprint. The size and structure of ESG teams in public companies vary according to industry. Consumer-facing companies tend to have larger teams than those in B2B markets. Capital-intensive companies, with relatively large revenues per employee, also have relatively smaller ESG teams. In many cases, a small central team is complemented by ESG professionals embedded in business units, who are accountable to the business unit head. Private equity companies hence have a range of models to study; the extent to which they are doing this now is modest.

A CULTURE OF INNOVATION

Currently, the ESG function doesn't have the authority to try new things out. That could change. Currently, ESG professionals are tasked with studying a firm's deal pipeline and portfolio, with relatively little time spent on re-imagining how the whole industry could catch up. ESG considerations are not always competitively sensitive, so more information-sharing (if needed, anonymized) and problem-solving among all firms, perhaps coordinated by an industry body, could help accelerate change.

AN INNOVATION IN THE CULTURE

Our prediction is the firms that truly re-imagine ESG will undergo a broad, firm-wide evolution in the way they do business. ESG considerations will become second nature to all professionals: deals with problematic ESG profiles will be screened out early, saving deal-team time. Deals that would have been screened out in the past will now qualify for closer scrutiny, as ESG considerations become sources of previously overlooked value. There is evidence for this already. Actis, a firm known for its work in Africa, has a reputation for commanding higher exit prices from strategic buyers, because these buyers can be confident that ESG issues have been well-managed during Actis' period of ownership. For Walter Piacsek, a former Boston Consulting Group and Apax partner, a holistic approach to ESG will have "strategic effects", around which deals to do, what kinds of funds to raise, and which LPs to serve. And it will have "portfolio-level effects", as ESG questions become more prominent in 100-day plans and "longer-term portfolio company strategies", and "best practices are documented and shared rigorously across the portfolio." ESG will go from being a "department" to being something that is "horizontal" and part of every professional's activities. And overall, "As ESG principles are increasingly incorporated into corporate strategy – of both GPs and companies – they will become relevant value levers. Purpose and profit will mix more and more."

In sum, pushing ahead on initiatives like these will help ESG become even more mainstream in the private capital investment business, which is where the clients – the asset owners – wish it to be.

Conclusion

The recent change in attitudes to environmental questions has been swift, and continues to gather force. The current health and social crises will accelerate changes in attitudes towards other, non-environmental dimensions of ESG factors, such as paid sick leave policies, the provision of healthcare and childcare, and other employee benefits that drive workforce engagement. Diversity and inclusion have gained new urgency. The growing financial materiality of these questions has made asset owners increasingly vocal, and GPs are now trying to catch up.

GPs may be tempted to take their old ESG approach, and just do it better. We suggest a different mindset is required: one where ESG becomes a substantial corporate function and value creation tool, informing strategy and operations of the firm and of the portfolio companies. Over time, we expect firm-wide cultural norms will shift to embrace ESG on these new terms. As ESG considerations continue to move to center stage, ESG professionals will find their leadership skills as critical to their success as their subject matter expertise. It is up to their CEOs – themselves presumably skilled leaders – to help them succeed.

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ABOUT IMPACT DELTA

Impact Delta (impactdelta.co) is a specialist consultancy. It advises private markets investors on ESG-related questions and impact investing activities.